GLOBALSOURCE PARTNERS

QUARTERLY REPORT

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TURKEY

Troubling Times

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These are unprecedented times for Turkey, with each passing day bringing new uncertainties and troubling developments. The environment makes forecasting a fool's errand, but we nevertheless try to take stock, and share some -- admittedly preliminary -- thoughts on the macroeconomics of 2017.

The global backdrop is edgy but generally supportive. It is the domestic politics that is getting trickier by the day. The Gulenist surge continues unabated, which now encompasses all dissidents and pro-Kurdish HDP. Adding to political turbulence, AKP might call a referendum on Executive Presidency in alliance with the nationalist MHP. Perceiving existential threats to its security, Ankara stands ready to intervene in Iraq, after Syria. The juxtaposition of such diverse risks makes working with a single scenario unfeasible, though the intersection of the most-likely cases is broadly supportive of a qualified muddle-through scenario that we flesh out here.

We think growth should inevitably slow further in 2017, from its average pace of just over 3% of recent years and the unemployment rate continue to edge up, while inflation and the current account deficit as a percent of GDP should both remain elevated at around 7.5%-8% and 4.5%-5%, respectively.

To generate faster growth, the government is intensifying interventions of all kinds -- through direct (higher spending) as well as indirect means (e.g., moral suasion on banks, provision of guarantees), but the problem is structural. Productivity growth is non-existent, which, in fact, is most likely to worsen with the ongoing institutional erosion, social polarization and increased government involvement, while on the demand side, all engines of private demand seem to be faltering. More generally, Turkey's debt-fuelled growth model seems to have run out of steam because of inadequate capital inflows, worsening credit risk and rapid growth in debt, particularly in the post-global crisis period. Formulating a credible and comprehensive macro/reform strategy is a must, but political turbulence and lack of social consensus make this an esoteric idea, efforts of a few ministers notwithstanding.

Fiscal headlines may continue to look relatively resilient a while longer, but ongoing weakness in the underlying stance suggests that the government's deficit targets of 1.6% and 1.9% of GDP for this and next year, respectively, will be difficult to meet. Monetary policy is in a very difficult bind. The Bank would like to continue the easing cycle --euphemistically called "simplification"-- a few steps further, but the lira has not permitted it last month, and is unlikely to do so any time soon. Meanwhile, the economy has managed to cope with the adverse effects of a Moody's downgrade (to below investment grade), and should be able to so in the highly probable event of another downgrade from Fitch.

We do not wish to sound complacent, however. The current state of affairs is unsustainable, although predicting the exact timing and nature of the proverbial straw, and what will follow in its aftermath, remains an elusive task.

Please note that there will be no Weekly Tracker this Sunday.

Assumptions

Global backdrop has gotten edgier since our last Quarterly (of July 31st), on the back of a December Fed hike now seen as a near-certainty and concerns related to a potential Trump victory at the U.S. elections of November 8th. Several risks that were on investor radars until recently (e.g., Chinese transition, health of the European banking sector) appear to have been put on the backburner for now, but they could easily flare up again.

Yet, we assume that the global environment will remain broadly accommodative during our forecast horizon (through end-2017). True, global growth remains sub-par, but Europe, Turkey's most important trade partner, is picking up in relative terms, while emerging markets are doing relatively better, a view also endorsed by the IMF earlier this month. The talk of a "dollar shortage" -- and a higher cost of capital going forward -- are sources of concern, particularly for an externally-indebted country such as Turkey, but secular upward move in longer term interest rates is still not the most likely outcome, given that the global economy in general and the U.S. economy in particular, remain relatively weak, and the central banks accommodative.

The trouble is that domestic politics has gotten a lot more complicated in the meantime, with Turkey fighting too many battles on too many fronts. To put it bluntly, we've been wrong in giving AKP the benefit of doubt, by considering the Gulenist menace as the bigger threat, compared to the party's authoritarian and Islamic impulses. While our guardedly-optimistic scenario held for a few months, at the end AKP succumbed to temptation, turning more authoritarian. By doing so, it is taking a series of risks at home and abroad, unprecedented in quantity and quality in recent history, which could render Turkey a regional power -- or a failed state. It is not prudent to pretend we have a good grasp of the future at a junction like this, with too many variables and actors playing a role in the outcome.

Hence, we classified risks in three categories, providing three scenarios for each. At the end, our base-case does grant support to our economic thesis of a difficult muddle through amidst a downward drift or a secular decline. We would not rule out Erdogan pulling victory out of the jaws of defeat, but our readers should be ready for very adverse outcomes in the next 3-6 months, too. On the other hand, we are cognizant of the fact that after Brexit and the ascent of Trump in the U.S. the financial community considers developed markets as risky as emerging ones, which might mean lower discounts for turbulent countries like Turkey going forward.

This messy political landscape notwithstanding, Turkey should continue to muddle through, thanks largely to a relatively benign global backdrop and assuming that the government/CBRT will avoid major policy mistakes. We call this scenario "muddle-through with a downward drift", as alluded to above, because we see things becoming progressively less sustainable and the growth outlook deteriorating, as we detail in the relevant section below.

Our baseline forecasts for this and next year are detailed in Table 1 below, while for reference purposes, a collection of forecasts from various sources/institutions and the MTP's three-year perspective are provided in Tables 2 and 3, respectively.

TABLE 1

Macro Framework: 2013-17

	2013	2014	2015	2016 (est.)	2017 (proj.)
Growth (GDP; %)	4.2	3.0	4.0	2.8	2.5
GDP (TL; bn.)	1,567	1,748	1,953	2,094	2,336
GDP ($; bn.)	822	799	717	702	717
CPI Inflation (%)					
Avg.	7.5	8.9	7.7	7.7	8.4
EoP	7.4	8.2	8.8	7.7	7.9
Central Government Budget (TL bn; MoF def)	-1.5	-5.4	-23.5	-39.6	-51.9
as % of GDP	-0.1	-0.3	-1.2	-1.9	-2.2
o/w: Primary Balance (as % of GDP; MoF def)	0.8	0.7	1.5	0.6	0.2
Central Government Debt (as % of GDP)	37.4	35.0	34.7	35.3	34.1
Domestic	25.7	23.7	22.5	...	...
External	11.7	11.3	12.2	...	...
Current Account Balance ($ bn)	-63.6	-43.6	-32.2	-33.9	-36.1
as % of GDP	-7.7	-5.5	-4.5	-4.8	-5.0
Trade Balance (TURKSTAT definition; $ bn)	-99.9	-84.6	-63.4	-60.1	-67.7
Exchange Rate (TL/$)					
Avg.	1.91	2.19	2.72	2.98	3.26
EoP (Dec. average)	2.06	2.29	2.92	3.18	3.34
%	15.8	11.1	27.3	8.9	5.0
Real Effective Exchange Rate (2003=100)					
EoP (Dec. average)	100.3	105.0	97.5	94.5	95.3
% ('+' means appreciation)	-9.1	4.7	-7.1	-3.0	0.8
Interest Rate (benchmark, compounded; %)					
EoP (Dec. average)	9.4	8.1	10.9	9.5	10.0
Benchmark Real Rate (eop; ex-post %)	1.9	-0.1	1.9	1.7	1.9
Interbank Rates (eop; avg. 5 b-days; simple, %)	7.75	11.09	10.75	8.25	9.5
Central Bank Policy/Reference Rate (eop; simple, %)	4.50	8.25	7.50	7.50	7.50
Memo Items:					
Oil Price (Brent, p/b, avg.)	108.7	99.0	52.4	43.8	50.0
Euro/USD (eop)	1.37	1.23	1.09	1.10	1.10

Source: CBT, MoF, Treasury, TURKSTAT, our calculations and projections.

TABLE 2

2017 Forecasts on Key Macro Indicators

	MTP	IMF	EC	WB	OECD	CBT Survey
GDP Growth (%)	4.4	3.0	3.7	3.5	3.7	3.6
GDP Nominal (TL bn)	2,404	2,427	...	...	...	...
GDP Nominal ($ bn)	756	769	...	...	...	...
Inflation (CPI, eop)	6.5	6.2	8.0	8.0	7.5	7.6
Current Account ($ bn)	-32.0	-43.1	...	...	...	-37.1
Current Account (% of GDP)	-4.2	-5.6	-5.1	-4.3	-4.6	...
Exchange Rate (TL; avg)	3.18	3.15	...	...	...	3.26

Source: Revised MTP Jan. 2016, IMF 2016 Article IV Staff Report, European Commission Forecast Spring 2016, World Bank April 2016, OECD November 2015, CBRT Survey April 2016.

