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Turkey: an economic hot spot

Turkey is consolidating its entry into the one-digit inflation mode. In the first months of 2005, year-on-year inflation stood at somewhat above 8%. Had it not been for the rising oil and transport prices, the rise in the consumer price index would have been even less: around 7%. In common with many other countries, it is to be observed that relatively high, yet declining inflation does not of necessity hamper vigorous GDP growth. This year the Turkish economy will in all likelihood record a lower growth rate than in 2004; however, growth will still be significantly higher than 5%. Last year, a marked rise in the demand for durable consumer goods boosted consumption, a major contributory factor being the introduction of a new regulation encouraging households to replace their old cars with new. That type of consumption boom is now past; moreover, the demand for fixed capital investment slowed down. Overall industrial output increased by 6.2% in the first quarter of 2005; manufacturing output by 5.6%. Within the latter sector, the output of leather, textiles and clothing diminished, whereas the output of mineral products, optical instruments, wood processing, electrical and transport equipment experienced a marked increase. Growth has had a minimal impact on employment levels; increased growth derives mainly from a higher rate of labour productivity. New entrepreneurs are now rapidly entering the market; in the first five months of 2005, over 40.000 new businesses opened up and some 12,000 closed down.[1]

Foreign trade expansion remained robust. According to balance of payments statistics, in the first four months of 2005 exports rose by 15.5% in euro terms, imports by 16.8%. The growth in exports was mostly attributable to increased exports of machinery, appliances and transport equipment. The greater competition from China notwithstanding, even textile exports rose significantly. As for imports, the demand for transport equipment dropped. Export revenues covered about three quarters of import expenditures. In the first four months of 2005, the deficit in the current account amounted to EUR 6.8 billion compared to 5.7 billion the year previous. The current account gap was not bridged by the inflow of foreign direct investment (some EUR 500 million), but by inflows of portfolio investment (EUR 2.2 billion) and other investment (EUR 4.5 billion). The latter inflows were also the main factor contributing to the EUR 1.9 billion rise in the country's currency reserves as indicated by the balance of payments for the period January-April 2005.

The latest edition of the central bank's quarterly monetary policy report stresses that over the period March 2004 to February 2005, Turkey attracted some EUR 15 billion in short-term financial investments or more exactly EUR 11 billion allowing for cash inflow

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1 Union of Turkish Chambers and Commodities Exchanges (TOBB).

registered as net error and omissions. Some EUR 8 billion of the total inflow comprised investments by foreigners, whereas the other EUR 7 billion were withdrawals from accounts held abroad by Turkish citizens. Most of this inflow, EUR 9 billion, entered Turkey during the period December 2004 to February 2005 reflecting the market's response to the news that broke December about the EU accession negotiations being scheduled to start on 3 October 2005.

A number of factors heighten the attractiveness of Turkey in terms of capital inflows: greater confidence in the country's positive macroeconomic prospects stemming, for example, from the government's strict budgetary discipline and a less vulnerable banking system; larger foreign currency reserves; and high nominal interest rates in tandem with expectations of continued exchange rate stability or even some nominal appreciation. Interest rates, such as the central bank's overnight rates or those in the secondary GDI market, range between 15 and 20%. By whatever reason, in the aftermath of the French EU referendum, the Turkish lira came under appreciation pressure, compelling the central bank to intervene repeatedly in order to 'halt excessive volatility'.

It is the inflow of short-term financial investment which covers the greater part of the current account deficit. Some analysts regard such 'hot money' inflow as a source of rising vulnerability, whereas others consider it as indicative of improving financial markets. From this latter point of view risks will remain within limits as long as fiscal and monetary policies avoid major mistakes. A completion of the banking sector reform reinforcing prudent banking rules could add to the economy's predominantly positive prospects. Throughout 2005 and 2006, slower inflation and high GDP growth are likely to continue. In spite of some deceleration, the latter most likely will remain above 5% annually. The exceptional boost in private consumption ground to a halt in the course of 2004, whereas the regular consumption growth is restrained by real wages close to stagnation and a lack of perceptible growth in employment. In all probability, GDP growth will remain predominantly based on increases in productivity. The unemployment rate will remain at its current level: around 10%. Foreign trade will continue to expand as the economy opens up still further. Commodity trade and current account deficits will remain high, as the adverse impact of liberalizing the textile markets may not be fully offset by the increase in exports of machinery, instruments and transport equipment.

The government will maintain its policy of budgetary restraint. Apart from that it will be preoccupied with all kind of political problems as it endeavours to come up to the expectations voiced by both the IMF and the EU. Although the deregulation of major companies such as Tüpraş (oil refinery), Erdemir (steel production) and the state-owned tobacco company run by Tekel is on the government's agenda, it will not be such a simple task.

In order to ensure that EU accession negotiations do start as planned on 3 October 2005, Turkey still has to sign a document pertaining to the adjustment of the customs union it has entered into with the EU: it will have to be extended in scope so as to include the new EU member states. This adjustment protocol, which will have to be completed in the course of the summer, will constitute, implicitly at least, some kind of recognition of the Greek Cypriot government. Although Turkey has declared its willingness to sign the protocol, the exact wording might still pose a problem. The EU Commission is supposed to issue an outline for the negotiations, on the basis of which the talks on Turkey's membership will be conducted. By the time negotiations begin, the Council of Europe will have had to accord the document official recognition.

To sum up, throughout 2005 and 2006, slower inflation and high GDP growth are likely to continue. Economic growth will be slower than in 2004; most likely, however, it will remain above 5% annually. Commodity trade and current account deficits will remain high. The manner in which these deficits are being funded offers some cause for concern. Despite the positive aspect of the exchange rate having stabilized, nominal appreciation in the wake of large capital inflows would give rise to an economically unsound situation. The emergent risk factor is the outcome of relatively high interest rates and improved economic fundamentals.

