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Economics Group

Special Commentary

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Solid Growth in Turkey in Q1 but Challenges Remain

Executive Summary

Real GDP growth in Turkey was solid in Q1, topping analyst estimates on a sequential basis and bringing year-over-year economic growth up to 7.4 percent. The underlying details suggest strong domestic demand and healthy momentum heading into Q2. However, subsequent developments have altered the outlook. On May 14, Turkish President Erdogan made comments in an interview that appeared to call into question the independence of the Turkish central bank. The Turkish lira, which was under pressure even before the interview, fell significantly in the ensuing weeks.

The central bank's recent moves to counter the lira's decline have helped calm markets, and the national elections that take place on June 24 will be key to the near-term outlook for financial markets. Regardless, the steep slide in the lira is likely to lead to faster inflation and slower growth in purchasing power for consumers, and tightening by the central bank will be a headwind to interest rate sensitive spending. As a result, economic growth in Turkey may slow in the second half of the year. Taking a longer-term view, the confluence of higher oil prices, elevated political risk and rising global interest rates suggest the underlying challenges associated with a gaping current account deficit are unlikely to abate anytime soon.

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Turkish Economic Growth Healthy on Eve of Market Turmoil

Real GDP in Turkey rose 2.0 percent (not annualized) in Q1-2018 on a sequential basis, which was more than double what most analysts had expected. Despite the stronger-than-expected outturn, the year-over-year rate of real GDP growth rose just 0.1 percentage point to 7.4 percent from the 7.3 percent year-over-year rate registered in Q4 (Figure 1). Private consumption rose a solid 11 percent year over year, and gross fixed capital formation increased 9.7 percent. Robust domestic demand helped drive a 15.6 percent increase in imports, while exports rose just 0.5 percent. On the supply side of the economy, the service and industrial sectors saw the fastest growth, rising 10.0 percent and 8.8 percent year over year, respectively.

Figure 1

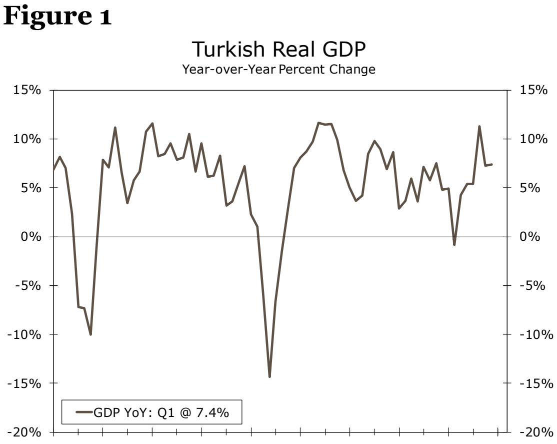
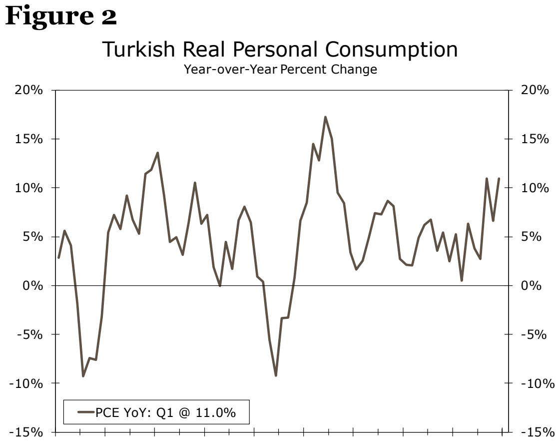


Figure 2



Source: IHS Markit and Wells Fargo Securities

The data released this morning suggest the Turkish economy started the second quarter with solid momentum, with domestic demand doing much of the heavy lifting for overall GDP growth in Q1. Subsequent developments have called the sustainability of this momentum into question. On May 14, Turkish President Erdogan made comments in an interview that appeared to call into question the independence of the Turkish central bank. The Turkish lira, which was under pressure even before the interview, fell significantly against many of the world's major currencies (Figure 3).

The recent sharp depreciation in the lira suggests prices are likely to accelerate further in the months ahead.

The ensuing market reaction and lack of an immediate reaction by Turkey's central bank began to snowball, as some market participants feared the delay in hiking interest rates confirmed that the central bank would refrain from tightening policy due to political pressure. The downward trend in the value of the lira had already put inflation in Turkey on an upward trend (Figure 4), and the recent sharp depreciation suggests prices are likely to accelerate further in the months ahead. A survey run by the central bank showed inflation expectations for the next 12 months rose again in June to the highest level since 2004.

Figure 3

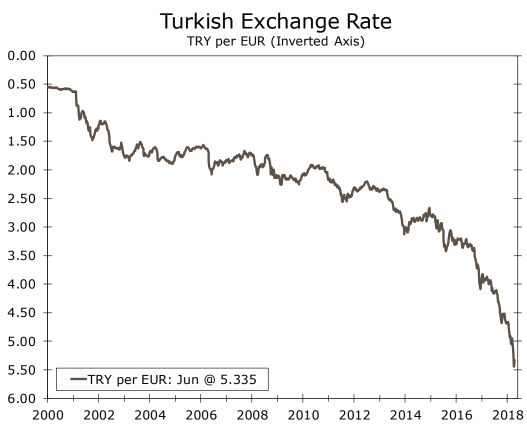
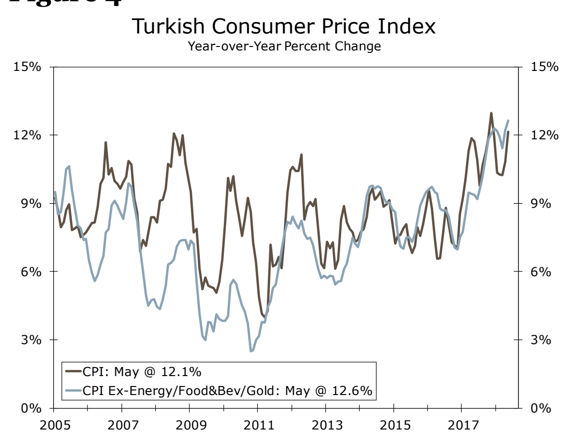