TABLE 3

Medium Term Program: Main Economic Indicators

	2016			2017			2018			2019
	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)	(3)
GDP Growth (%)	4.0	4.5	3.2	4.5	5.0	4.4	5.0	5.0	5.0	5.0
Domestic Demand Contribution (inc. stocks)	4.6	4.3	4.3	4.7	4.5	4.2	5.0	4.2	4.6	4.5
Net Exports Contribution	-0.6	0.2	-1.1	-0.2	0.5	0.2	0.0	0.8	0.4	0.5
GDP (bn TL)	2,141	2,207	2,148	2,376	2,489	2,404	2,640	2,770	2,686	2,987
GDP (bn USD)	694	736	726	732	796	756	800	854	815	884
GDP Per Capita (in USD, market rate)	...	9,364	9,243	...	10,030	9,529	...	10,659	10,164	10,926
Consumer Prices (eop, %)	6.5	7.5	7.5	5.5	6.0	6.5	5.0	5.0	5.0	5.0
Unemployment Rate (%)	10.3	10.2	10.5	10.2	9.9	10.2	9.9	9.6	10.1	9.8
Cent. Gov. Budget (bn TL)	-15.4	-29.7	-34.6	-14.8	-25.0	-46.9	-11.1	-23.1	-44.3	-40.1
as % of GDP	-0.7	-1.3	-1.6	-0.6	-1.0	-1.9	-0.4	-0.8	-1.6	-1.3
Central Government Primary Balance (bn TL)	39.6	26.3	16.9	44.2	34.0	10.6	51.9	39.9	17.7	32.4
as % of GDP (%)	1.8	1.2	0.8	1.9	1.4	0.4	2.0	1.4	0.7	1.1
Current Account (bn USD)	-34.0	-28.6	-31.3	-34.4	-29.3	-32.0	-35.2	-29.9	-31.7	-31.2
as % of GDP	-4.9	-3.9	-4.3	-4.7	-3.7	-4.2	-4.4	-3.5	-3.9	-3.5
Non-Gold CAB (as % of GDP)	-4.7	-3.8	-4.8	-4.3	-3.6	-4.2	-4.0	-3.4	-3.8	-3.5
Foreign Trade Balance (bn USD)	-66.3	-55.2	-54.9	-69.6	-67.2	-60.7	-73.1	-71.8	-66.9	-68.7
Energy Import (bn USD)	39.2	33.0	27.5	42.5	43.7	32.0	48.6	51.6	37.0	41.3
Tourism Revenues (bn USD)	28.6	27.0	18.6	30.6	29.4	23.5	32.1	31.8	27.0	27.7
Memorandum Items										
TL/USD (implicit, our est.)	3.09	2.999	2.959	3.25	3.127	3.180	3.30	3.244	3.296	3.379
Oil Price-Brent (USD/barrel)	57.6	39.7	43.3	58.3	46.8	50.7	58.1	51.4	53.5	55.6

1 = 2015 October MTP; 2 = 2016 January MTP (revised October 2015 MTP); 3 = 2016 October MTP

As usual, it is possible to consider at least two alternative scenarios: a "perfect storm" scenario whereby messy politics and policy mistakes domestically mix up with a difficult global environment (leading to at least a few quarters of negative growth) and an alternative, more benign scenario whereby international risk sentiment toward Turkey improves, policy-makers hold the line on monetary and fiscal policies, and the economy proves more resilient than envisaged.

Turkey lost its sovereign hard currency investment grade (IG) rating from Moody's in September, and has a stable outlook. All eyes are now on Fitch, which still keeps Turkey at IG with a negative outlook, and is expected to undertake its next formal review of the country some time early next year. Turkey is quite likely to lose its IG from Fitch as well, we think, sometime during our forecast horizon, but should be able to cope with the repercussions, *ceteris paribus*.

Finally, regarding the two prices that enter our forecasts, we assume that the oil price (Brent) will average $50 per barrel for next year, which is sort of consistent with the "new normal" of the oil market, and that the euro-dollar cross-rate will hover around 1.10, in the absence of a stronger conviction or an alternative.

Parenthetically, we believe Turkey has the ability to avoid the worst – like a major financial crisis – mainly owing to: 1) a relatively benign global environment, 2) relative strength of the balance sheets of the banking as well as the sovereign sectors (with capital adequacy and public debt to GDP ratios standing at around 16% and 35%, respectively, according to most recent data), which provide adequate buffers to absorb the growing losses in the system, and 3) our expectation that policy pragmatism (like a rate hike) will prevail, if need be.

Political Risks and Scenarios

Poll Trouble: There is 70% likelihood that Turks will head for some kind of ballot in the next six months. This will either take the shape of a referendum on the presidential system, or if MHP refuses to back it in the parliament, AKP calling early elections. Our base-case scenario is a presidential referendum in late winter or early spring, which Erdogan should win after a tight race. Even though with his new powers he is likely to turn even more authoritarian, we consider this a muddle-through scenario, since both the actors of the economy and investors are used to his discretionary behavior and the slow erosion of democracy.

The bad-case scenario entails Erdogan losing the referendum, and refusing to cede power. We might witness nation-wide unrest, intra-party revolts, or even more coup attempts by a newly emboldened and reinvigorated pro-Ataturkist Army. The least likely and good-case scenario would entail Erdogan winning the referendum and against all odds choosing to restore democracy, or an Erdogan defeat and AKP calling early elections, where like June 2015, it will lose its majority in the Grand Assembly. Given AKP's go-for-broke policy mix at this point, we would consider any coalition an improvement over the current government.

Domestic Unrest: AKP has declared Holly Jihad on all of its perceived enemies. The Gulenist purge has turned into a witch hunt, which is affecting the conservative constituencies, as well as traditional dissidents. The Kurdish Rights Movement is about to be eliminated from the political spectrum, with 10 of HDP MPs arrested today. The raid on secularist newspaper Cumhuriyet, the attack on CHP Deputy Bulent Tezcan (he was shot on the foot by a fan of Erdogan) and the bench warrant on its chairman Mr. Kilicdaroglu for the trumped-up charge of insulting Erdogan's son Bilal, suggest that even mainstream opposition might soon not be tolerated. As the massive Gezi demonstrations of 2013 proved, our ability to predict social unrest is very limited but these happen with alarming frequency in Turkey. After Gezi, the country witnessed Kurds' Kobane protests and the ditch-wars in Kurdish cities. If AKP's multiple purges continue, some kind of reaction is very likely.

The worst case scenario is a Gezi stoked by an alliance of Kurds and secularists, perhaps joined by some elements in the Islamist movement or the rear guard of Gulenists. With police and army authorized to use excessive force, bloodshed might ensue, or AKP might completely suspend democracy. The base-case is a society which sullenly puts up with AKP, but increasingly loses its democratic vigor and economic vitality. Some brain drain and capital flight is likely. The disenfranchisement of non-AKP voters from politics echoes in economic activity, diminishing spending and increasing dollarization. The unlikely but best-case scenario is AKP pulling back from the purges, as its fortunes drop in the polls, or the economy takes a nose dive.

Syria and Iraq Adventures: As a matter of principle, we don't dwell much in the past, but it is worth considering how Turkey came to intervene in Northern Syria and stands poised to do the same in Iraq. In an alternative world, Ankara could have befriended Syrian Kurds by advancing the Peace Process at home, in which case a buffer Kurdish state in Syria would have become an asset. Ankara put all of its chips in Iraq on Kurds, neglecting Shia Baghdad. At the same time, it turned a blind eye to the suffering of Shia Turkmeni under the tyranny of ISIS.

Had it championed the rights of all Turkmeni and built stronger bridges to Baghdad, military threats wouldn't be necessary to defend the Sunni Arabs or Turkmeni today, or would have commanded the moral high ground. But bygones are bygones, and Ankara remains committed to carve out a safe zone in Syria and to stop Shia paramilitary and PKK in Iraq advancing on Mosul and Turkmeni homelands. While foreign press and investors don't pay enough attention, this is the area where we see the most immediate threats.