Table TR

Republic of Turkey: Selected Economic Indicators

	2000	2001	2002	2003	2004 [1]	2004	2005	2005	2006
						1st quarter		forecast	
Population, th pers., mid-year [2]	67469	68618	69757	70885	72003	.	.	72003	73109
Gross domestic product, YTL mn, nom.	124583	178412	277574	359763	430512	81166	.	492900	553800
annual change in % (real)	7.4	-7.5	7.9	5.8	8.0	11.8		6	6
GDP/capita (EUR at exchange rate)	3210	2372	2776	3004	3375	.	.	.	.
GDP/capita (EUR at PPP)	6260	5570	5950	6250	6750	.	.	.	.
Gross industrial production									
annual change in % (real)	6.0	-7.5	9.4	7.8	9.8	10.4	6.2	6	8
Gross agricultural production									
annual change in % (real)	3.9	-6.5	6.9	-2.5	2.0	2.7	.	.	.
Construction industry									
annual change in % (real)	0.2	-10.6	-6.1	-9.0	4.6	12.7	.	.	.
Consumption of households,YTL mn, nom.	89098	128513	184420	239586	284631	59746	.	.	.
annual change in % (real)	6.2	-9	2.1	6.6	8.3	12.4	.	7	7
Gross fixed capital form., YTL mn, nom.	27848	32409	46043	55618	76722	13507	.	.	.
annual change in % (real)	16.9	-31.5	-1.1	10.0	35.0	57.6	.	25	15
LFS - employed persons, th, avg.	20557	20492	21463	21147	21791	19902	20838	.	.
LFS - employed pers. in agricult. th, avg.	7176	8105	7623	7390	7414	6412	.	.	.
LFS - employed pers. in industry th, avg.	3731	3767	3913	3821	3955	3844	.	.	.
LFS - employed pers. in services th, avg.	9650	9647	8969	9127	9316	8924	.	.	.
LFS - unemployed, th pers. average [3]	1449	1905	2473	2493	2498	.	2750	.	.
LFS - unemployment rate in %, average	6.5	8.4	10.3	10.5	10.3	12.4	11.7	10.8	11
Reg. unemployment rate in %, average	3.3	3.2	1.9	2.5	.	.	.	.	.
Average nom. wages (YTL/Hour)	1.48	1.95	2.68	3.30	.	.	.	.	.
annual change in % (real)	0.8	-14.6	-5.4	-1.9	2.5	0.4	.	.	.
Consumer prices, % p.a.	54.9	54.4	45.0	25.3	10.6	9.5	8.6	8	6
Wholesale prices in manufacturing, % p.a.	56.1	66.7	48.3	23.8	11.1	8.6	10.9	.	.
Government budget, % GDP									
Central government revenues	26.7	29.0	27.5	27.9	25.6	29.6	.	.	.
Central government expenditures	37.4	45.1	41.6	38.9	32.6	38.3	.	.	.
General governm. deficit (-) / surplus (+) [4]	-11.9	-16.2	-12.6	-8.6	-7.0	-8.7	.	.	.
Public debt in % of GDP	53.8	100.4	88.8	83.3	.	.	.	.	.
Discount rate % p.a., end of period	60.0	60.0	55.0	43.0	.	.	.	.	.
Current account, EUR mn	-10670	3798	-1603	-7120	-12506	-4293	-4893	-14000	-17000
Current account in % of GDP	-4.9	2.3	-0.8	-3.3	-5.1	-8.8	.	-5	-5
Gross reserves of CB, excl. gold, EUR mn	24095	21050	26902	28430	27657	.	.	.	.
Gross external debt, EUR mn	129107	127620	137229	128901	130143	.	.	.	.
FDI inflow, EUR mn	1855	3684	621	367	2199	556	546	.	.
FDI outflow, EUR mn	788	25	5	7	691	152	96	.	.
Exports of goods, BOP, EUR mn	33385	38484	42203	45365	53909	11478	13626	62000	71300
annual change in %	22.8	15.3	9.7	7.5	18.8	10.9	18.7	15	15
Imports of goods, BOP, EUR mn	55673	42495	49557	57777	73159	15517	18429	84100	96000
annual change in %	54.5	-23.7	16.6	16.6	26.6	23.4	18.8	15	14
Exports of services, BOP, EUR mn	22130	17961	15570	16855	19334	2578	3078	.	.
annual growth rate in %	39.7	-18.8	-13.3	8.3	14.7	14	19.4	.	.
Imports of services, BOP, EUR mn	9776	7731	7271	7548	9056	1826	2162	.	.
annual growth rate in %	11.4	-20.9	-6.0	3.8	20.0	12.2	18.4	.	.
Average exchange rate YTL/USD	0.6252	1.2284	1.5095	1.4967	1.4253	1.3309	1.3249	.	.
Average exchange rate YTL/EUR (ECU)	0.5753	1.0963	1.4332	1.6894	1.7714	1.6670	1.7371	.	.
Purchasing power parity YTL/USD	0.2744	0.4301	0.6183	0.7451	0.7126	.	.	.	.
Purchasing power parity YTL/EUR	0.2950	0.4668	0.6689	0.8116	0.8857	.	.	.	.

Notes: 1) Preliminary. - 2) 2004 to 2006 SIS projections. - 3) Civilian Labour Force: unemployed. - 4) Based on the Public Sector Borrowing Requirement (PSBR) methodology including local public administraion, social security and enterprises under public administration.

Source: Central Bank of Turkey; State Institute of Statistics (SIS); State Planning Organization; Undersecretary of Treasury.