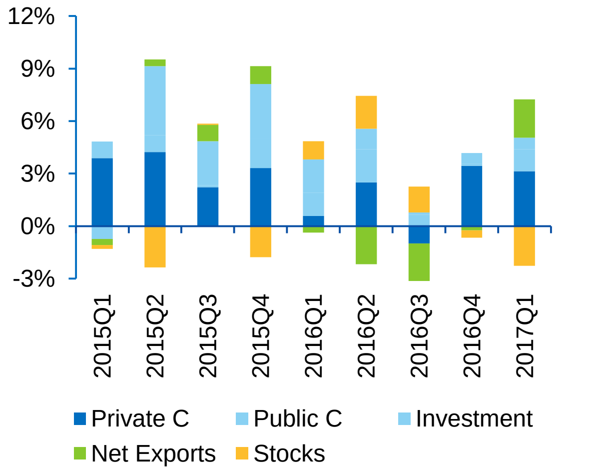
3. Turkey Economic Outlook

Economic activity remained strong in 2Q

Economic activity strengthened yet for another quarter, and Turkey GDP grew by 5% in 1Q thanks to the acceleration in net exports, robust public spending as well as a still solid growth rate in private consumption growth. Government stimulus seems to have helped households wipe out the negative effects of the volatility in the financial market throughout the quarter and has engaged the private sector in the recovery of the business cycle. In addition to the solid performance in private consumption, robust government expenditure led the overall consumption contribution to reach 4.4pp in this period. **Private investment remained weak**, which is particularly visible in the contraction of machinery investment. Specifically, the improvement in the services sector contributed to the production side of GDP growth with 3.5pp.

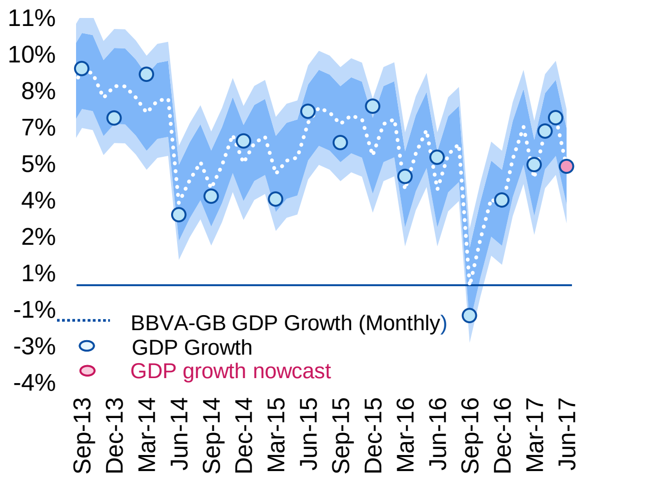
As economic activity strengthening above initial expectations, our monthly GDP indicator is also signaling a similar growth trend in 2Q with a growth level close to 5%. The unfavorable calendar effect due to the shift of the Ramadan holiday this year will somewhat slow-down economic activity; however, GDP growth might be even stronger in 2Q as industrial production (IP) has already risen by 5%, YoY in the April-May period. **Rapid credit growth thanks to the Government's Credit Guarantee Fund and intensified fiscal stimulus were the main factors behind the high momentum in 2Q.** If these factors finally materialise, the economic recovery will gain momentum in the second half of the year.

Figure 3.1 GDP Growth by Expenditure Composition (%, annual contribution)



Source: TURKSTAT, BBVA Research and Garanti Research

Figure 3.2 Garanti-BBVA Research Monthly GDP (3MA, YoY)