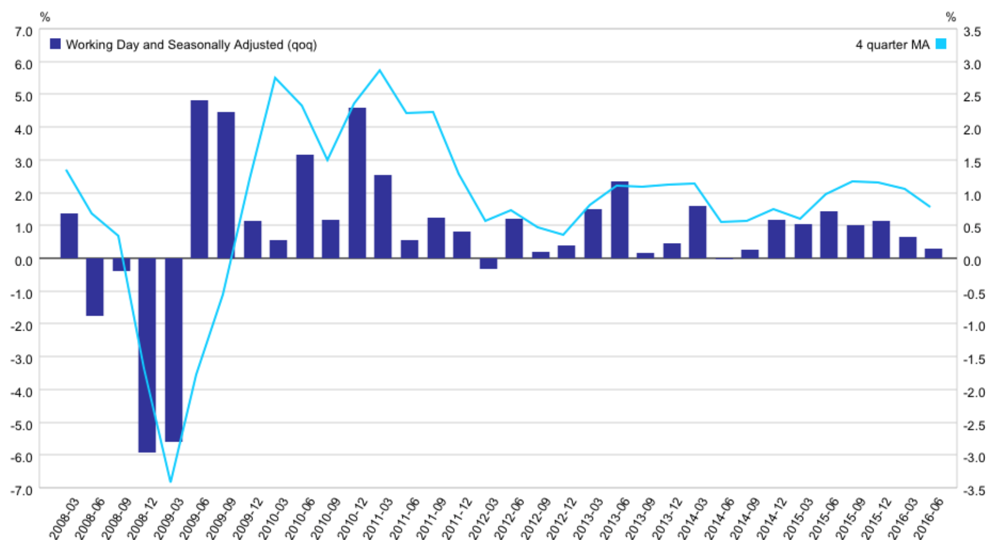
In the worst-case scenario, with non-negligible likelihood, military suffers humiliating defeats or large casualties in Syria in the hands of ISIS and Syrian Kurds. Later in Iraq the story repeats, when it intervenes, as Shia paramilitaries invade Tel Afar, or PKK sets up camp in Shengal region. The defeat drastically reduces AKP's support at home, triggering a second Gezi or Erdogan's defeat in a potential referendum. The most likely scenario is a "Turkish Vietnam", where the Army gets bogged down for long-term, ill-defined missions in Syria, and perhaps in Iraq. Turkey has to drastically increase military spending to finance its Syrian and/or Iraqi ventures and prop up shaky allies like the FSA, Turkmenis or Iraqi Kurds. Turkish presence abroad becomes a source of friction with U.S., Russia, Iraq and Iran. In the least likely scenario, Syrian Kurds and PKK sue for peace, intimidated by Turkey's military power. In Iraq, the Shia stays away from Mosul and Tel Afar, while the administration of mostly Sunni Nineveh Province is turned over to Turkey's allies post-ISIS.

Growth and Employment

Recall that growth had begun to slow in Q2, i.e. before the July coup attempt of July 15th (Graph 1), and we now see it slowing further to some 2% during H2. After registering some 4% growth in H1, this means that the year could end with a growth rate of just under 3%, according to our estimates.

GRAPH 1

GDP Growth (seasonally and working day adjusted, qoq, %)

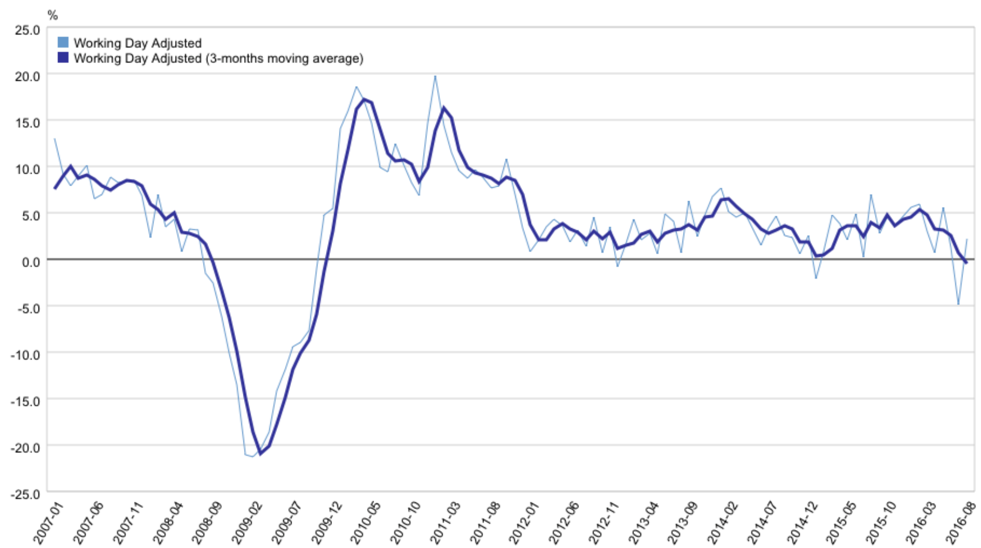


The July coup incidence has created enormous volatility in the numbers, with collapses during July-August in most indicators, followed by a rebound of sorts during September-October. There are several examples of this, such as the sharp collapse (in July) and the subsequent recovery (in August) of industrial production; a very depressed manufacturing PMI reading during August-September, followed by a relatively sharp rebound in October, and very sharp volatility in various confidence indicators (Graphs 2-4).

But this should not deflect from the real issue, which is that Turkish growth is experiencing both a cyclical and structural slowdown – something that is likely to become more apparent in the next several quarters.

GRAPH 2

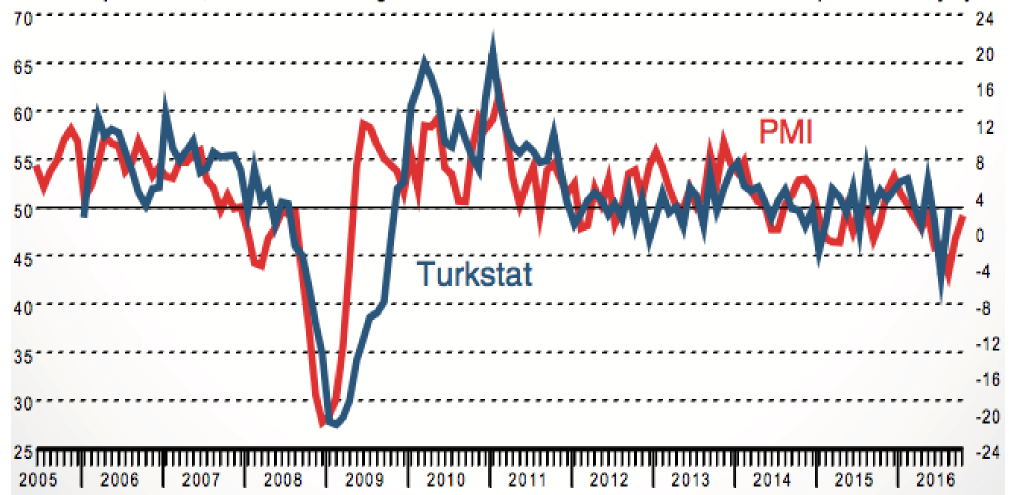
Industrial Production: Working Day Adjusted (yoy, %)



