Turkey’s growth slowed from 6.1 percent in 2015 to an estimated 2.1 percent in 2016, as the failed coup attempt depressed consumer and business confidence and tourism revenues fell.

Deteriorating expectations are putting pressure on the Lira, while falling banking sector roll-over rates are likely to constrain domestic credit growth.

Turkey faces headwinds that will prevent strong recovery, with estimated 2017 growth of 2.7 percent driven by net exports and public spending.

Turkey’s economy shrank in Q3 amid temporary political turmoil and falling tourism revenues. Seasonally adjusted GDP plunged by 2.7 percent q-o-q in Q3, recording the largest drop since March 2009, because the failed coup attempt and its aftermath depressed business and consumer confidence and tourism revenues declined. Private consumption took a significant hit, dropping by 2.6 percent q-o-q in Q3, as increased uncertainty induced households to hold off spending especially on durable goods. Similarly, investment fell by 1.7 percent q-o-q. Government spending grew by 6.1 percent q-o-q, making the only meaningful positive contribution to growth. On the external side, imports dropped thanks to subdued domestic demand, while exports fell due to weaker external demand and a 36 percent y-o-y drop in tourist arrivals.

The contractions on the expenditure side were mirrored by declines on the production side. The manufacturing sector contracted for the third consecutive quarter, shrinking by 4.8 percent q-o-q in Q3. Although agriculture, services, and construction also recorded a fall in output in Q3 by 0.9 percent, 1.7 percent and 4.6 percent respectively, the recession in manufacturing is emblematic of the difficulties in the real sector. Notably, a number of manufacturing firms have been experiencing difficulties to withstand the depreciation of the Lira owing to their open FX positions, while slower domestic and external demand was constraining sales growth.

We revise our growth forecast to 2.1 percent for 2016 because recovery in Q4 was weaker than envisaged earlier. After dropping considerably in Q3, industrial production bounced back in October, but remained flat in November, disappointing the hopes for a strong recovery. Similarly, the manufacturing PMI retreated to 48.8 in November and further to 47.7 in December, suggesting that manufacturing activity remains subdued. Moreover, power outages hit Turkey in late December, particularly in the industrial region spanning from Kocaeli to Istanbul, causing some firms to halt production. On the demand side, auto and white goods sales surged, as consumers front-loaded their purchases with the anticipation that prices will rise due to currency depreciation and tax hikes on auto. However, flat performance of retail sales suggests that recovery in consumer spending is not broad based. The pick-up in consumer credit growth confirms that a recovery in private consumption has taken place in Q4, although not as strong as anticipated. Slightly weakening corporate loan growth and falling investment expenditures in the business tendency survey suggest corporates cut investment spending in Q4 amid deteriorating balance sheets and declining profitability due to currency depreciation. Net exports make a greater contribution in Q4 compared to the previous quarter, as exports grew faster than imports, thanks to strengthening economic activity in the EU. These developments point to a weaker than expected recovery in Q4, leading to a downward revision of our growth forecast to 2.1 percent for 2016.

Inflation surged by 1.5 pps to 8.5 percent in December. One-off factors, such as tax hikes, account for one-third of the increase in inflation, while the sharp increase in food prices accounts for another one-third. Particularly, tax increases on tobacco products added 0.4 pps and tax increases on automobiles added 0.1 pps to headline inflation. The depreciation of the Lira exacerbated the rise in global oil prices, increasing transport and domestic energy prices. 12-month core inflation increased by 0.5 pps to 7.5 percent, while the 12-month domestic PPI rose by 3.5 pps to 9.9 percent in December. The substantial rise in the domestic PPI is worrisome as it might be signaling cost pressures. The FX pass-through associated with the rapid Lira depreciation will feed into prices starting in Q1 2017. Moreover, unfavorable weather conditions are likely to hurt harvest, putting upward pressure on food inflation.
**Selected Economic Indicators**

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<tr>
<td>Real GDP Growth Rate (percent)</td>
<td>5.2</td>
<td>6.1</td>
<td>2.1</td>
<td>2.7</td>
<td>3.5</td>
<td>3.7</td>
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<tr>
<td>Consumer Price Inflation (end period, in percent)</td>
<td>8.2</td>
<td>8.8</td>
<td>8.5</td>
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<td>8.5</td>
<td>8.0</td>
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<tr>
<td>General Government Budget Balance (in percent of GDP)</td>
<td>-0.5</td>
<td>0.1</td>
<td>-1.8</td>
<td>-1.6</td>
<td>-1.5</td>
<td>-1.2</td>
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<tr>
<td>General Government Debt (in percent of GDP)</td>
<td>31.1</td>
<td>30.3</td>
<td>30.9</td>
<td>30.8</td>
<td>30.5</td>
<td>30.1</td>
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<tr>
<td>Current Account Balance (in percent of GDP)</td>
<td>-4.7</td>
<td>-3.7</td>
<td>-4.1</td>
<td>-5.0</td>
<td>-5.5</td>
<td>-6.0</td>
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*Source: World Bank staff projections, TURKSTAT, Central Bank, Undersecretariat of Treasury *

**The current account deficit widened in Q4 due to worsening services balance.** The 12-month current account deficit increased by $1.3 billion to $33.7 billion between September and November. The services balance accounted for $1.2 billion of the increase, driven by substantially lower tourist arrivals on the back of security concerns. Core merchandise exports (excluding energy and gold) grew by 1.2% y-o-y in Oct-Nov, while core merchandise imports increased by 2.7%, causing a $0.3 billion deterioration in the 12-month core merchandise trade balance between September and November. Going forward, rising energy prices may impose the most significant upside pressure on the current account deficit.

