We are revising down our growth projection for 2016 from 3.5 percent to 3.1 percent because private investment and consumption appear to have slowed down in the aftermath of the failed coup attempt.

The current account deficit is likely to rise in 2016, as tourism revenues fall.

The government plans to ease fiscal policy in Q4 to support growth amid weakening private demand.

Growth continued to slow in Q2 because of weaker domestic demand. After falling to 0.7 percent in Q1, seasonally and working day adjusted (SWDA) GDP growth dropped to 0.3 percent q-o-q in Q2. Private consumption contributed negatively to growth for the first time in the last 9 quarters, while government spending maintained its positive momentum. Private investment surged significantly in Q2 but it is unlikely to have been sustained in the remainder of the year given that the failed coup attempt increased risk aversion, leading corporates to postpone investment decisions. The contribution of net exports remained negative, as exports contracted due to declining tourism arrivals and imports grew at a slower rate because of weaker domestic demand in Q2.

High frequency indicators suggest a slower growth in the second half of 2016. The failed coup attempt and the recent geopolitical developments have increased domestic uncertainty and weakened business confidence. Industrial production (SWDA) declined by 3.1 percent q-o-q in Q3, and the purchasing managers index (PMI) reading continued to indicate a contraction through October. Similarly, employment creation slowed significantly in Q3, confirming slower economic activity. Investment expenditure surveys suggest a sharp fall in private investment in Q3, following a significant surge in Q2, suggesting corporates are postponing investment decisions. On the demand side, heightened uncertainty increased risk aversion among households, which is holding back spending, leading retail sales to decline 1.7 percent q-o-q and a slower credit growth momentum in Q3. In addition, net exports are likely to have remained in negative territory in Q3. In summary, these high frequency indicators suggest real GDP growth may fall into the negative territory in Q3. In the last quarter, we expect private consumption to recover slightly, thanks to government measures to boost consumer spending, and government spending to partially offset weaker private demand. Against the backdrop of a weaker growth outlook in the second half of the year, we are revising the annual growth projection to 3.1 percent for 2016.

The current account deficit started to widen again in May, reversing the earlier trend. After falling to a monthly low of $27.7 billion in May, the 12-month current account deficit started to increase, reaching $32.4 billion in September, mainly because of falling tourism revenues. Foreign arrivals to Turkey dropped sharply in 2016 on the back of Russian sanctions and security concerns, which curbed flows from Russia and Europe. The energy deficit, the main driver of external adjustment in the last two years, began to stabilize along with energy import prices at about $25 billion in the summer of 2016. Global oil prices have rebounded since early Q1, and this will negatively impact the energy deficit with a lag, increasing energy deficit in 2017.

Food prices create volatility in headline inflation. Food price inflation became highly erratic in 2016. After dropping from 11.7 percent to 0.6 percent between January and April, 12-month food inflation increased to 9.6 percent in July before dropping to 3.9 percent in September. With the recent fall in food inflation, the headline inflation rate eased to 7.2 percent by October. On the other hand, the core inflation rate, which excludes food, energy, beverages, and tobacco products, has comedown consistently since January, reaching 7.0 percent in October. Going forward, volatile food prices and the recent wave of Lira depreciation, if it becomes permanent, are the main upside risks on the inflation outlook.
Selected Economic Indicators

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth Rate (percent)</td>
<td>3.0</td>
<td>4.0</td>
<td>3.1</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Consumer Price Inflation (end period, in percent)</td>
<td>8.2</td>
<td>8.8</td>
<td>8.0</td>
<td>8.0</td>
<td>7.5</td>
</tr>
<tr>
<td>General Government Budget Balance (in percent of GDP)</td>
<td>-0.6</td>
<td>0.1</td>
<td>-2.1</td>
<td>-1.9</td>
<td>-2.0</td>
</tr>
<tr>
<td>General Government Debt (in percent of GDP)</td>
<td>36.3</td>
<td>36.0</td>
<td>36.4</td>
<td>36.7</td>
<td>37.0</td>
</tr>
<tr>
<td>Current Account Balance (in percent of GDP)</td>
<td>-5.4</td>
<td>-4.5</td>
<td>-4.7</td>
<td>-5.0</td>
<td>-5.5</td>
</tr>
</tbody>
</table>