GRAPH 3

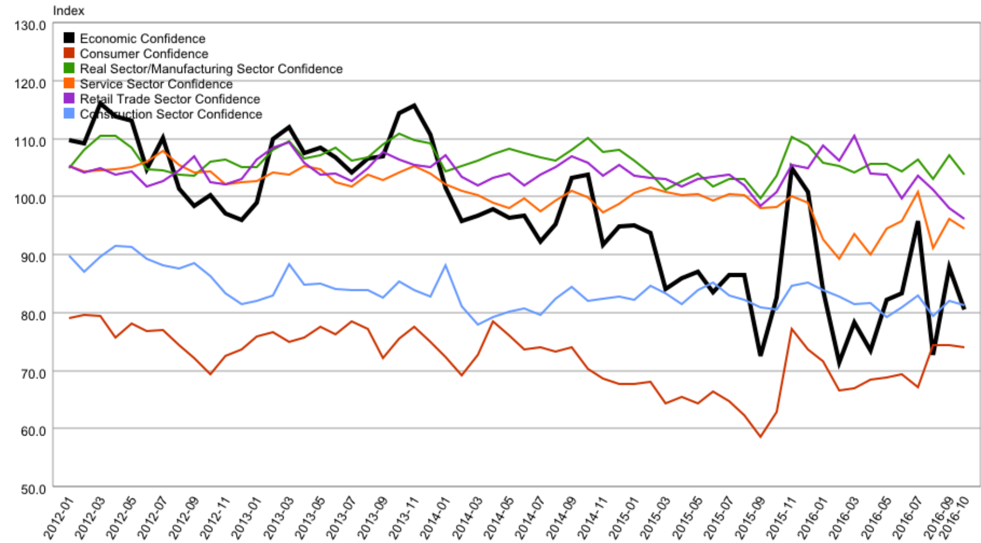
Historical overview

PMI Output Index, 50.0 = no change industrial production yr/yr%



GRAPH 4

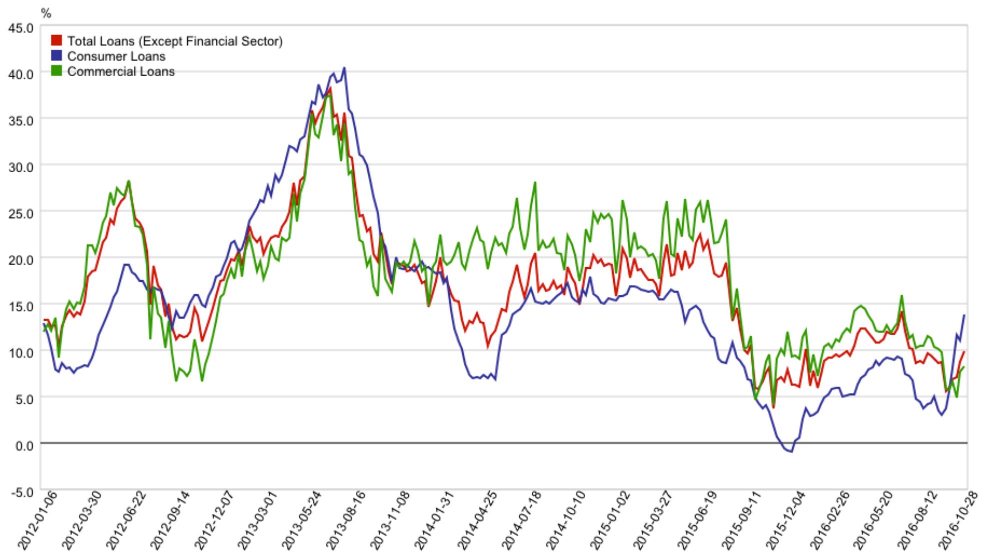
Economic Confidence Index



We base this claim on a number of observations. First, Turkey's debt-dueled growth is running out of steam. Credit growth, some recent albeit most likely temporary pick-up especially in consumer credit notwithstanding, barely keeps up with nominal GDP growth nowadays (Graph 5). We think this credit slowdown is attributable to both supply (e.g., lack of adequate inflows and hence, the CBRT's inability to create permanent liquidity, a growing NPL problem in the financial sector) and demand factors (such as a highly indebted consumer), which are more structural than cyclical in nature. Considering that "credit impulse" has been substantial even when growth was running around 3%, this does not bode well for future growth (Graph 6).

GRAPH 5

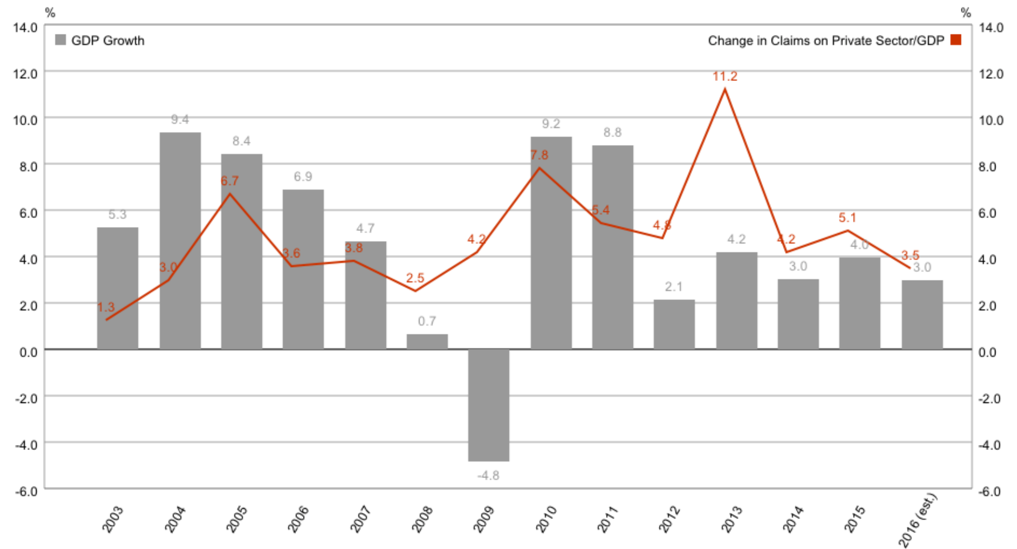
Loan Growth (FX adjusted, 13-week moving average, annualized, %)



GRAPH 6

GDP Growth (%) vs. Credit Impulse (Change in Private Credit/GDP Ratio)

TURKEY DATA MONITOR



Second, Turkey's institutions are undergoing a massive erosion. According to the latest results of World Justice Project's Rule of Law Index, for instance, Turkey ranks very poorly -- 99th out of 113 countries. According to the World Bank's Rule of Law Index, Turkey's score turned negative (-0.06) in 2015, for the first time since 2002. In terms of the broader health of institutions, transparency and media freedoms, Turkey's performance in recent years has also been disturbing.

Institutional health, according to a sub-pillar of WEF's Global Competitiveness Index, has regressed to the 75th place among 140 countries in 2015, down from the 56th place as recently as in 2013. (2016 figures are expected soon.) Latest Transparency International Corruption Perceptions Index showed that Turkey's score fell to 42 in 2015 from 50 in 2013, while Freedom House's Freedom of Press 2016 Report stated that Turkey is in the "not free" league in terms of press freedom, ranking 71th out of 100, falling by six positions. These shifts are arguably somewhat unusual for countries at Turkey's development level, in terms of their rapidity as well as breadth.

Third, as it is very well-known, growth has been of low quality, having become increasingly dependent on two demand engines: private consumption and government spending. The latter is likely to continue, but we now see private consumption also slowing for a number of reasons (e.g., uncertainty, indebtedness, poor job market prospects), while private investment and exports are unlikely to morph into "engines of Turkish growth" any time soon.

Finally, because the authorities have yet to come to terms with the structural features of this slowdown, they are trying to deal with the challenge through a number of internally inconsistent (e.g., recent macro-prudential steps to relax cc installments) and/or ultimately unsustainable and distortionary mixture of interventions. The latter takes the form of stepped up lending by state banks, offering of various guarantees/ debt-takeovers on mega-projects as well as creation of highly dubious entities like a Sovereign Wealth Fund. (See our previous Quarterly for a brief discussion.)

Putting all these together, we view a reacceleration of growth back to near- or above-4% levels, as foreseen by the MTP, highly unlikely. This is why we are working with, no matter how preliminary, a below-consensus 2.5% growth for 2017 as a whole, driven almost entirely by domestic demand (Table 4).

TABLE 4

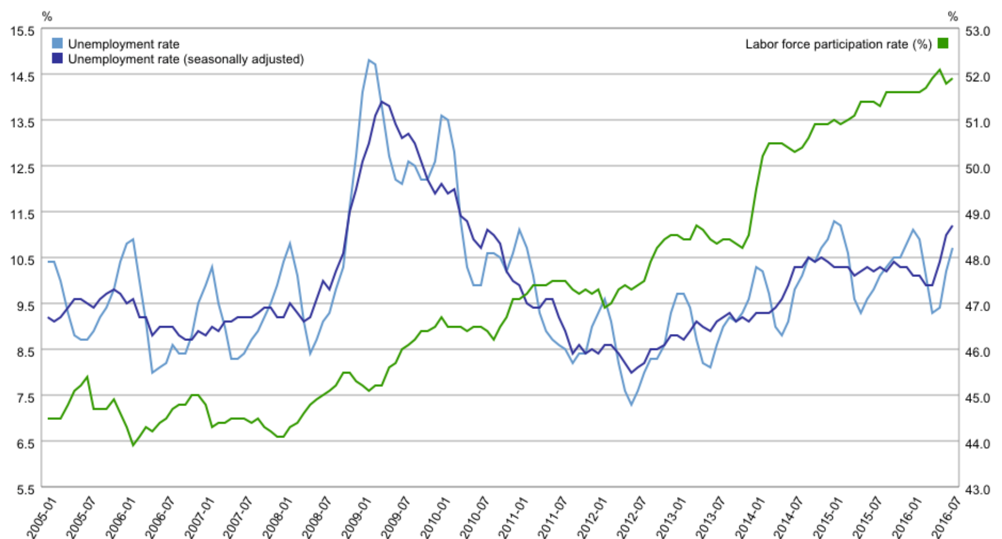
Growth Components: 2012-17
(annual; %)

	2012	2013	2014	2015	2016 H1 (act.)	2016 H2 (proj.)	2016 Full (proj.)	2017 (f)
Domestic Demand 1/	-0.4	5.2	1.2	4.8	5.5	1.9	3.6	3.7
Consumption	0.4	5.3	1.9	5.0	7.2	2.1	4.5	3.8
Private	-0.5	5.1	1.4	4.8	6.1	1.3	3.6	2.6
Public	6.1	6.5	4.7	6.7	13.5	7.1	10.0	10.0
Gross Fixed Cap. Formation	-2.7	4.4	-1.3	4.0	-0.3	1.2	0.4	2.9
Private	-4.9	0.5	0.3	3.1	-1.2	-0.5	-0.9	1.2
Public	10.3	24.1	-8.2	7.7	4.5	7.1	6.0	10.0
Change in Stocks 1/	-1.5	1.6	-0.2	-0.6	0.2	0.5	0.3	-0.3
Foreign Demand 1/	4.0	-2.6	2.0	-0.3	-1.8	-0.5	-1.2	-0.8
Exports	16.3	-0.2	7.4	-0.9	1.2	1.6	1.4	0.7
Imports	-0.4	9.0	-0.3	0.2	7.5	3.8	5.6	3.5
GDP	2.1	4.2	3.0	4.0	3.9	1.9	2.8	2.5

Source: TURKSTAT, our calculations.
1/ Contributions to GDP growth.