Source: BBVA-Garanti Research Monthly GDP Model, Turkstat

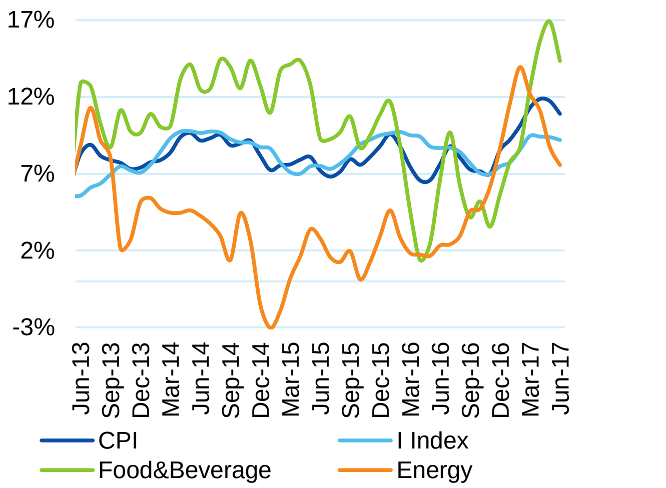
The strong growth performance and improvement in overall economic activity started to pay off in the labour market as well from the beginning of the year, and the unemployment rate fell gradually down to 11.3% (SA) in April from December's reading of 11.9%. Job creation was observed in all subsectors. The improvement in the service sector presented the most significant rise in performance among these sectors with an increase of around 320K in employment.

Inflation started to recede but only marginally

After reaching 11.3% in March, consumer inflation got to its peak of 11.9% in April. A favorable base impact on food inflation with a slight withdrawal in core prices and plummeting energy prices started to help the headline inflation by then, but the improvement has proved to be only marginal so far, as it reached 10.9% as of June.

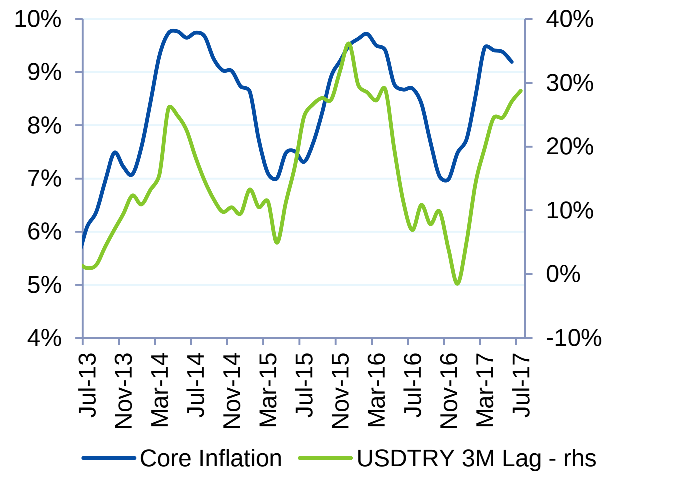
Food inflation and cost shocks, which are still alive and pushing up prices, stemming from the exchange rate pass-through continued being the prominent factors that kept inflation at high levels. Year-to-date food inflation climbed up to 8.9% in the first half of the year (vs. 0.3% during the same period last year), driving yearly food inflation to 14.6% by June. Meanwhile, core inflation eased only slightly to 9.2% due to the extension of tax cuts on durable goods and the methodological change assigning fixed weights to the clothing and footwear group. Despite the declining energy inflation on top of lower prices, **the trend in core inflation remained high due to second round effects of exchange rate depreciation, sticky service inflation on cost-push factors and the failure to contain inflation expectations** (at highest levels since December 2008).

Figure 3.3 Turkey: Annual Inflation



Source: TURKSTAT, BBVA Research and Garanti Research

Figure 3.4 Turkey: Core Inflation & USD/TRY (YoY)



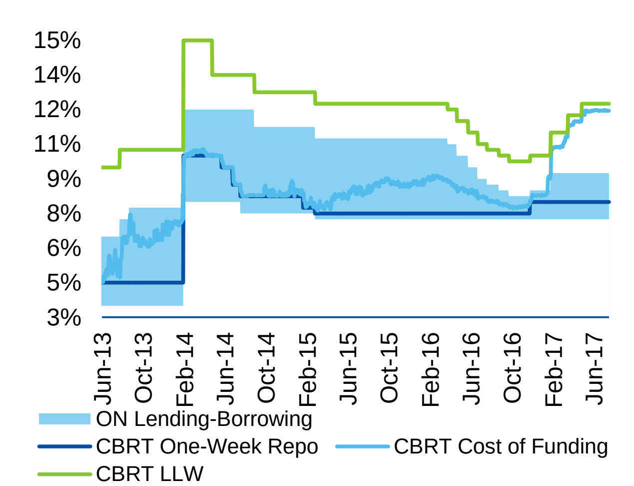
Source: TURKSTAT, BBVA Research and Garanti Research

Hawkish stance of the Central Bank against inflationary pressures

The high level of inflation and the volatility of emerging markets financial conditions stemming from uncertainties on the expected FED stance, led the CBRT to maintain its tight stance throughout 2Q. The Central Bank reinforced the hawkish tone in its June meeting by overlooking the expected disinflationary impacts of the fall in energy prices and partial correction in food prices in the summer months.

