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Turkey: investment and construction boom

With third quarter figures on GDP growth amounting to 7%, growth for 2005 is now estimated to be just below the 6% mark. Private investment activity has continuously been speeding up through 2005 reaching an increase in the third quarter of 26.7% above the corresponding level in 2004. Taking the first nine months together, it emerges clearly that investment components of aggregate expenditure have been growing much more strongly than the consumption components (private consumption +6.9%[1], private investment +15.9%, public consumption +3.9%, public investment +32.7%) and furthermore that growth in imports (+10.1%) outstripped growth in exports (+5.8%). As regards sectoral developments, there was a relatively balanced pattern with agriculture growing at 4.5%, industry at 5.5%, services at 4.4% (with strong growth in trade of 5.8%); the exception was construction activity, which increased by as much as 19.7%. Hence we can speak of the Turkish growth performance being carried in 2005 by an investment and a construction boom.

As to the causes of this boom, to some extent one may still speak of a sustained recovery following the deep slump in the wake of the crisis in 2001 (the pre-crisis level of GDP was regained only in mid-2003). However, most commentators would agree that the recent developments – strong disinflation (bringing CPI inflation rate down to 7.7% by end-year 2005 from an average inflation rate of over 70% in the 1990s), a sustained and successful effort to reduce public debt levels (the gross public debt ratio to GDP declined from a peak of 107.5% in 2001 to 61.2% in 2005[2]) and general political stabilization through a strong government and the expected and then actual decision to start negotiations concerning EU membership – have sharply improved the underlying mood of domestic and international actors with respect to the sustained character of the Turkish growth performance.

The one worrying item in the overall performance is the apparent inability to increase (so far) the overall export-import ratio in goods trade, which amounted to 74.3% in 2004 (January-November) and fell to 70.5% (same period) in 2005.[3] This gap between the levels of exports and imports (and the continued discrepancy in their growth rates) is central to the discussion of whether the Turkish growth performance on its current path is sustainable. We take a relatively optimistic position on the pure trade side of the current

1 All growth figures refer to growth in the first nine months of 2005 over the same period in 2004.

2 The central government budget deficit declined from 15.2% in 2001 to 7.1% in 2004 and to 2.8% in 2005 (the last figure is an estimate given data until November 2005). Interest payments on public debt declined from 23.3% of GDP in 2001 to 7.1% in 2004 and 2.8% in 2005 (again an estimate).

3 Given the substantial surplus in services trade (mostly in tourism) this ratio increases for overall goods and services trade to 90.5% in 2004 and 86.4% in 2005.

account which could be seen as a typical feature of a catching-up economy which is in the process of upgrading its production capacities (industry experiences fast productivity growth and there is evidence of upgrading in export structures; see below). However, the greater concern exists with regard to developments in the international financial accounts: over the period January-November 2005, a record high capital inflow of USD 36.7 billion was observed. Of this total, USD 6.3 billion was in the form of foreign direct investment (i.e. only 17% of the inflows), USD 11.2 billion was through portfolio investment and USD 19.2 billion in the form of other investments. Half of the inflow through the portfolio investment account stems from the net purchases of foreigners in the domestic equity market, the rest went into net purchases of domestic bonds and treasury bills and euro-bond issues by the Treasury. Of the total inflows through the other investments account, USD 9.8 billion was through the banking sector mainly due to the loans received from abroad; the other sectors (mainly corporate sector) account for a further USD 12.1 billion, mainly through trade and other credits they acquired from abroad.

As a result of these developments, the current account deficit (which amounted to USD 18.7 billion during the period January-November 2005) was financed by a capital inflow of USD 36.7 billion and a positive balance of USD 3.8 billion in the net errors and omissions account. There were USD 4.9 billion net repayments to the IMF and hence the official reserves increased by USD 14.5 billion over the period. The picture which presents itself is thus a massive capital inflow in the context of government policy which is committed to reducing inflation, with nominal interest rates coming down (e.g. interest rates on government debt instruments, GDI, have come down from 20.3%[4] at the beginning of 2005 to 13.8% at the end of the year) and – resulting from the capital inflow – a nominal appreciation of the currency (by 12.9% vis-à-vis the euro in 2005). The remaining considerable nominal interest rate differential between domestic and international loans encourages borrowing from abroad by the private sector which in turn accounts for a substantial share of foreign capital inflows. Monetary policy finds itself in a difficult position, trying to stem some of the exuberant items of private expenditure (on consumer durables, on construction activity and in the housing market) through a relatively cautious interest rate policy, but this maintains the attractiveness to borrow abroad, hence enhances capital inflows and exchange rate appreciation with detrimental effects on the possibility to reduce the import-export gap. A shock in the form of a further rise in the oil price or falling tourism income in the wake of the birds flu epidemic could severely test the inherent vulnerability of this situation.

