TURKEY

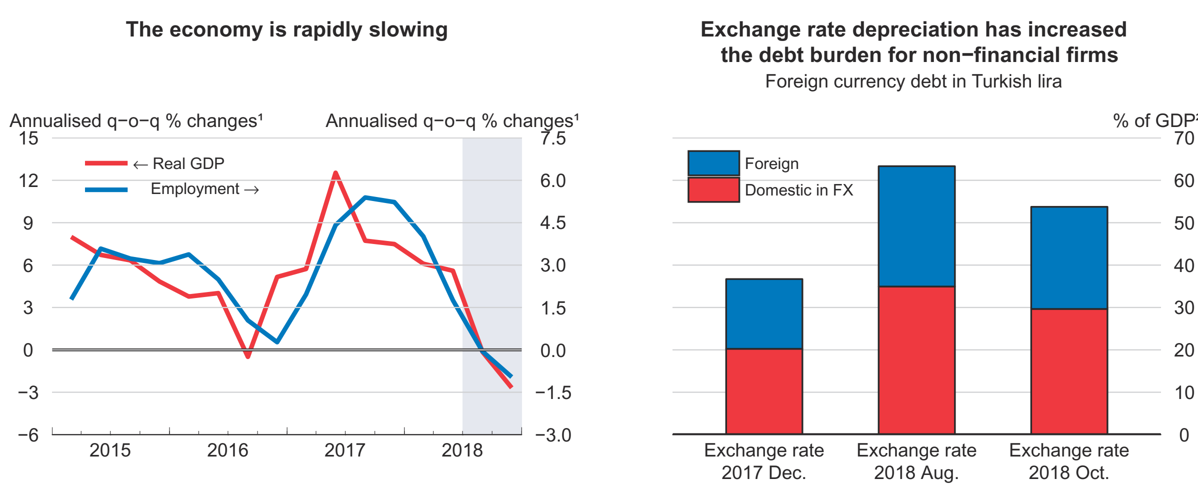
Following several years of strong growth and significant external borrowing, the exchange rate has depreciated steadily since mid-2017. Intensified market pressures in August 2018 led to a further depreciation of around 30%, followed by a partial recovery thereafter. The economy is projected to contract in 2019 as a sharp fall in domestic demand from the second half of 2018 will be offset only partially by an increase in exports. A gradual recovery in domestic confidence and demand is projected to help growth to recover in 2020.

Regaining business, household and investor confidence in monetary and fiscal policies will be crucial. The central bank should remain independent and monetary policy should remain tight to ensure that inflation converges to target. Fiscal targets should be realistic and met to maintain credibility, which would be supported by the publication of quarterly general government accounts according to international standards. These projections assume that the impairment of corporate balance sheets is contained.

The economy has slowed sharply after an exchange rate shock

Following very strong GDP growth in 2017, domestic demand, inflation and the current account deficit continued to increase on the back of policy stimulus until mid-2018. As market pressures increased in response to growing imbalances, the central bank tightened monetary conditions strongly and growth was decelerating when a further confidence shock hit in August. The exchange rate depreciated by nearly 40% in two weeks and risk premia and long-term interest rates rose strongly, reaching highly penalising levels. Inflation has recently surged to close to 25% as a result - from 16% in July.

Turkey



1. Three-quarter moving average.
2. The ratio is calculated using exchange rates prevailing on 31 December 2017, 31 August 2018 and 18 October 2018. OECD estimates.

Source: OECD Economic Outlook 104 database; The Ministry of Treasury and Finance; Banking Regulation and Supervision Agency (BRSA); and OECD calculations.

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Turkey: **Demand, output and prices**