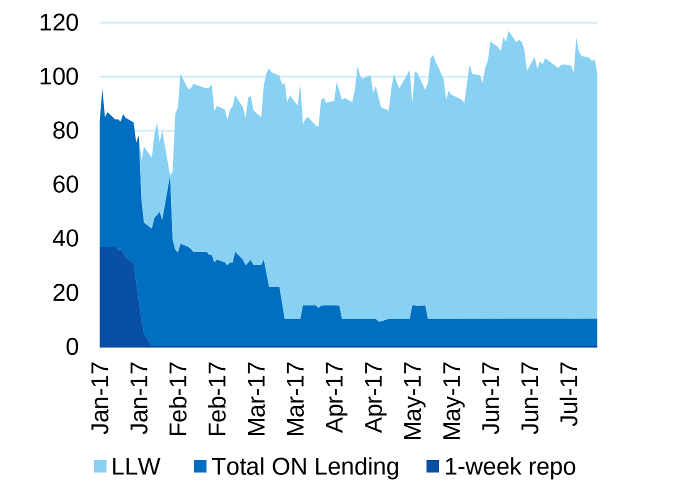
Since the third week of January, the CBRT has been funding the markets through a combination of O/N lending (9.25%) and the Late Liquidity Window (12.25%). Almost 90% of CBRT funding has been via the Late Liquidity Window (LLW) facility since the start of 2Q. This has made the LLW, once an extraordinary monetary policy tool, the most relevant interest rate in the CBRT's monetary policy framework. **So far this year, the CBRT has raised the average funding rate by 370 basis points, from 8.3% at the start of the year to almost 12% as of July, preventing the lira weakening any further.**

Figure 3.5 Turkey: CBRT Interest Rate Corridor



Source: CBRT, BIST, BBVA Research and Garanti Research

Figure 3.6 Turkey: CBRT Funding Composition, bn TL



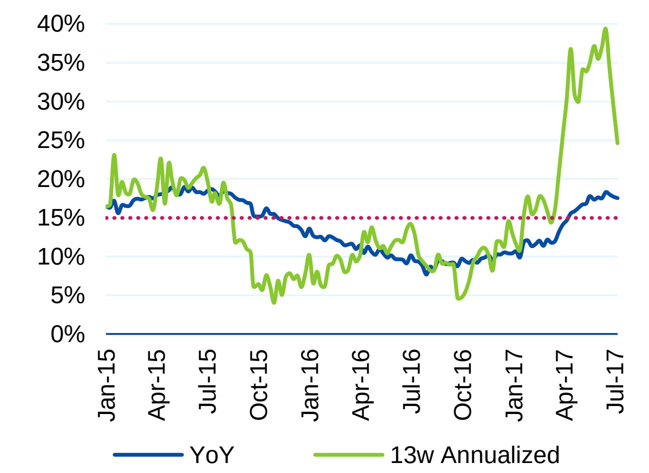
Source: CBRT, BBVA Research and Garanti Research

Thus, the CBRT managed to reduce the volatility of Turkish financial assets contributing to the stabilisation of the Turkish Lira at a level of 3.5-3.6 against the US dollar, **which was also supported by reduced political uncertainties after the referendum in April. As inflation and inflation expectations remain high, the need to maintain the tight monetary policy stance is reinforced until inflationary pressures clearly diminish.**

The positive risk appetite towards EMs was also supportive in 2Q. **The yield curve continued to be negatively sloped as a result of the high level of inflation and the CBRT's monetary tightening. Although inflation is expected to stay at double digits until the end of the year, still lower risk premiums (despite the deterioration) have kept the long end of the yield curve downward.** On the other hand, the more hawkish tone of global central banks since July has resulted in a sell-off in global bond markets, which has led the yield curve to shift upwards marginally at both ends in recent weeks.