Apart from the above-discussed developments on international financial accounts, tendencies in the real economy are very promising. There were strong increases in manufacturing labour productivity, which resulted in a constantly high growth rate of exports

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[4] Refers to the interest rate of the most actively traded bond on the secondary market.

despite a pronounced appreciation of the new Turkish lira. The widening trade deficit is mostly due to imported intermediates and capital goods and to a lesser extent due to increased consumption expenditures on imports. Hence the current account deficit is now tied to strong increases in investment rates, which leads some analysts to interpret the current account deficit (6.2% of GDP in 2005) as an expression of economic strength since it reflects faster productivity-driven output growth relative to Turkey's main trading partners.

The trade to GDP ratio (which stands now at 50%) has been marked by the increased openness of the Turkish economy over the past five years (trade to GDP ratios had earlier moved from 23% in 1990 to 40% in 2000). The EU remains by far the most important trading partner, however, increasingly also other markets are targeted. In 2000, the Turkish government initiated a trade development strategy with neighbouring countries with the aim to take advantage of Turkey's location as a local hub in the region. Trade among Turkey and these countries has more than doubled over the past four years. Asian markets were targeted in a similar strategy starting in 2005, and the strategy plans for the year 2006 to increase Turkish presence in the US market, which currently accounts for about 6% of Turkish exports. There is a clear trend (supported by a number of policies) towards higher-quality export products which is seen as a major challenge for Turkish exporters. There is also a shift away from traditional export goods, such as textiles and clothing. While still being the primary export category, the industry's share in total exports is decreasing. In 2005 the textile industry had to stand up against fierce competition from China and other previously quota-constrained exporters. This was primarily felt through rapid import increases on the domestic market, leading to output falls despite special safeguard measures taken up against China. Due to increased market opportunities in the US market, textile exports expanded in absolute terms in 2005. The diversification of Turkish exports is reflected in the rise in exports of transport equipment, which has become the second most important export category. Favourable developments were further observed in chemical and electronic goods (above all household appliances).

2005 has been characterized by high privatization revenues from selling to both Turkish and foreign investors. The last months of the year brought two major deals. One of the largest deals of the entire year 2005 was the takeover of Turkey's second largest mobile phone operator Telsim by the British Vodafone Group. Vodafone paid more than EUR 3.5 billion and will invest an additional EUR 1.2 billion. A further big deal was struck in the steel industry where Erdemir, Turkey's largest steel producer, which was acquired in September by the Turkish OYAK group (operating in diverse fields such banking to automobiles), was partially sold to Arcelor.

Total privatization revenues for the year 2005 are estimated to be around EUR 14 billion, to which also smaller, domestic investments contributed a notable share.[5] Outward investment has also increased compared to the previous year through a range of smaller deals, such as the opening up of the first Koç's Edward's (high fashion) store in Moscow and the takeover of a German ceramic tile manufacturer by Eczacıbaşı Building Materials Division.

As far as the outlook is concerned, we take as central forecast for 2006 and 2007 a continuing growth rate in GDP of about 6%, but point to the important vulnerability of such a projection in the short to medium term based on the evidence presented above regarding the high international borrowing activity by the private sector which puts pressure on the nominal exchange rate and the current account. An external shock in the form of a further sharp increase in the oil price, perceptions of a conflict potential in the Middle East or a scare in relation to the birds flue epidemic, which might affect Turkey's substantial reliance on tourism income, could lead to a reversal of short-run international capital movements, thus affecting credit conditions and further investment activity.

[5] For example, the tourism sector experienced a bout of privatization. The Istanbul Hilton hotel was sold to Aydin Doğan, owner of the English newspaper *Turkish Daily News* and Turkey's biggest media owner for EUR 205 million. Further, a Turkish joint-venture group (Tahinicioğlu-Nida-M.V.) acquired the Büyük Efes hotels in Izmir from the state retirement pension fund for EUR 97.6 million while the Büyük Efes hotels in Ankara went to Çelikler İnşaat A.Ş. for roughly EUR 30 million.

