

Economics Group

Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274
 Michael Pugliese, Economist
michael.d.pugliese@wellsfargo.com • (212) 214-5058

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.

The underlying challenges associated with a gaping current account deficit are unlikely to abate anytime soon.

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

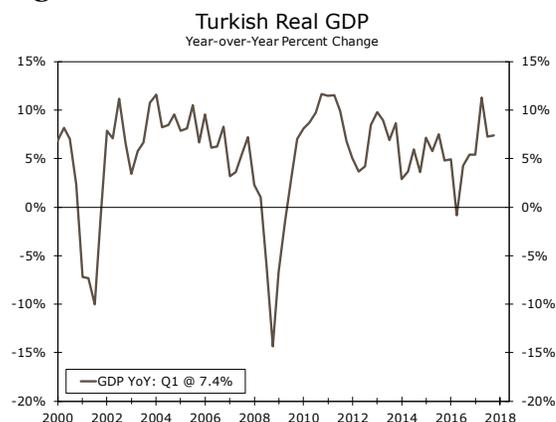
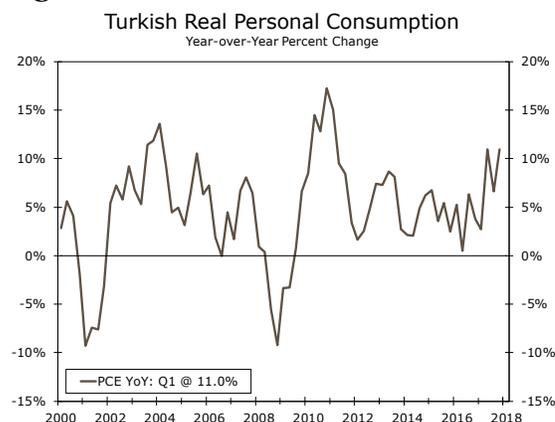


Figure 2



Source: IHS Markit and Wells Fargo Securities



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

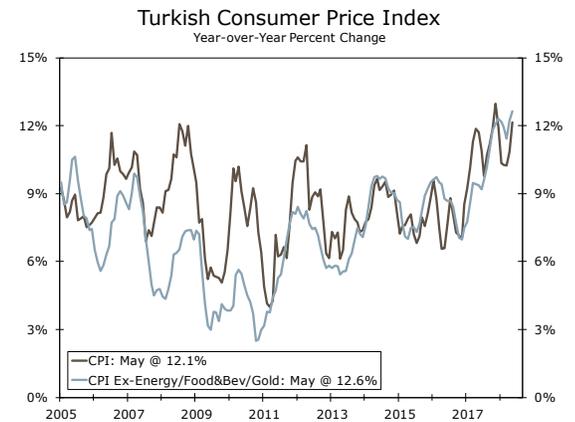
The data released this morning suggest the Turkish economy started the second quarter with solid momentum, with domestic demand doing much of the heavy lifting for overall GDP growth in Q1. Subsequent developments have called the sustainability of this momentum into question. On May 14, Turkish President 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 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:

“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

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

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

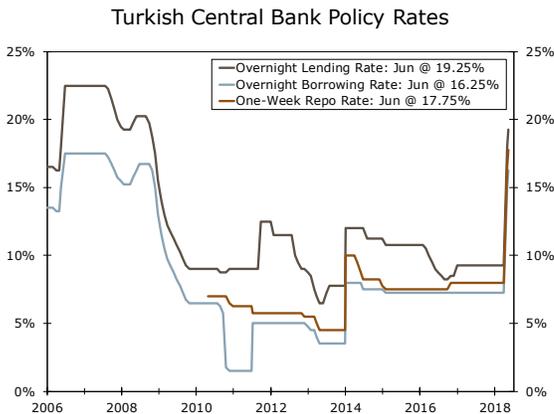
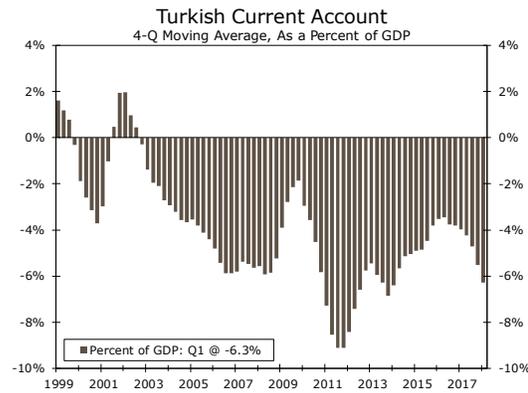


Figure 6



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.

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.

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

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloría, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC, is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2018 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