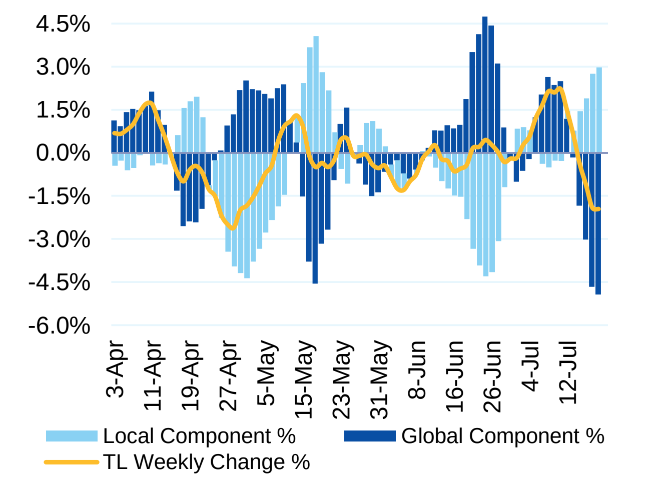
In order to boost economic activity, **the Turkish authorities implemented a Credit Guarantee Fund backed by the Treasury with a limit of up to TL250bn (around 9% of GDP).** So far roughly 160TL bn (6% of GDP) has been used, of which near 90% of the credits have been used by SMEs (mostly in manufacturing and service sector activities). There is still uncertainty about the final impact but credit growth reacted sharply and the FX adjusted loan growth rate accelerated significantly to 18% in June, from below 10% at the end of last year.

Figure 3.7 Turkey: FX Adjusted Total Credit Growth



Source: CBRT, BIST, BBVA Research and Garanti Research

Figure 3.8 Turkey: Exchange rate Global vs Local factors



Source: CBRT, BBVA Research and Garanti Research.

Procyclical measures continued to widen the budget deficit in 2Q17

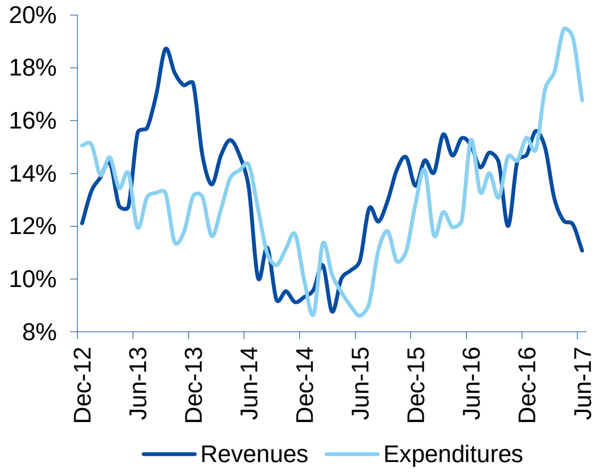
The Government continued to stimulate growth via procyclical measures, while revenue generation performance was only moderate in 2Q17 mainly due to tax cuts. Although recovering domestic demand and the extension of the tax amnesty have started to back revenues since May. **According to our calculations, the budget deficit to GDP ratio increased to 2.0% by June, while the primary balance to GDP ratio reached -0.2% of GDP, down from 0.3% by 1Q and 0.8% at the end of last year.**

Although total tax revenues improved in 2Q mainly on top of corporate tax revenues (thanks especially to banks), total revenues stayed depressed because of sizably lower privatisation revenues compared to the same period of last year. Revenue collection from tax amnesty reached almost TL 6bn, 2% of the total revenues in the first half of the year.

On the expenditure side, though still high, non-interest expenditure decelerated in 2Q, mostly due to the Government's scale back in current transfers and investment expenditures. All in all, total revenues were up by 8.8% in annual terms in the first half of the year, marginally surpassing the Government's whole year target of 7.9%; while total expenditures grew by 18.5%, remarkably higher than the whole year target of 10.5%. Despite the higher than expected revenue collection from the tax amnesty and improving domestic demand, tax cuts and lower privatisation revenues (TL 5.9bn vs. TL 10bn in the first half of this year and last year) led to the generation of lower revenues.