Table TR

Republic of Turkey: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 [1)]		2006	2007
									forecast	
Population, th pers., mid-year [2)]	66350	67420	68365	69302	70231	71152	72065		.	.
Gross domestic product, YTL mn, nom.	77415	124583	178412	277574	359763	430511	491000		544000	603000
annual change in % (real)	-4.7	7.4	-7.5	7.9	5.8	8.9	5.8		6.0	6.0
GDP/capita (EUR at exchange rate)	2626	3211	2386	2799	3028	3416	4070		.	.
GDP/capita (EUR at PPP - wiiw)	5320	6000	5370	5650	5810	6520	6830		.	.
Gross industrial production										
annual change in % (real)	-5.0	6.1	-8.7	9.4	7.8	9.3	5		.	.
Gross agricultural production										
annual change in % (real)	-5.0	3.9	-6.5	6.9	-2.5	2.0	5		.	.
Construction industry										
annual change in % (real)	-9.4	0.2	-10.6	-5.6	-9.0	4.6	20		.	.
Consumption of households,YTL mn, nom.	55928	89098	128513	184420	239586	284631	.		.	.
annual change in % (real)	-2.6	6.2	-9	2.1	6.6	10.1	7		.	.
Gross fixed capital form., YTL mn, nom.	16931	27848	32409	46043	55618	76722	.		.	.
annual change in % (real)	-15.7	16.9	-31.5	-1.1	10.0	32.4	18		15	15
LFS - employed persons, th, avg.	22048	21580	21524	21354	21147	21791	22138	I-IX	.	.
LFS - employed pers. in agricult. th, avg.	8856	7769	8089	7458	7165	7400	6872	I-IX	.	.
LFS - employed pers. in industry th, avg. [3)]	3784	3810	3774	3954	3846	3988	4203	I-IX	.	.
LFS - employed pers. in services th, avg.	9410	10001	9661	9942	10136	10403	11063	I-IX	.	.
LFS - unemployed, th pers. average [4)]	1830	1497	1967	2464	2493	2498	2467	I-IX	.	.
LFS - unemployment rate in %, average	7.7	6.5	8.4	10.3	10.5	10.3	10		9.7	9.3
Reg. unemployment rate in %, average	2.1	3.3	3.2	1.9	2.5	.	.			
Average gross wages (YTL/Hour)	0.95	1.48	1.95	2.68	3.30	.	.		.	.
annual change in % (real)	11.0	0.8	-14.6	-5.4	-1.9	2.5	.		.	.
Consumer prices, % p.a.	64.9	54.9	54.4	45.0	25.3	10.6	7.7		5.5	4.5
Wholesale prices in manufacturing, % p.a.	57.2	56.1	66.7	48.3	23.8	11.1	5.9		.	.
Government budget, % GDP										
Central government revenues	24.3	25.6	26.7	24.9	27.5	24.6	.		.	.
Central government expenditures	36.2	37.4	44.6	40.9	38.9	32.6	.		.	.
General governm. deficit (-) / surplus (+) [5)]	-15.7	-11.9	-16.2	-12.6	-8.6	-7.0	-3.0		-2.4	.
Public debt in % of GDP	52.7	68.8	106.4	92.7	82.7	77.1	61.2		54.8	.
Discount rate % p.a., end of period	60.0	60.0	60.0	55.0	38.5	25.0	13.8		11.0	.
Current account, EUR mn [6)]	-1264	-10663	3797	-1606	-7126	-12555	-18200		-21500	-23800
Current account in % of GDP	-0.7	-4.9	2.3	-0.8	-3.4	-5.2	-6.2		-6.5	-6.5
Gross reserves of CB, excl. gold, EUR mn	21798	24078	21042	28250	29812	28973	38275	XI	.	.
Gross external debt, EUR mn	97121	129107	127620	137229	128901	130143	137750		.	.
FDI inflow, EUR mn [6)]	765	1854	3685	1205	1816	2604	7200		.	.
FDI outflow, EUR mn [6)]	28	787	25	145	303	370	800		.	.
Exports of goods, BOP, EUR mn [6)]	27125	33362	38469	42229	45344	53873	61000		72000	86000
annual change in %	0.2	23.0	15.3	9.8	7.4	18.8	14		18	20
Imports of goods, BOP, EUR mn [6)]	35689	55145	41572	48476	55532	70344	84000		101000	121000
annual change in %	-6.3	54.5	-24.6	16.6	14.6	26.7	20		20	20
Exports of services, BOP, EUR mn [6)]	15800	22115	17954	15579	16872	18448	21000		.	.
annual growth rate in %	-24.4	40.0	-18.8	-13.2	8.3	9.3	15		.	.
Imports of services, BOP, EUR mn [6)]	8759	9769	7728	7276	7556	8162	9000		.	.
annual growth rate in %	-2.5	11.5	-20.9	-5.9	3.8	8.0	16		.	.
Average exchange rate YTL/USD	0.4178	0.6250	1.2253	1.5077	1.5003	1.4253	1.3443		.	.
Average exchange rate YTL/EUR (ECU)	0.4443	0.5755	1.0940	1.4307	1.6918	1.7714	1.6745		1.65	1.65
Purchasing power parity YTL/USD	0.1917	0.2711	0.4240	0.6115	0.7524	0.7930	0.8301		.	.
Purchasing power parity YTL/EUR	0.2193	0.3081	0.4859	0.7084	0.8817	0.9277	0.9977		.	.

Notes: 1) Preliminary. - 2) 2004 and 2005 SIS projections.- 3) Mining and Quarrying,, Manufacturing, Electricity, Gas and Water.- 4) Civilian Labour Force: unemployed. - 5) Based on the Public Sector Borrowing Requirement (PSBR) methodology including local public administraion, social security and enterprises under public administration. - 6) Converted from USD.

Source: CBRT-EDDS (Central Bank of Turkey, Electronic Data Distribution System), SIS (State Institute of Statistics), SPO (State Planning Organization), UT (Undersecretary of Treasury), Eurostat.