	2015	2016	2017	2018	2019	2020
	Current prices TRY billion	Percentage changes, volume (2009 prices)				
GDP at market prices	2 338.6	3.2	7.4	3.3	-0.4	2.7
Private consumption	1 411.8	3.7	6.0	3.6	-4.1	2.3
Government consumption	324.6	9.8	4.7	8.0	2.0	2.2
Gross fixed capital formation	694.8	2.2	7.8	1.0	-5.6	3.7
Final domestic demand	2 431.1	4.1	6.4	3.4	-3.7	2.7
Stockbuilding[1]	- 31.5	0.0	-0.8	-2.0	0.0	0.0
Total domestic demand	2 399.6	4.2	5.7	1.4	-3.6	2.7
Exports of goods and services	546.0	-1.9	11.9	8.3	10.3	5.1
Imports of goods and services	607.0	3.8	10.2	-1.8	-2.3	5.0
Net exports[1]	- 61.0	-1.4	0.1	2.6	3.5	0.0
Memorandum items						
GDP deflator	_	8.1	10.9	16.1	14.2	10.3
Consumer price index	_	7.8	11.1	16.8	19.5	10.7
Core inflation index[2]	_	8.5	10.1	16.9	19.7	10.7
Unemployment rate (% of labour force)	_	10.9	10.9	10.8	12.7	12.8
Current account balance (% of GDP)	_	-3.8	-5.6	-5.3	-2.9	-3.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 104 database.

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Business and household confidence has fallen and, according to high-frequency indicators, private consumption and investment are contracting in the second half of 2018. Exports, in contrast, have accelerated in both manufacturing and tourism on the back of price competitiveness gains. Imports have decelerated and net export growth has turned positive, helping to reduce the large current account deficit.

Employment appears to have peaked in the summer and the unemployment rate has reached 11%, with the youth unemployment rate at 19%. Labour market conditions are expected to deteriorate further, notably in the construction sector, which employs a large share of low-skilled workers. The presence of around 4 million refugees adds to social inclusion challenges.

Managing the adjustment will be challenging and restoring confidence is key

Policymakers responded to financial market pressures by releasing some foreign exchange liquidity by cutting banks' reserve requirements and limiting their engagement in cross-currency swaps. The central bank raised its benchmark policy rate substantially in September to 24%, which will help to support the exchange rate and the required economic adjustment. A "New Economic Programme" aims at fostering exports and increasing domestic saving through fiscal consolidation. The headline fiscal deficit is projected to fall from 2.4% of GDP in 2018 to 1.6% in 2019, mainly through cuts in public investment. A "Comprehensive Plan Against Inflation" was announced in October, based on administrative price freezes and voluntary private sector price cuts in targeted items of the consumer basket over two months, subsequently accompanied by temporary VAT cuts on certain goods and services. Relative prices are expected to be altered during this period, but a durable success with disinflation will ultimately require the trust of market participants in the commitment of the central bank to the inflation target and its independence in pursuing this objective.

Fiscal targets should be realistic so that credibility can be built. The automatic stabilisers should be allowed to function. Improving fiscal transparency by publishing standard quarterly general government accounts would help with this, while also addressing concerns about fiscal profligacy.

Managing financial stability risks will be a major challenge. While the banking sector was broadly hedged against exchange rate movements, many dynamic medium and large-size enterprises have funded their investments with foreign currency loans. The depreciation has increased debt service costs and the increased cost of roll-over of these loans will strain firms' liquidity and solvency. The number of bankruptcy protection filings has already soared. To limit contagion to the banking sector and to the rest of the economy, special interventions may be necessary. The authorities have confirmed that they are running stress tests to gauge the need for such measures, which may entail significant fiscal costs.

The economy will contract, but this is projected to be short-lived

If corporate distress is contained, domestic and international confidence is projected to recover, supporting domestic demand. The large external funding needs, estimated to reach 25% of GDP in 2019, could then be secured, albeit at increased cost. Export growth is projected to remain strong and related investments to be unimpaired. GDP is projected to contract by 0.4% in 2019, before expanding by 2.7% in 2020. Achieving such a rebound requires credible and transparent monetary and fiscal policies and the successful handling of the strains in the corporate and banking sectors, which are assumed to be contained in this projection.

If confidence is restored more swiftly than assumed and delivers faster reductions in risk premia and long-term interest rates, the economy can recover more rapidly and growth could be stronger. However, if disruptions in the business sector spill over and confidence fails to improve, growth would be significantly weaker. If inflation expectations remain unanchored, this could put renewed pressure on the exchange rate, with negative feedback loops. In any case, Turkey remains vulnerable to a tightening in global financial conditions, which could lead to higher interest costs, further exchange rate instability and external funding tensions. Geopolitical risks related to the neighbouring region and beyond could also impact on confidence and trade prospects.