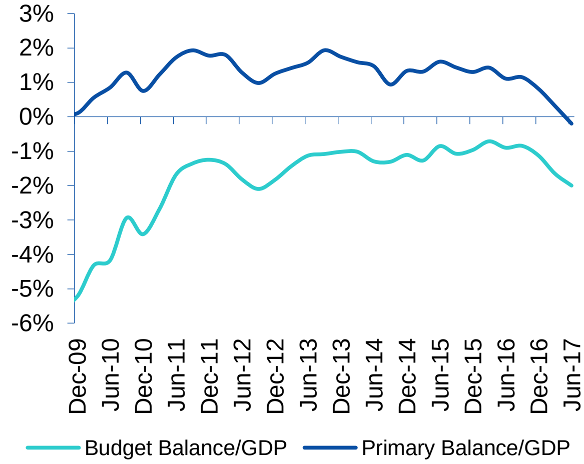
BBVA | Research

Figure 3.9 Turkey: Budget Revenues & Expenditure (12 months cumulative, YoY)



Source: Ministry of Finance, Garanti Research

Figure 3.10 Turkey: Budget & Primary Balance (% of GDP)



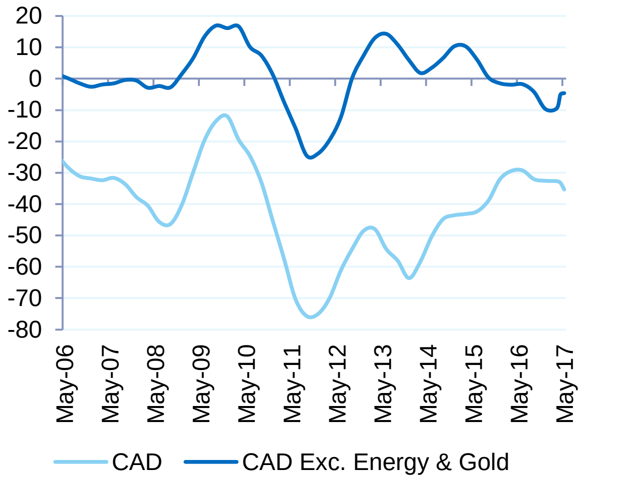
Source: Ministry of Finance, TURKSTAT, Garanti Research

The current account deficit deteriorated on energy and gold imports

The current account deficit (CAD) increased to USD 35.3bn in May from USD 32.7bn at the end of 1Q (to around 4.3% of GDP from 3.9%). While this increase was mainly due to higher energy bill and gold imports, the ongoing solid performance of exports and the gradual recovery in the tourism sector were the factors that contained the deterioration in the current account deficit in this period. Excluding net energy and gold, the deficit improved to USD 3.9bn by May from roughly USD 5bn at the end of 1Q, reflecting the effect of both supportive external demand and still modest import demand despite the high momentum in economic activity.

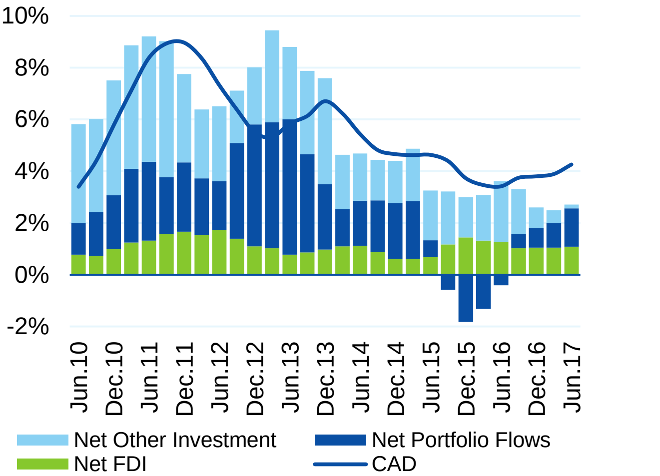
On the financing side, portfolio flows became the prominent factor thanks to the external debt issuance of both the Treasury and the banks (roughly a total of USD 6bn in April-May). **This current account financing is equilibrated not only with portfolio inflows (34% of the financing), but also net foreign direct investment and other investments (deposits and external credit lines) comprised 26% and 4% of the financing on a 12-month cumulative basis**. Net errors and omissions were positive with a 9% share, while the CBRT reserves also contributed by taking a 26% share in the same period. **Both the banking sector and the real estate sector continued to reduce their long-term external borrowing**, as the 12-month cumulative long-term external debt rollover ratio stood at 103% for banks and 123% for the non-financial sector as of May.