Unsurprisingly, with growth slowing and labor force participation (LFP) staying relatively elevated, labor market has finally begun to weaken noticeably, with the unemployment rate (UR) edging up by over 1 pp during May-July (Graph 7). The trouble is that we do not see how these figures could improve much, based on a mechanical simulation, unless the LFP rate starts falling sharply. If anything, the UR is likely to worsen, creating a major political headache as a result.

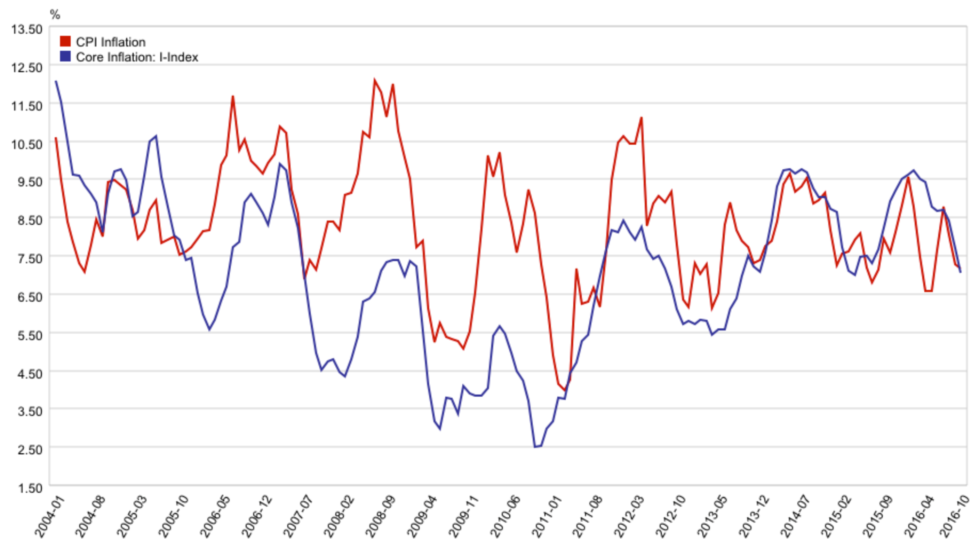
GRAPH 7



Inflation and Monetary Policy

Consumer price inflation eased further in October to 7.2%, from a peak of 8.8% in July, which was accompanied by a similar drop in core inflation (Graph 8). While this surely is a positive development, a little perspective is called for. For one thing, we've been through these cycles time and again. The decline in core, for instance, appears largely driven by the lira's turnaround, which has been – until recently -- undergoing a period of relative stability. So whether core inflation will continue easing, or will decelerate to levels consistent with the 5% target have yet to be seen.

GRAPH 8



A second issue concerns service inflation, an area in which improvement has been relatively slow. True, the overall service index had also eased to 7.8% in October from the peaks of near-9% earlier in the year, but it still remains high on the aggregate. And in certain key categories, like rents and hospitality services, inflation remains particularly elevated, which is a clear sign of "stickiness", in our view. Incidentally, this has been confirmed (albeit indirectly) by the CBRT in an analytical box included in its latest Inflation Report. (The box, which is available at this link [in Turkish only], is based on a paper that is in progress by the CBRT staff).

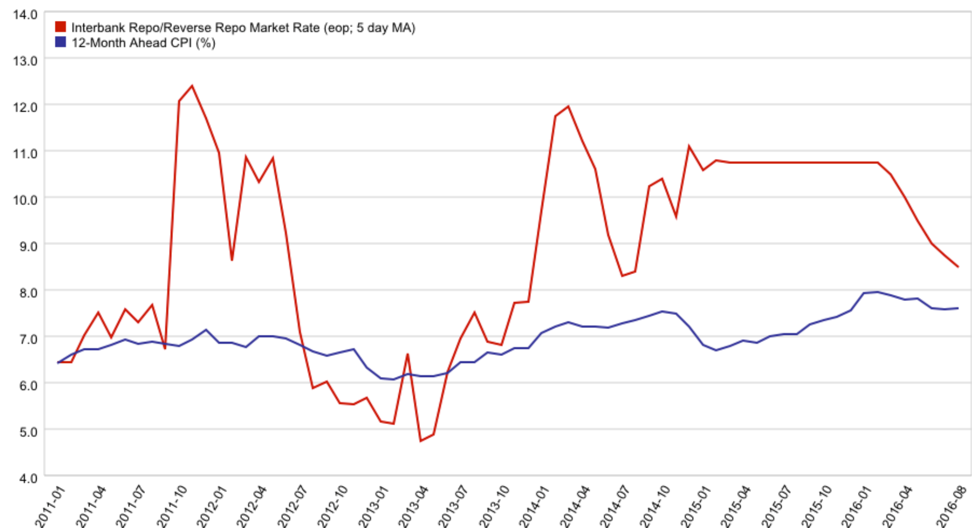
The study is fairly useful and comprehensive, and so is worth elaborating a bit. It reviews the 10-year period from 2006 through 2015 in two sub-periods, one with the formal IT regime and another with the more complex multi-instrument/multi-target regime. It is shown that CPI inflation averaged around 8% in both periods, but the dynamics of inflation differed substantially. In the 2006-15 period, the importance of so-called "macro factors", namely the exchange rate and real wages rose considerably (others are output gap and import prices), while that of non-core factors (roughly food, alcohol and tobacco, and taxes) declined. Notably, in both periods some 3 pps of inflation was unexplainable by standard factors – core or non-core, which is interpreted as evidence for stickiness or rigidity in the inflation process.

The Bank then arrives at a number of conclusions: that the Food Committee is important; improving savings, the current account deficit; and decreasing dollarization are a must; monetary and fiscal policies should be coordinated (given the importance of tax adjustments in driving inflation); and policies to increase productivity and make labor market more elastic should be put in place to curb wage pressures.

This is all very fine work, and we look forward to reading the original paper. But we think the conclusions driven by the Bank are incomplete at least in three respects. First, the 3 pps of unexplained contribution might just as well be interpreted as a "credibility gap" of the CBRT that must somehow be fixed. Second, the increase in importance of two of the above-mentioned macro factors (currency and wages) may be attributed to macro mismanagement or a vicious cycle of sorts that has emerged among inflation, wages and depreciations, for which the CBRT is partly to blame. Finally, the point that demand management matters and successful disinflations require setting interest rates at the "right" level does not receive adequate attention in the paper. With money market rates at barely above inflation expectations -- and not even consistently so (Graph 9) – perhaps it is not all that surprising that inflation target is never achieved.

GRAPH 9

Money Market Rates vs. Inflation Expectations

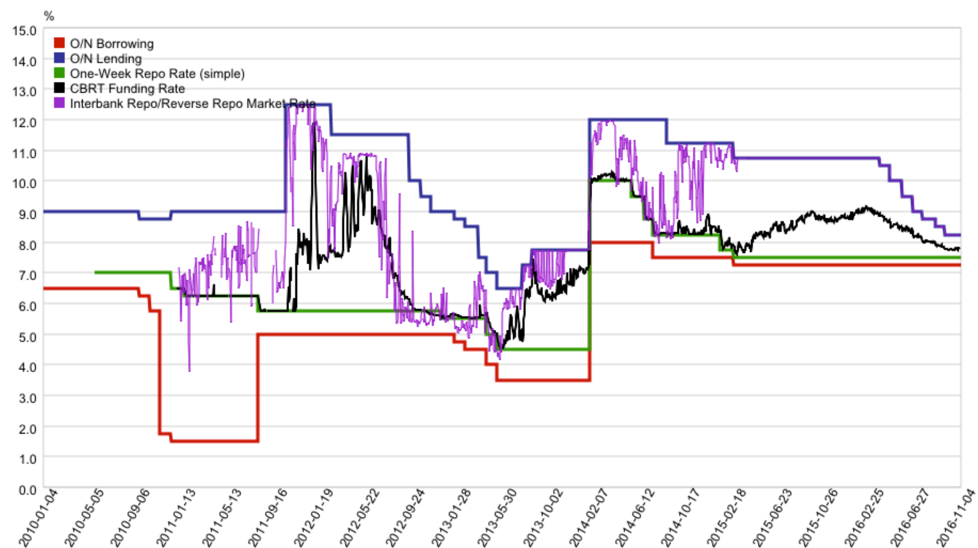


What is the implication of all this for projecting inflation forward? Actually quite significant, we would think. As we've long been arguing, the CBRT study confirms that we should expect trend inflation to stay somewhere in the 7%-8% range for the foreseeable future, because of a broader stickiness problem, since it is unlikely to go away anytime soon. The rest, i.e. cyclical ups and downs around this trend, is driven by a combination of base effects, as well as "shocks", notably to lira, food prices and energy prices. Since it is hard to forecast shocks, we forecast the trend -- and conclude that after rising a little to above this range sometime during the first half of next year (because of a weaker lira and base effects), inflation should settle back in that range by the end of next year.

