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Economics Group

Special Commentary

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Turkish Economy Ended 2017 on a Solid Note

Executive Summary

Real GDP growth in Turkey slowed on a year-ago basis in the fourth quarter, but the exceptional growth rate in Q3 was artificially boosted by coup-related weakness during the preceding year. Real GDP grew at an impressive rate of 7.4 percent in 2017 as all major spending categories registered solid rates of growth. Although real GDP should decelerate in 2018, we generally remain constructive on the economic outlook in Turkey.

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.

Did the Turkish Economy Really Slow in Q4?

The exceptional growth rate in Q3 simply reflected base effects.

Real GDP in Turkey rose 1.8 percent (not annualized) in Q4-2017 on a sequential basis, which was stronger than most analysts had expected. Despite the stronger-than-expected outturn, the year-over-year rate of real GDP growth slowed to 7.3 percent from 11.3 percent in the previous quarter (Figure 1). Does this mean that the Turkish economy is decelerating? Not really. The exceptional growth rate in the third quarter simply reflected base effects. That is, the attempted coup in Q3-2016 weakened the economy in that quarter, so a double-digit growth rate a year later was not hard to achieve. The year-over-year growth rate simply returned to a more "normal" rate in Q4.

Figure 1

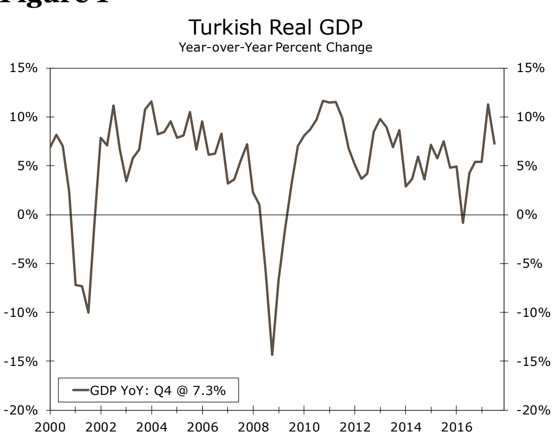
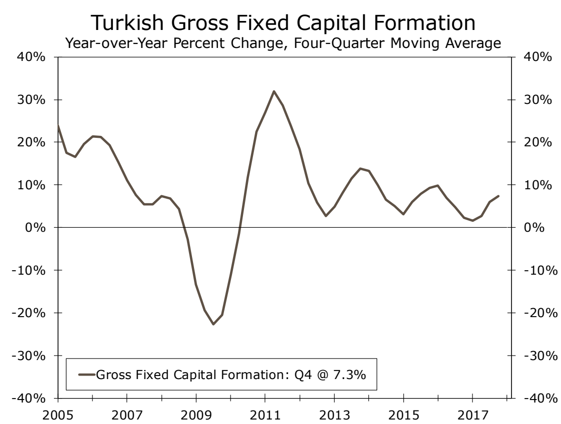


Figure 2



Source: IHS Markit and Wells Fargo Securities

Looking at the entire year, real GDP grew 7.4 percent in 2017 (off of a depressed base of 3.2 percent in 2016). Moreover, growth was broad based across spending categories. Growth in consumption spending strengthened in 2017, which was to be expected following its temporary coup-related weakness in 2016, and investment spending also accelerated (Figure 2). Real exports of goods and services, which contracted 1.9 percent in 2016, jumped 12.0 percent last year. Acceleration in global economic activity and the depreciation of the Turkish lira, which we discuss further below, boosted Turkish exports last year. We do not explicitly forecast real GDP growth in Turkey, but the consensus looks for the Turkish economy to grow roughly 4 percent per annum in both 2018 and 2019.

Turkish Economic Outlook: Inherently Risky

The Turkish lira has nosedived in recent years.

Despite the improvement in economic growth in 2017, the Turkish economy remains in a somewhat fragile state. The Turkish lira has experienced broad-based weakness over the past few years and has undergone an especially sharp depreciation vis-à-vis the euro more recently (Figure 3). The downward pressure on the lira has spurred double-digit inflation (Figure 4), leading the Turkish central bank to maintain a tight monetary policy stance.

Figure 3

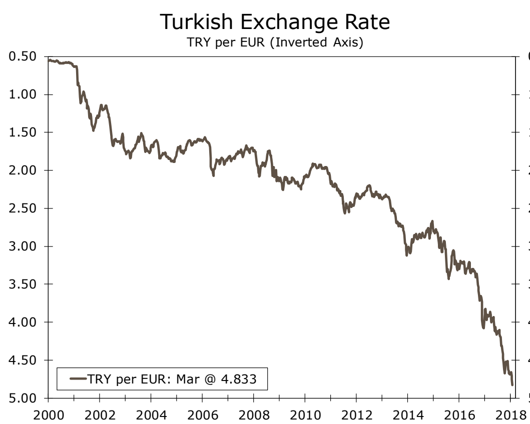
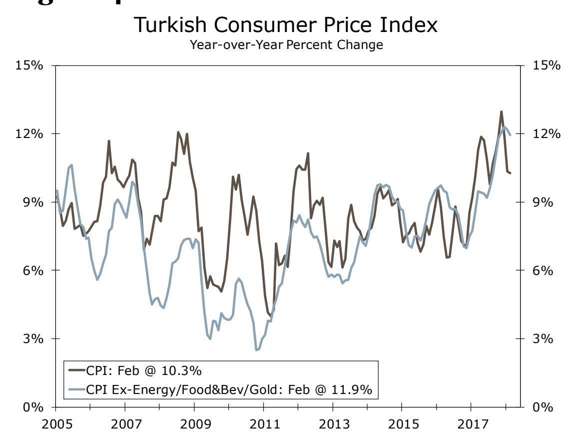


Figure 4



Source: IHS Markit and Wells Fargo Securities

Turkey's persistent current account deficit underlies much of the aforementioned challenges. Turkey runs a deficit in its current account because its national saving rate, which is low, falls short 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 reversed (Figure 5).

