Although Turkey’s economy continues to face headwinds which warrants a cautious medium-term outlook, the new government is well positioned to implement its structural reform program.

Substantial Turkish lira depreciation in 2015 helped external adjustment but stoked inflation.

The political uncertainty and tightening global financing conditions caused a shortfall in financing for the current account deficit in 2015, despite robust long-term inflows.

Despite election uncertainty, Turkey’s economy posted strong growth in Q3 of 2015. Seasonally-adjusted (SA) GDP grew at an annualized rate of 5.2 percent q-o-q in Q3, thanks mostly to a large drop in imports and resilient private consumption. Despite depressed consumer confidence and increased election uncertainty after the inconclusive June election, private consumption surprisingly accelerated. Public spending also continued to support growth. However, private investment, which led growth in Q2, dropped sharply in Q3, suggesting that the private sector cut back capital spending when the June election did not resolve uncertainties. Inventory de-stocking continued for the third consecutive quarter and contributed negatively to growth. On the external side, imports continued to fall, due to real exchange rate depreciation, inventory de-stocking, and lower investment demand, making the largest contribution to growth in Q3. Moreover, exports recovered notably, due to firming activity in the European Union and improvement in the MENA market. On the production side, the agriculture, construction and services sectors grew, while value added in industry declined in Q3. With the much stronger outcome in Q3, growth in Turkey is estimated to have accelerated to 4.2 percent in 2015 as a whole.1

The labor market showed signs of recovery in early Q4. Non-agricultural job creation (SA) slowed to 2,000 in Q3 from 129,000 in Q2, due to weaknesses in industry. Although job creation in construction and services increased, employment reductions in industry outweighed this positive impact, leading to a slow slowdown in overall job creation. At the same time, the labor force rose by 57,000 in Q3, compared to 174,000 in Q2, increasing non-agricultural unemployment (SA) by 55,000 and bringing non-agricultural unemployment rate (SA) to 12.5 percent in Q3. However, early Q4 data points to a recovery in job creation in non-agricultural sectors in the three months through November, creating 155,000 new jobs.

**Lira depreciation stoked inflation.** After easing to 6.8 percent in July, 12-month CPI inflation climbed to 8.8 percent by December, due to FX pass-through on consumer goods and high food inflation, ending the year significantly above the Central Bank’s 5 percent target. The substantial depreciation of the lira increased transport, furnishings, and clothing inflation significantly, bringing inflation above the target band. Moreover, food inflation continued to be highly volatile and pose upside risks to inflation. CPI inflation momentum reached 8.5 percent in December; however, easing in hotels and restaurants, recreation, housing and energy, and health inflation momentum prevented an otherwise larger rise in CPI inflation momentum. Similarly, 12-month core inflation rose to 9.5 percent in December, while the core inflation momentum remained above 10.5 percent. Going forward, the 30 percent increase in minimum wages from January 1, 2016 is likely to keep inflation above the target band in 2016.

**External adjustment accelerated, thanks to a favorable base effect in energy and gold.** The monthly energy deficit (SA) is stabilizing at around $2.5 billion, while the gold balance is fluctuating between a small surplus and a small deficit. However, 12-month energy and gold balances improved by $6.1 billion and $3.7 billion, respectively since July, thanks to favorable base effects. Moreover, firming activity in the EU and a recovery in MENA support Turkey’s exports, while depreciation is taming import demand, bringing the non-energy non-gold merchandise balance up by $1.2 billion in this period.2 Against this backdrop, the 12-month current account deficit sharply dropped by $10.7 billion to $34.7 billion between July and November. Going forward, the 12-month energy balance is poised to come down by another $5-6 billion due to the base effect in the coming months.

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1 The recovery in Q3 was mostly due to agriculture and construction, while services continued to decline.

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<table>
<thead>
<tr>
<th>Selected Economic Indicators</th>
<th>2013</th>
<th>2014</th>
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<th>2016</th>
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<tbody>
<tr>
<td>Real GDP Growth Rate (percent)</td>
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<td>2.9</td>
<td>4.2</td>
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<tr>
<td>Consumer Price Inflation (end period, in percent)</td>
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<td>8.2</td>
<td>8.8</td>
<td>7.5</td>
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<tr>
<td>Central Government Budget Balance (in percent of GDP)</td>
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<td>-1.3</td>
<td>-2.7</td>
<td>-2.6</td>
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<tr>
<td>Central Government Debt (in percent of GDP)</td>
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<td>32.5</td>
<td>30.7</td>
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<tr>
<td>Current Account Balance (in billions of US dollars)</td>
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<td>-34.7</td>
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<tr>
<td>Current Account Balance (in percent of GDP)</td>
<td>-7.9</td>
<td>-5.8</td>
<td>-5.0</td>
<td>-4.6</td>
<td>-4.8</td>
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**Source:** World Bank staff projections, TURKSTAT, CBRT, Undersecretariat of Treasury