Monetary policy/CBRT had to take a pause in October, after easing the O/N lending rate by 250 bps and the average funding rate by about half of that, since March (Graph 10). Lira weakness was the main reason, and looking ahead, its behavior continues to be the biggest source of uncertainty on the course of monetary policy -- and poses a dilemma of sorts for the Bank. One the one hand, the Bank does not mind lira weakness; it has, in fact, been overly tolerant in this particular cycle, with the lira and money market rates diverging sharply since early last year. (Recall that this was not so much the case in the previous two shocks, in 2011 and 2014.) Moreover, Governor Cetinkaya did not signal an end to simplification (or easing, rather) during its latest speech during the presentation of the Inflation Report, and we are already well aware of the Bank's pro-growth bias.

GRAPH 10

Policy and Short Term Rates (%)



Then again, things look a little tricky this time, and because the risk of a lira backlash is rather substantive, the Bank may choose to wait a while longer, rather than fanning the flames. In any event, predicting CBRT's next move is about predicting how this tug of war between a pro-growth bias and fear of further lira weakness will play out. For now, recent lira weakness might have, *de facto*, ended the easing, but there is no guarantee that should a window of opportunity open up, the Bank would not continue the journey, taking the attendant risk of an even bigger backlash eventually.

Whether the Bank manages to ease further or not, we still work with the conjecture that a rate *hike* will be inevitable at some point during our forecast horizon.

Fiscal Policy and Public Debt

The upshot of Turkish fiscal policy -- as we've been writing for some time -- is one of underlying weakness masked by favorable headlines, which, incidentally, has made it to a recent Bloomberg article. (Click here for the article.) This argument is still more or less true, but risks are growing as well.

First, in the year through September, primary expenditure growth has been outpacing tax revenue growth in inflation-adjusted terms (Table 5). We've seen a slowdown of sorts in primary expenditures in September by our favorite gauge (Graph 11), but this is likely to be temporary, whereas slowdown in tax revenue growth is likely to prove permanent, because of a weaker economy.

TABLE 5

Central Government Budget: 2015-2017
(in billion TL; unless otherwise indicated)

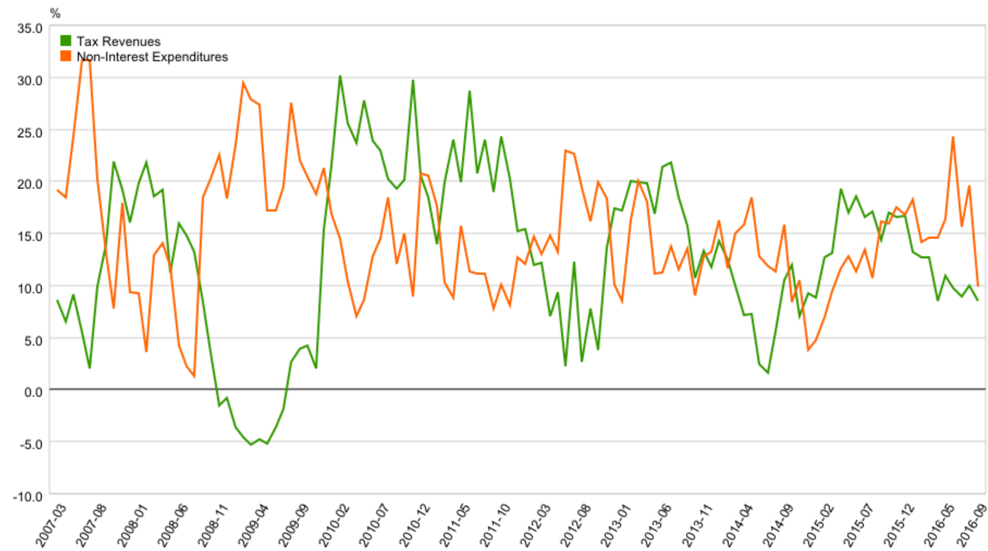
	Jan. - Sep.		Real growth (%)	2015	2016		2017
	2016	2015		Act.	Budget	Official Estimate	Budget (draft)
Central Government Revenues	404.5	354.2	5.9	482.8	540.8	546.5	598.3
as % of GDP	...	...	...	*24.7*	*24.5*	*25.4*	*24.9*
o/w: General Budget Revenues	389.4	340.4	6.1	464.2	528.3	...	...
Tax Revenues	329.0	298.3	2.3	407.8	459.2	450.0	511.1
as % of GDP	...	...	...	*20.9*	*20.8*	*20.9*	*21.3*
o/w: Tax on Income	100.4	86.4	7.7	119.1	135.7	...	155.1
Income Tax	69.4	61.9	3.9	85.8	98.9	...	108.9
Corporation Tax	31.0	24.5	17.4	33.4	36.8	...	46.2
Tax on Goods and Services	136.7	122.7	3.3	167.1	183.8	...	212.3
o/w: VAT	38.6	34.5	3.8	46.4	51.2	...	57.1
SCT	85.7	77.4	2.6	105.9	116.3	...	136.4
Tax on Foreign Trade	60.2	59.5	-6.2	83.2	96.7	...	96.8
Non-Tax Revenues	75.5	55.9	25.2	75.0	81.7	96.5	87.2
Expenditures	416.5	367.7	5.0	506.3	570.5	581.1	645.1
as % of GDP	...	...		*25.9*	*25.8*	*27.0*	*26.8*
Non-Interest Expenditures	374.8	322.9	7.6	453.3	514.5	529.6	587.6
as % of GDP	...	...	...	*23.2*	*23.3*	*24.7*	*24.4*
o/w: Personnel (inc. soc. sec. premiums)	132.2	110.6	10.9	146.1	172.7	175.8	189.8
Current Transfers	167.5	138.8	11.9	182.7	217.7	223.0	249.3
o/w: Social Security	85.1	65.6	20.3	83.2	106.1	...	...
Local Administrations	38.3	34.4	3.4	46.1	52.7	...	...
Investment	33.1	35.5	-13.5	67.6	59.3	66.3	77.1
Interest Expenditures	41.7	44.8	-13.7	53.0	56.0	51.5	57.5
as % of GDP	...	...	...	*2.7*	*2.5*	*2.4*	*2.4*
Overall Balance	-12.0	-13.5	...	-23.5	-29.7	-34.6	-46.9
as % of GDP	...	...	...	*-1.2*	*-1.3*	*-1.6*	*-1.9*
Primary Balance	29.6	31.3	...	29.5	26.3	16.9	10.6
as % of GDP	...	...	...	*1.5*	*1.2*	*0.8*	*0.4*
Memo items:							
Primary Balance (IMF Definition)	-1.4	15.4	...	9.4	1.3	-20.2	-13.7
as % of GDP	...	...	...	*0.5*	*0.1*	*-0.9*	*-0.6*
GDP (official figure for 2016 and 2017, act. otherwi	...	...	...	1,953	2,207	2,148	2,404

Source: Ministry of Finance, Turkey Data Monitor, MTP 2017-2019.

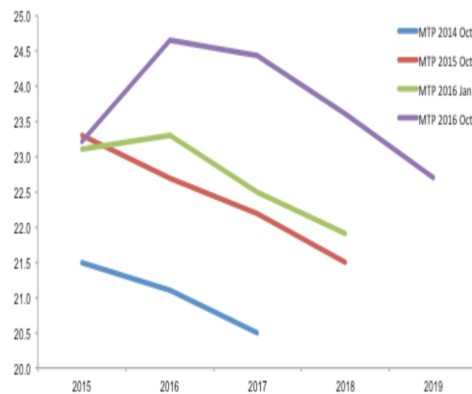
Second, we are seeing time and again that the government can't control primary expenditures, which has driven the IMF-defined primary balance to negative territory. This is most vividly seen through a comparison of MTPs over the past two years: notice how primary expenditure rise and the primary balance deteriorates (as a percent of GDP) over the span of a few MTPs (Graph 12).

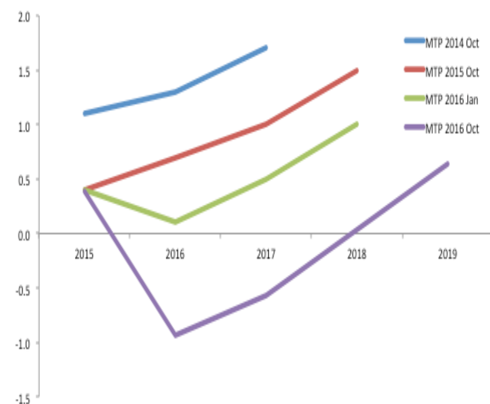
Finally, the positive headline figures are largely attributable to the resilience on the revenue side, but that comes with some caveats, too. For one thing, the significance of one-off revenues has been increasing, and is unlikely to continue at this pace. (As of September, the latter had reached some TL37 billion in 12-month rolling terms, compared to historic averages of some TL15-20 billion.) Moreover, the budget is often assisted by restructuring of various tax and premium debt – in fact another scheme is now in the works – which saves the day, yet at the expense of distorting incentives in the long-term, for timely compliance and payment of tax obligations.