Figure 3.11 Turkey: Current Account Balance (12 months cumulative, bn USD)



Source: BBVA Research and Garanti Research

Figure 3.12 Turkey: CAB Funding Composition (12 months cumulative,% of GDP)



Source: CBRT, BBVA Research and Garanti Research

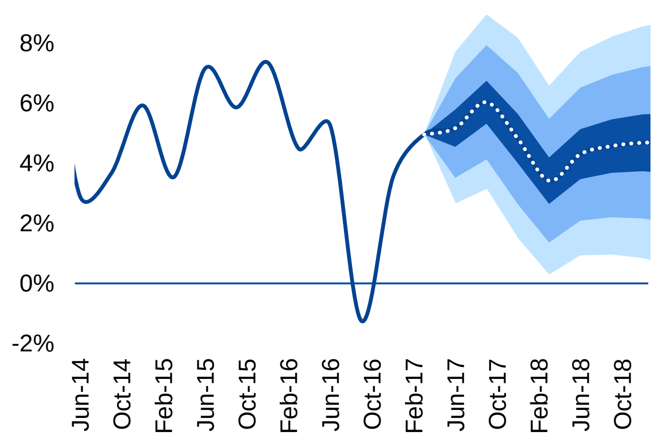
Base effects and robust initial performance signal significant growth in 2017

The robust growth of 5% YoY recorded during the first quarter has maintained its momentum. **A first insight from industrial production (IP) and other high frequency indicators reflects that** the path of recovery has remained robust and the economic recovery has broadened to the rest of the sectors. The IP accelerated to 5% in the period from April-May from 2.1% in 1Q, and **the rest of the sectors by not relying exclusively on the automotive and electricity sectors as in 1Q has supported the growth rate. According to our monthly GDP indicator (with 26% information by June), the GDP growth in 2Q will maintain at least a similar growth rate, close to 5%.**

During the third quarter the economic recovery will peak supported by Government stimuli (including some current tax reductions and other incentives), the Credit Guaranteed program, and the recovery of tourism, lower political uncertainty and extraordinary positive base effects. (If the economy grows 5% in 2Q, the economy will grow at least 5% in 2017 even with zero quarterly growth rates in 3Q and 4Q).

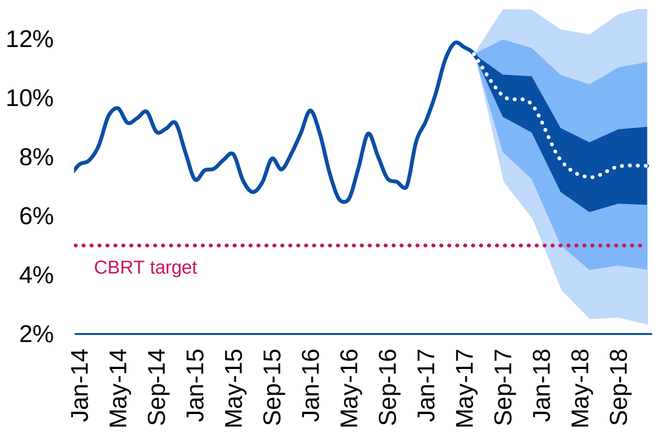
All in all, taking into account the recent high momentum, the improvement in the production of sub-sectors across-the-board and favourable base effects in 3Q, we are revising our 2017 GDP growth estimate significantly upwards from 3% to 5%, with there still being risks on the upside.

Figure 3.13 Turkey: GDP Forecasts (YoY)



Source: BBVA Research and Garanti Research

Figure 3.14 Turkey: Inflation Forecasts (3MA, YoY)



Source: BBVA Research and Garanti Research

Headline inflation will remain at double digits until December's fall

Inflation will moderate but will remain high. The Government's decision not to hike taxes on tobacco will help the headline consumer inflation fall below 10% in July, but this effect will later reverse in August due to the **reversal of base effects on food. Core inflation will worsen in September-October due to the methodological change assigning fixed weights to the clothing and footwear group, as well as the still high level of inflation in the service sector. The deceleration of inflation will become evident at the end of the year (particularly in December).**

To sum up, we maintain our 2017 year-end inflation forecast at 9.0%. The narrowing output gap thanks to the recovery in domestic demand and a supply credit shock from the credit guarantee program will be compensated by lower energy prices in international markets, tighter than initially expected monetary policy and the decision to not raise taxes or administrative prices in the rest of the year**.**