**Portfolio outflows from the bond market accelerated in Q4 due to domestic and external factors.** The surprising result of the US presidential election and anticipation that the Federal Reserve will increase interest rates faster than earlier envisaged decreased global risk appetite, triggering outflows from developing countries. Slowing GDP growth, rising inflation and a widening current account deficit add to investors’ concerns, while the Central Bank’s actions fall short of expectations. Against this backdrop, outflows from the bond market amounted to $3.4 billion in Q4, while the equity market witnessed marginal inflows of less than $0.1 billion. The outflows increased the benchmark 2-year government bond yield by 1.94 pps to 10.65 percent, while Lira depreciated by 17.4 percent to 3.52 per USD by the end of Q4, compared to the end of Q3. The losses in financial markets extended into January, as bond yields rose by 2.72 pps and currency depreciation reached 29 percent by January 27 compared to September 30.

**The banking sector roll-over rate has fallen since June.** The 12-month banking sector roll-over rate dropped from 187 percent in June to 111 percent in November, as foreign banks became more cautious about lending to Turkish banks and demand for external financing from Turkish banks was subdued. The continuation of this trend could imply slower credit growth in the domestic market, as banks rely heavily on foreign funding to extend credit.

**The rapid Lira depreciation and its likely impact on inflation is leading the Central Bank to increase interest rates.** Following a small rate hike in November, the Central Bank kept all short-term interest rates on hold in its December meeting, further fueling the depreciation trend. In January, the Central Bank increased the overnight lending rate by 75 bps to 9.25 percent and the late liquidity lending rate by 100 bps to 11 percent. Moreover, starting from mid-January, the Central Bank ceased 1-week repo auctions and lowered the single borrower limit for overnight lending facility in order to force banks to borrow at the late liquidity rate, tightening liquidity and increasing the average cost of funding by 196 bps to 10.27 percent between December 30 and January 27. This tightening stance somewhat alleviated the pressure on the Lira, although persistent depreciation could pose a threat, not only for price stability but also for financial stability, with direct risks for corporates and indirect risks for banks. A meaningful interest rate increase would help shore up confidence in the Central Bank, stem the depreciation trend and maintain price and financial stability.

**Fiscal policy is providing considerable stimulus to growth.** Central government expenditures grew by 15.3 percent in 2016, thanks to increases in the wage bill, purchases of goods and services, and transfers. The fall in capital spending and interest expenditures helped to contain the increase in total expenditures. Despite slower tax revenue growth due to slower economic activity, central government revenues grew by 14.8 percent in 2016, supported by non-tax revenues, such as interest and share income and capital revenues. As a result, the central government budget is estimated to have posted a moderate deficit of 1.2 percent of GDP in 2016, in line with fiscal targets.

**Growth is expected to recover to 2.7 percent in 2017 thanks to improving net exports.** We expect growth in 2017 to be driven more by public spending and net exports and less by private consumption and investment. Strengthening growth in the EU will help increase exports, while subdued private demand will constrain import growth. Despite improving relations with Russia, security concerns are likely to keep limiting tourist arrivals from both Europe and Russia. The depreciation of the Lira may further feed into consumer prices, eroding the purchasing power of households. Moreover, the balance sheet of corporates might deteriorate given the large open FX position, thus weakening private investment prospects. The size and pace of the depreciation make a monetary policy correction inevitable, with a considerable interest rate increase highly probable in 2017. This is likely to constrain domestic demand in the near future but have positive effects in the medium-term. Moreover, falling banking sector roll-over rates may limit credit growth.

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1. Turkey Regular Economic Note is a brief that assesses recent economic developments in Turkey and provides World Bank forecasts on key macroeconomic variables. Given that the focus is on the recent past, the Note reports seasonally adjusted quarter-on-quarter changes (or 3-month-on-3-month changes). Although year-on-year rate is much less volatile, the main advantage of using a quarter-on quarter growth rate is that it is easier to identify turning points in the economy, such as the end of a recession or the beginning of an expansionary period.

2. TURKSTAT recently revised the GDP series to align the methodology with the EU and UN standards. We rely on the new GDP series in our analysis.

3. In order to populate services sector, we aggregate all sub-sectors except agriculture, industry, and construction.

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