GRAPH 11



GRAPH 12





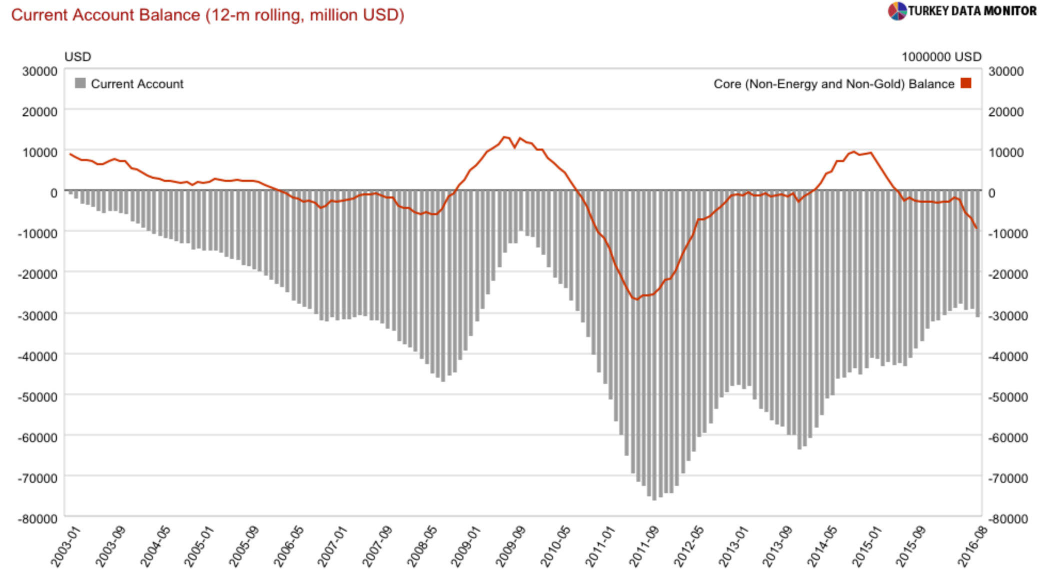
The good news is that none of this constitutes a major threat to debt sustainability in the immediate term. Central government debt to GDP stood at 35% at end-June and we estimate that it will be around these levels by the end of this year. It takes multiple shocks all impinging at once to destabilize public debt dynamics in Turkey's circumstances (like higher real rates, lower growth, negative primary balance and so on all taking place at once), which, of course, is good news.

Then again, this is not just about debt dynamics. The combination of a sub-2% of GDP overall central government deficit and a sizeable primary surplus has been a central feature – and an anchor of sorts -- of Turkish macroeconomics, the loss of which would send all the wrong signals to investors. Moreover, a looser fiscal policy would arguably contribute to the worsening of Turkey's twin imbalances, rather than helping to curb them.

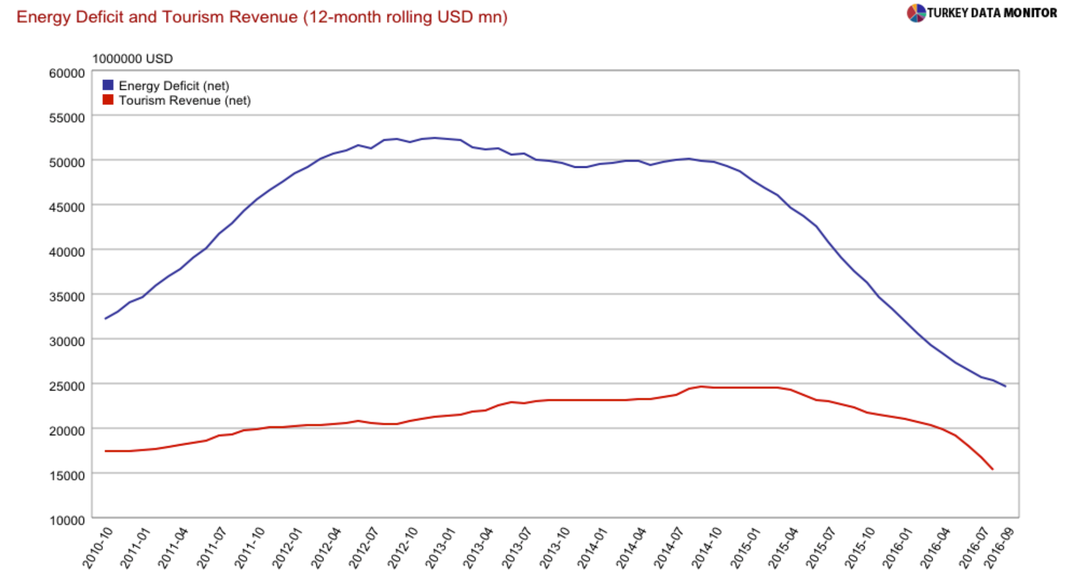
External Developments and the Real Exchange Rate

Twelve-month rolling CAD stood at some $31 billion in August, pointing to a relatively sizeable $3-$3.5 billion widening since May, as the deterioration in core deficit (overall less energy and gold) mainly on the back of sharply falling tourism revenue, more than offset the continued improvements in the energy bill (Graphs 13-14).

GRAPH 13



GRAPH 14



More recent trade data (actual for September and preliminary for October), combined with projected weakness in tourism revenue for the two remaining peak months of tourism, suggest that the CAD will likely edge up further to some $34 billion in October, before ending the year at around this level (Table 6).

It is worthwhile observing that this is a slightly higher CAD level than in 2015, but with a fairly different composition, of a markedly larger core deficit (estimated at $13 billion in 2016 vs. $3 billion in 2015) offset by a lower energy bill, at some $24 billion, down from around $33 billion. As for 2017, we forecast the CAD to persist at around these levels, as core deficit improves somewhat on the back of a modest recovery in tourism, but is more than offset by gold trade turning into a modest deficit from a relatively sizeable surplus. Energy deficit remains broadly unchanged, at $26 billion.

TABLE 6

Current Account Balance: 2013-17
(US$ billion)

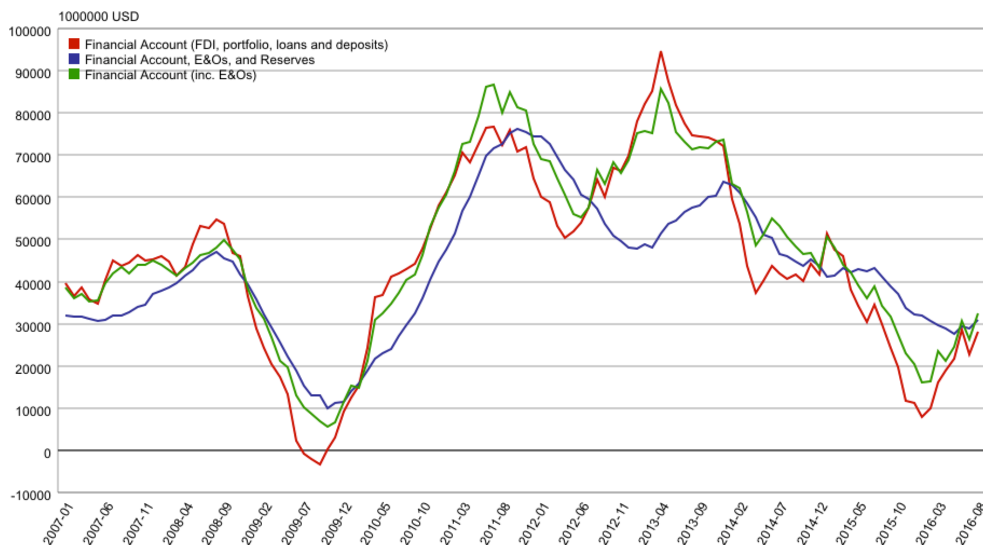
	2013	2014	2015	2016 (f)	2017 (f)
Current Account	-63.6	-43.6	-32.2	-33.9	-36.1
as % of GDP	-7.7	-5.5	-4.5	-4.8	-5.0
Merchandise Trade (BOP def.)	-79.9	-63.6	-48.2	-42.2	-48.9
as % of GDP	-9.7	-8.0	-6.7	-6.0	-6.8
Exports (f.o.b.; TURKSTAT def.)	151.8	157.6	143.8	142.6	143.5
y/y, %	-0.4	3.8	-8.7	-0.8	0.6
o/w Energy	6.7	6.1	4.5	3.1	3.1
Gold	3.3	3.2	7.4	7.9	4.8
Imports (c.i.f.; TURKSTAT def.)	-251.7	-242.2	-207.2	-202.8	-211.1
y/y, %	6.4	-3.8	-14.4	-2.2	4.1
o/w Energy	-55.9	-54.9	-37.8	-27.5	-29.4
Gold	-15.1	-7.1	-3.4	-4.7	-6.0
Services	23.7	26.8	24.1	15.3	19.0
as % of GDP	2.9	3.4	3.4	2.2	2.7
o/w Travel (net)	23.2	24.5	21.2	14.1	16.4
Income	-8.6	-8.1	-9.5	-8.6	-7.8
as % of GDP	-1.0	-1.0	-1.3	-1.2	-1.1
Current transfers	1.2	1.4	1.3	1.6	1.6
as % of GDP	0.1	0.2	0.2	0.2	0.2
Memorandum items:					
Non-Energy/Non-Gold Current Account Balance	-2.6	9.1	-2.9	-12.8	-8.5
Merchandise Trade Balance (TURKSTAT def.)	-99.9	-84.6	-63.4	-60.1	-67.7
Energy	-49.2	-48.8	-33.3	-24.4	-26.3
Gold	-11.8	-3.9	4.0	3.3	-1.2
Non-Energy/Non-Gold	-38.9	-31.9	-34.0	-38.9	-40.1
Oil Price (Brent, p/b, avg.)	108.7	99.0	52.4	43.8	50.0
%	-2.6	-8.9	-47.1	-16.5	14.3