Capital inflows dried up amid increasingly difficult global financial conditions. The market turmoil during the summer led to a sharp sell-off in developing country assets and a drop in capital inflows to those economies. Similarly, in Turkey, net portfolio outflows continued through November, except October, when a short-lived improvement in risk appetite following the September FOMC meeting led to small net inflows. Long-term inflows slightly weakened after July due to lower FDI inflows. As a result, the net financial account showed $0.4 billion worth of net outflows in the three months through November, bringing year-to-date net inflows to $10.8 billion. Net errors and omissions recorded $11.9 billion worth of unrecorded inflows, while the Central Bank’s reserves declined by $5.2 billion to finance the gap in the first eleven months of 2015.

The simplification of the monetary policy framework is pending despite the US Fed’s rates hike decision. The Fed raised interest rates in December for the first time in nearly a decade, ending the near-zero borrowing costs in the United States. According to the road map, the Central Bank will narrow the width of its interest rate corridor and make it more symmetric around the one-week repo rate. The Central Bank had communicated clearly that it intends to simplify the framework by shifting the funding composition increasingly towards 1-week repo while maintaining the average cost of funding stable, rather than tightening the policy. However, it remains to be seen whether the simplification steps will be enough to maintain price and financial stability at a time when upside risks for already-elevated inflation coincide with weaker capital inflows to developing countries and a gradual rise in global interest rates.

Fiscal balances remain solid, as the firm rise in consumption spending boosted revenues. The central government budget posted a budget deficit of 0.3 percent of GDP in the first eleven months of the year, with the primary surplus reaching 2.3 percent of GDP, compared to 1.3 percent and 1.5 percent in 2014 as a whole, respectively. Total expenses increased by 12.3 percent y-o-y and continue to support growth, whereas revenues increased by 14.2 percent y-o-y in this period, thanks to strong tax revenue performance. In particular, robust consumption spending throughout the year boosted domestic VAT and special consumption tax revenues. In addition, revenues from VAT on imports surged significantly on the back of lira depreciation. In 2016, election promises, once put in place, are likely to add additional burdens on fiscal balances.

A recovery in imports is likely to slow growth to 3.5 percent in 2016 despite sustained domestic demand momentum. We expect private consumption to continue to be the main driver of growth, thanks to the 30 percent rise in the minimum wage. However, the lagged effect of currency depreciation and elevated inflation will be restraining private consumption growth to the rates observed in 2015. Public spending is expected to contribute positively, albeit at a slower rate. Private investment should somewhat recover and contribute moderately to growth in 2016. Firming activity in the EU is helping exports, but net exports should turn negative as imports recover. Low oil prices are helping to stabilize the current account deficit at around 4.6 percent of GDP.

Turkey’s economy continues to face headwinds on several fronts, contributing to a cautious medium-term outlook. Lira depreciation has strained balance sheets and raised the debt service burdens of the corporate sector, which has large foreign exchange exposures. These, along with existing weaknesses in the investment climate, impinge on private investment and growth. In addition, Russian sanctions and disappointing global growth are likely to partially limit export growth in 2016. At the same time, the continuing need for large capital inflows is a concern, amid difficult global financing conditions, especially since the Central Bank’s net reserves are modest.

Medium-term growth prospects depend on the implementation of structural reforms. The new government has announced its Economic Reform Agenda and the updated 2016-2018 Medium Term Program. The new government is well positioned to proceed with the implementation of its structural reform program in order to increase growth. One way to stimulate growth is to boost productivity by reducing resource misallocations within industries. Reforms that could eliminate distortions and allow reallocation of resources from less productive firms to more productive firms would be particularly helpful. Enhancing flexibility of the labor market by allowing more flexible contracts and reducing severance obligations, and enhancing the quality of regulatory institutions, strengthening the rule of law, and creating a better environment for domestic and foreign investors would do much to improve resource allocation in Turkey. Robust and timely implementation of the reform commitments, particularly starting from those under the 64th Government 2016 Action Plan, will be critical.

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1. Raw GDP data has greatly diverged from the working day adjusted GDP data in 2015. The raw data suggests a cumulative growth rate of 3.4 percent, while the working day adjusted data shows 3.9 percent in the first three quarters. On the other hand, the seasonally and working day adjusted data points to a 4.1 percent growth in this period. In our view, adjusted GDP data gives a better indication of actual growth, whereas raw data is subject to fluctuations arising from calendar effects.

2. This refers to nonenergy general merchandise on a balance of payment basis, which excludes non monetary gold trade.

3. In December 2015, parliament passed an interim budget for the first quarter of 2016. A full budget is expected to be passed by March.


5. Please see the complementary Focus Note for a detailed discussion on resource misallocation in the Turkish manufacturing industry and its consequences on productivity growth.