Figure 5

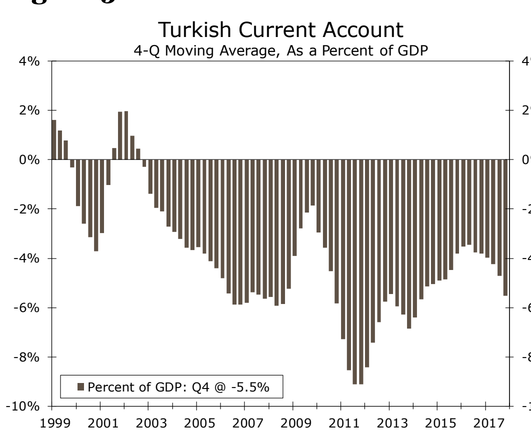
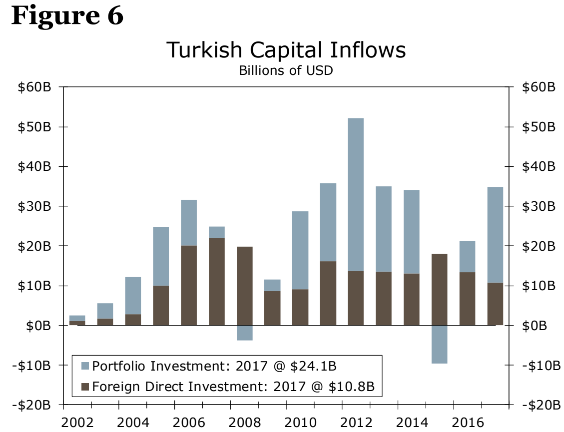


Figure 6



Source: 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 should continue unperturbed. As we wrote in a report last year, foreign direct investment (FDI) helped finance Turkey's current account deficit amid hopes that Turkey would eventually become a member of the European Union (EU). In recent years, however, prospects of Turkish entry into the European Union have dimmed, and political risks in the country have risen. Consequently, FDI has softened. This trend continued in 2017 as inbound FDI was only $11 billion, the smallest amount since 2010 (Figure 6). Fortunately for Turkey, a "risk-on" mentality for global investors in 2017 helped spur large portfolio investment inflows (i.e., foreign purchases of Turkish stocks and bonds). Portfolio investment inflows into Turkey totaled $24 billion in 2017, the largest inflow since 2012.

FDI has weakened and portfolio investment has strengthened.

However, portfolio investment inflows can be easily reversed should investors adopt a "risk-off" mentality as the result of global or Turkey-specific events. Were this to occur, the lira would likely come under additional downward pressure, pushing inflation higher. The Turkish central bank would likely be forced to increase interest rates in an effort to choke off inflation and stem capital outflows, but tightening policy in a period of heightened uncertainty and/or slowing economic growth is an unenviable situation.

Political turmoil is a clear risk in this regard. The political situation in Turkey has been tumultuous in recent years, and another political episode that heightens uncertainty in the country could cause skittish investors to beat a hasty retreat from Turkish stocks and bonds. Beyond political risk, another possible driver of capital flight could be the recent upturn in interest rates and bond yields in advanced economies. Historically low bond yields in advanced economies have driven some investors to turn to emerging markets in the hunt for yield. With economic conditions improving and monetary policy moving toward a more neutral stance in the United States and the Eurozone, bond yields have jumped to start the year more rapidly than most analysts expected. Should this trend of higher-than-expected interest rates continue, Turkey's relative attractiveness as a place to invest could erode.

Conclusion

Economic growth in Turkey strengthened in 2017. Domestic demand bounced back from the coup-related weakness in 2016, and solid global growth and a weak currency boosted exports. The flip side of currency depreciation has been double-digit inflation. The Turkish central bank has kept policy tight in its efforts to rein in inflation and keep capital flowing into the country. Cyclical strength in the exports of goods and services has helped boost economic growth, but structurally, Turkey is an importer of capital. In tranquil economic times, this should cause few disruptions, but during periods of heightened uncertainty there is a risk that investors will seek safer places to park their money. Turkey's growing reliance on portfolio investment to finance its capital account deficit increases this risk, as portfolio flows are often far easier to liquidate than foreign direct investment.

We are generally constructive on the economic outlook in Turkey. Economic growth will likely slow this year as favorable base effects begin to fade, but a solid global backdrop should continue to support GDP growth in Turkey. Taking a longer-run view, Turkey's relatively young population is a positive for potential growth, but low saving rates and political uncertainty are possible headwinds to the investment that would spur faster labor productivity growth, the other key ingredient to potential GDP growth.

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