Source: CBT; TURKSTAT; our calculations

On the financing side, the picture through August has been somewhat mixed. On the one hand, there is a pick-up in total inflows. The 12-month rolling inflows (FDI, portfolio and other investment all combined) recovered to $28 billion, from a low of some $8 billion earlier this year. The recovery appears primarily driven by (a return of) portfolio flows and stepped-up borrowing by corporates, while all other flows including FDI remain relatively weak. Central bank reserves have also recovered to positive territory in 12-month rolling terms, from a deficit of $15 billion, even though a good chunk of this seems driven by a transfer of F/X liquidity from commercial banks to the CBRT (Graphs 15-16). The bad news is that these flows are unlikely to strengthen further, which will be just enough for Turkey to muddle through.

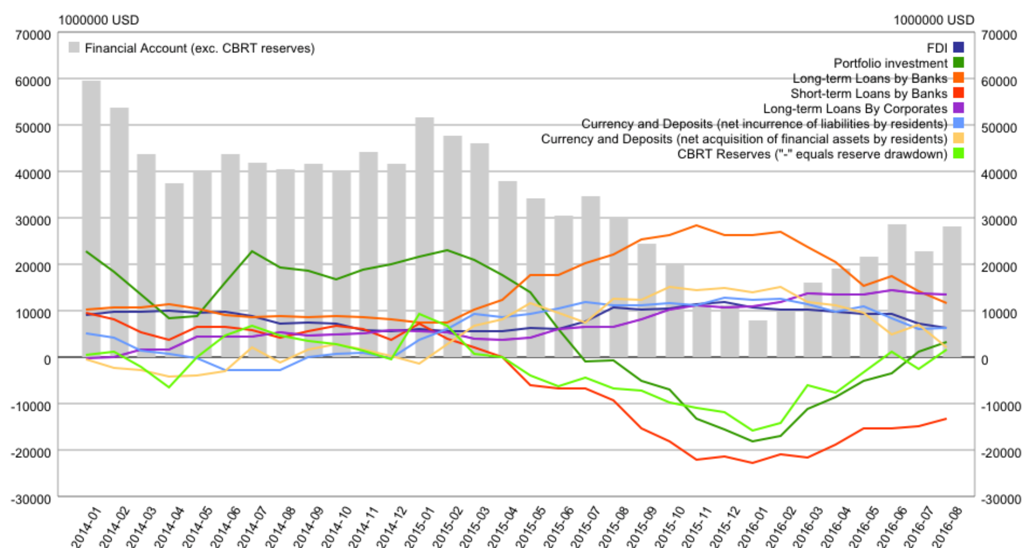
GRAPH 15

Capital Inflows (12-month rolling)



GRAPH 16

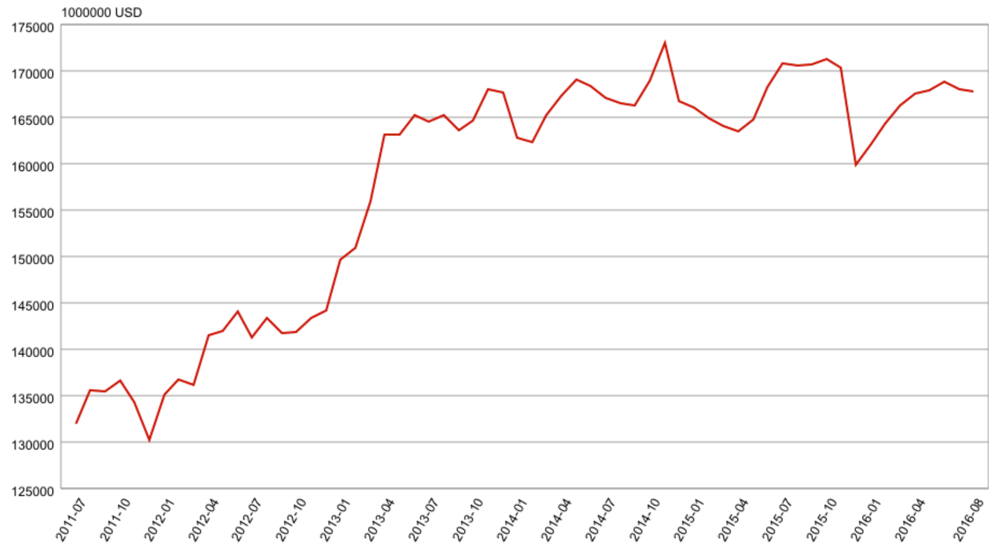
Financial Account: Selected Items (12-month rolling)



Turkey's short term external debt (by remaining days to maturity) has been relatively stable in recent period, at around $165-$170 billion (Graph 17). Combined with a working figure of some $35 billion CAD, this makes a relatively large financing requirement, of over $200 billion or almost 30% of GDP. This is not a trivial number, but the usual argument applies: assuming no major shock – or the perfect storm scenario we have noted in the introduction – it should be financeable through a combination of short-term portfolio and deposit inflows, as well as relatively longer term corporate borrowing. Then again, the figure vividly reminds us where the country's biggest constraint lies and how little room Turkey has for complacency.

GRAPH 17

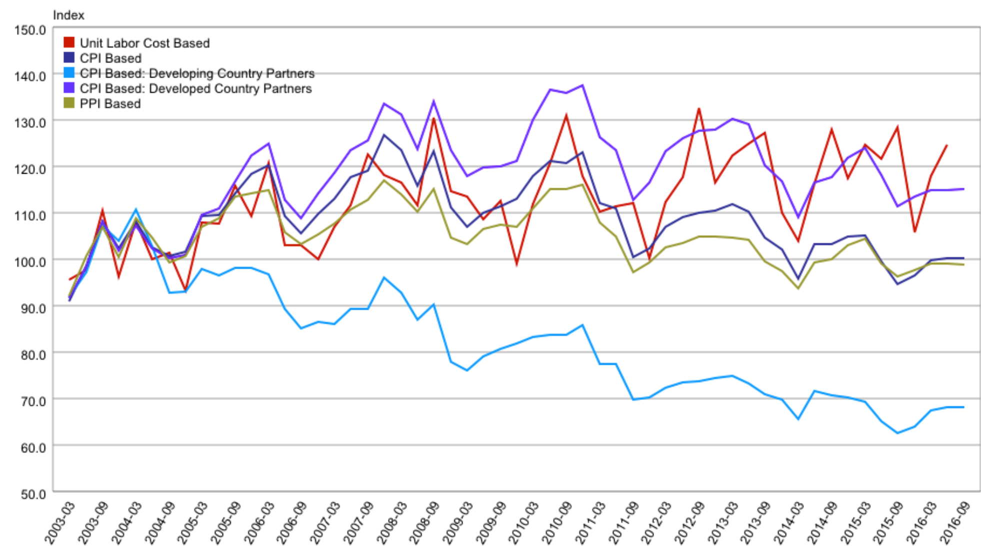
Short Term External Debt Due (By Remaing Days to Maturity)



The real exchange rate is “fairly valued” by some indicators. As of October, for instance, the CPI-based REER stood at less than 100 (98.5), which is some 10-15% lower than its average of the past 10-15 years. But other metrics such as the ULC-based index and the developed country sub-component of the REER suggest a very different -- and a much less competitive – picture (Graph 18). As importantly perhaps, a combination of messy politics, a pro-growth monetary policy and a high external financing requirement does not bode well for the lira. We thus see lira weakness, at least in nominal terms, continuing in the period ahead, the fairly low level of the REER index notwithstanding.

GRAPH 18

Real Effective Exchange Rate: Alternative Indicators (2003=100)



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