Figure 4



Source: IHS Markit and Wells Fargo Securities

On May 28, the central bank finally brought its full weight to bear, effectively doubling its main policy rate in an effort to stem the tide (Figure 5). The central bank increased interest rates again on June 7, and noted that the "tight stance in monetary policy will be maintained decisively until the inflation outlook displays a significant improvement." This surge in interest rates has brought some stability to the lira and lessened some of the concerns about the central bank's willingness to act, but it brings with it its own set of challenges. Higher interest rates will serve as a headwind to interest rate sensitive spending, such as investment, and accelerating prices will weigh on growth in household real disposable income. Thus, the steps taken to head off the lira's decline will likely lead to slower economic growth and a rebalancing away from domestic demand and towards more export-driven growth in the coming quarters.

How did conditions deteriorate so quickly? In our write-up on the Turkish economy's outlook on March 29 when the last GDP print was released, we outlined our primary downside risk scenario:

Turkey's persistent current account deficit underlies much of the country's current economic challenges.

> "That said, Turkey is not without its risks. The country incurs a gaping current account deficit due to its low national saving rate, and these deficits must be financed by capital inflows. These inflows have increasingly taken the form of portfolio investment, which can be easily reversed. If risk aversion should increase because of global or Turkey-specific events, the Turkish lira could come under even more downward pressure, which could push inflation even higher."[1]

The events of the past few months have brought this hypothetical scenario into reality. Turkey's persistent current account deficit underlies much of the country's current economic challenges. Turkey runs a deficit in its current account, because its national saving rate, which is low, falls short

[1] Bryson, J. & Pugliese, M. (March 29, 2018). "Turkish Economy Ended 2017 on a Solid Note". Wells Fargo Economics.

of its rate of national investment. As a result, the country must borrow from abroad to finance its current account deficit. Turkey has been incurring red ink in its current account since 2003, and some narrowing over 2015-2016 has since sharply reversed (Figure 6). As a net energy importer, the recent rise in oil prices are yet another challenge for the country's current account woes. In Q1-2018, the current account deficit widened to a whopping 7.9 percent of GDP.

Figure 5

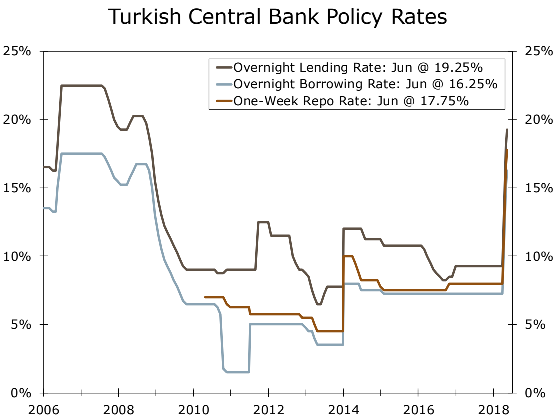
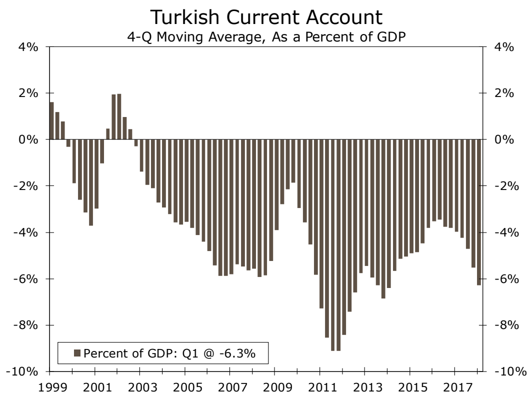


Figure 6



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Running a current account deficit is not in and of itself a problem. So long as foreigners remain willing to supply the shortfall of savings needed to finance national investment, economic growth can continue unperturbed. However, the current account deficit in Turkey has been increasingly financed by portfolio investment inflows (e.g., stocks and bonds), which can be easily reversed, as has occurred recently. This makes Turkey highly susceptible to developments that drive capital outflows, such as financial market risk-off moves, sharp jumps in global interest rates or Turkish political turbulence.

Economic growth in Turkey may slow in the second half of the year.

The central bank's recent moves to counter the lira's decline have helped calm markets, and the national elections that take place on June 24 will be key to the near-term outlook. Any unexpected developments in the results or unrest among Turkey's citizens could lead to more jitters among those investors providing the capital inflows into the country. Regardless, the steep slide in the lira is likely to lead to faster inflation and lower purchasing power for consumers, and tightening by the central bank will be a headwind to interest rate sensitive spending. As a result, economic growth in Turkey may slow in the second half of the year.

Taking a longer-term view, the confluence of higher oil prices, elevated political risk and rising global interest rates suggest the underlying challenges associated with a gaping current account deficit are unlikely to abate anytime soon. While some components of the long-run economic outlook in Turkey are favorable, such as its relatively young population, it will take painful action by both political leaders and central bank policymakers to fully get a handle on these underlying challenges. It remains to be seen if the political will exists to tackle them head on.

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