Source: World Bank staff projections, TURKSTAT, CBRT, Undersecretariat of Treasury

Volatility in financial markets has increased since May due to global and domestic factors. The Brexit vote in late June and the failed coup attempt in mid-July weakened Turkish asset prices, but a rapid recovery followed in both cases. Since September, volatility has increased further, reflecting a weak global outlook, expected interest rate increase in United States, slower domestic growth, a widening external deficit, and an accommodative macro policy mix. Moreover, in late September, Moody’s cut Turkey’s credit rating from Baa3 to B1, one notch below investment grade. As a result, Turkey has seen portfolio outflows, particularly from the domestic lira-denominated bonds, and the Lira has come under pressure, depreciating by about 8 percent to an all-time low of TRY 3.17 per USD by early November. More recently, the surprising outcome of the US presidential election has pushed global bond yields up and put emerging market currencies under pressure. Against this backdrop, the Lira has depreciated by 7 percent to 3.37 per USD, while the benchmark 2-year bond yield surged by about 1 pp to 10.44 percent by November 21. The depreciation of the Lira puts additional strain on the balance sheets of corporates, which have large open FX position, weighing on confidence and investment outlook.

Concerned with a weakening Lira, the Central Bank paused its monetary easing in October. The Central Bank cut the overnight lending rate by 250 bps to 8.25 percent between March and September, but kept the 1-week repo and overnight borrowing rates unchanged, bringing the average cost of CBRT funding down by 100 bps. In an attempt to lower funding costs for banks and ease credit conditions in the aftermath of the failed coup attempt, the Bank also lowered the reserve requirement ratios for all maturities by 100 bps in total in August and September. However, the recent depreciation of the Lira increased concerns for inflation dynamics and financial stability. Thus, the Central Bank kept all interest rates unchanged in its October meeting.

The government is set to ease fiscal policy in Q4 to boost growth. The central government budget deficit was contained to 0.6 percent of GDP in the first three quarter of 2016, compared with an annual deficit target of 1.6 percent. Tax revenue growth slowed in comparison with 2015, while non-tax revenue growth strengthened thanks to capital and ownership revenues, keeping total revenue growth reasonably high. Despite a faster increase in the wage bill and current transfers, a fall in capital expenses, capital transfers and interest expenditures prevented a deviation from historical growth trends. However, the medium-term program anticipates a looser fiscal policy going forward, using fiscal space to support growth. Government consumption is likely to rise in the remainder of the year to offset the weaknesses in private demand, and public investment is expected to grow significantly to support GDP growth in 2017. General government budget deficit is projected to increase to 2.1 percent in 2016, before easing to 1.9 percent in 2017.

We project GDP growth to rebound to 3.5 percent in 2017, thanks to improving net exports due in large part to the removal of Russian sanctions. Recovery in private consumption is likely to start in Q4, due to supportive macroeconomic policies and as the negative impact of the coup attempt on consumer demand fades. We expect private consumption to converge back to the pre-July trend in 2017. Despite a limited recovery, private investment is likely to remain weak in 2017, as business confidence remains weak and the recent round of currency depreciation strains balance sheets. The structural reforms aimed at rebuilding business confidence and improving investment climate should gradually help improve private investment in the medium-term. On the other hand, the medium-term government program sets out a generous public investment plan for 2017, which will increase the contribution of total investment to growth, while the contribution of government consumption will slow significantly. The rise in global oil prices and negative net exports are expected to bring the current account deficit to 5 percent of GDP in 2017.

As loans have risen faster than deposits, boosting the loan to deposit ratio to 120 percent, lending growth may become a binding constraint on growth in the medium-term. So far, banks have financed loans in excess of the funding provided by deposits almost exclusively via external borrowing that reached $160 billion in August 2016. Lira volatility may depress the appetite for foreign borrowing while low domestic savings are likely to limit scope for further deposit and declining profitability trend discourages capital increases. As a result, loan growth is likely to remain moderate, negatively affecting private investment and private spending.

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1 Turkey Regular Economic Brief 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 beginning of an expansionary period.

2 Investment expenditure survey refers to the fixed investment expenditure subcomponent of the real sector confidence index published by the Central Bank.