TURKEY

Economic growth is projected to edge up to around 3½ per cent in 2017 and 2018. Consumer price inflation is back in double digits and disinflation is projected to be slow.

Fiscal and other measures, supported by a pick-up in export demand, have stimulated private consumption and investment. Their impact on public finances and the quality of credit allocation should be monitored. Faced with sharp exchange rate depreciation and rising inflation expectations, the monetary stance has been tightened, but explicit increases in the main policy rate are warranted.

Increasing net exports through further integration in global and European value chains is crucial for job creation in the face of a high unemployment rate, without further increasing the current account deficit. To this effect, the long-planned, though now uncertain, deepening of the customs union agreement with the European Union and its extension to agriculture and service sectors is key. To make the most of the resulting opportunities, up-skilling programmes should be implemented not only for young workers but also for entrepreneurs and low-skilled workers.

The economy has recovered from the shocks of 2016

Economic activity slowed in 2016 against the backdrop of a failed putsch in July and increased geopolitical tensions in the region. However, helped by numerous government measures, both private consumption and investment have started to recover. Against the backdrop of steady increases in the labour force, the youth unemployment rate is historically high, reaching 24% for young workers in early 2017.

Growth is being supported by an acceleration of goods exports, on the back of improving demand from Europe and competitiveness gains delivered by exchange rate depreciation. In contrast, service exports, while are dominated by tourism (representing 16% of total exports), remain weak. Tourist inflows from Russia resumed, but the inflow of...
visitors from Europe (which represent two thirds of all tourist arrivals) remains subdued. The current account deficit is widening again.

**New fiscal stimulus measures have been put in place**

Policymakers have made use of the fiscal space created by past budget restraint to launch measures to support private consumption, investment and job creation. Substantial restructuring of tax and social security contribution obligations has been offered. Purchases of new housing, furniture and white goods benefit from VAT cuts. Prudential rules for consumer loans and credit cards have been relaxed. In the business sector, government credit guarantees covering from 85% to 100% of bank loans to large firms, SMEs and exporters, and zero-interest loans to large numbers of SMEs are fuelling business loans. Increased risks of excessive balance sheet leverage must be kept in check with effective prudential rules.

A “national employment campaign” was launched in early 2017. The employment costs of newly hired workers are being subsidised by 30% for one year, and for four years for young and female workers. Other exemptions are offered for firms hiring various categories of workers in different regions.

The ensuing fiscal implications, including for off-budget liabilities, have yet to be reported. The publication of general government accounts, as part of the comprehensive national accounts revisions in December 2016 (which entailed a 20% increase in the level of GDP) was a long-awaited step in fiscal transparency. The cost of the new stimulus measures should be reported in this framework to strengthen the credibility of the public
finances. This is important for the smooth financing of Turkey’s large external funding needs, projected at 20% of GDP in 2017.

Monetary policy was tightened after the putsch attempt in response to a sharp exchange rate depreciation which raised inflation and inflation expectations. Inflation rose to double digits in 2017, reaching 11.9% in April, far above the 5% target. Since the beginning of 2017, the central bank has tightened the monetary policy stance using liquidity management rather than standard policy tools. As inflation and exchange rate-related risks remain high, a direct increase in the policy rate is needed.

**Uncertainties remain high**

As the impact of exceptional incentives fades, private consumption and investment are projected to settle on a moderate path. Given continuing regional geo-political tensions, and prior to general elections in 2019, growth is projected to edge up to around 3½ per cent in 2017 and 2018. If long-delayed economic reforms are implemented, confidence could improve and growth could be stronger. If instead geopolitical strains or domestic political tensions worsen, or if relations between Turkey and the European Union and the planned renegotiation of the Customs Union Agreement suffer, business confidence, investment and growth would be weaker and tensions may arise in securing the large external funding needs - including the roll-over of the significant external corporate debt stock. Specific developments affecting tourism may also have an impact on growth.