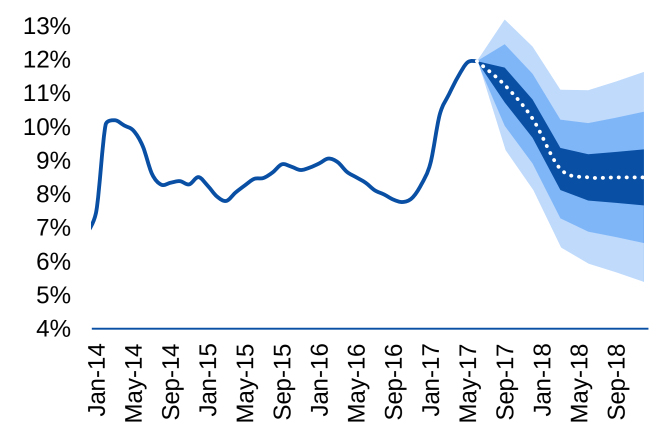
…which will require the CBRT to remain tight in the rest of the year

We expect the CBRT to maintain its tight monetary policy stance and to continue with the extraordinary late liquidity window facility as a regular policy tool until a sizable correction in inflation is realised. After still falling in July, we expect annual inflation to stay around at least 10-10.5% until December. We assume that the CBRT should maintain real interest rates in positive territory (at least 1%) to anchor inflation expectations according to our models, thus maintaining this stance until inflation declines to at least the upper bound of the inflation target. Our end of the year average funding cost estimate has been revised upwards by 75 bp to a level of 10.25%.

We expect the CBRT to maintain such a policy stance in the short term by only managing the daily available TL liquidity in the market. **Reducing the weight of the LLW facility in its daily funding would allow the CBRT to ease**

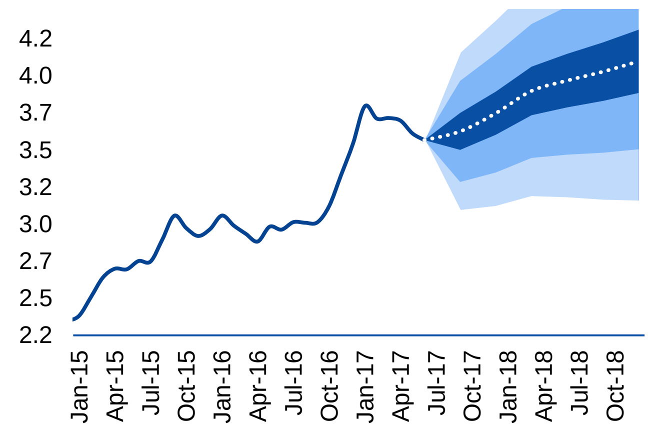
monetary conditions gradually towards the end of the year, if global financial conditions remain supportive and headline inflation recedes towards single digits as we forecast.

Figure 3.15 Turkey: Official Interest Rate Forecasts (%, CBRT average funding cost)



Source: BBVA Research and Garanti Research

Figure 3.16 Turkey: Exchange Rate vs USD (USD/TRY)



Source: BBVA Research and Garanti Research

The budget deficit will widen but will be lower than previously expected

As clearly seen in the first half of the year, the Government's intensified countercyclical measures will further increase the budget deficit in the second half, but this increase will be much lower compared to our previous estimation on the back of the economy's robust performance and the higher than expected revenue collection from the tax amnesty. Sizable public spending to boost private demand and postponed social security insurance premium collection will likely continue to generate a deficit at least in the short term. On the other hand, some upside risks remain for the following years as delayed contingent liabilities pose some negative risks if they materialisse.

We expect the budget deficit to GDP ratio to increase to 2.1% in 2017 (down from our previous estimate of 2.5%) from 1.1% in 2016. This will generate a rise in the EU defined public sector debt to GDP ratio to 29.6% from 28.3% in 2016, according to our forecasts. Although still better than international standards, such as the Maastricht criteria, complacency should be avoided, in our view. The electoral cycle will start soon (next elections should take place in 2019) and entering the political uncertainty game with a significant deterioration would pose important extra risks. Thus, **the rapid path of economic recovery should be accompanied by a gradual correction in the stimulus policy.**

As increased budget deficit creates additional borrowing needs for the Treasury, where its debt rollover ratio rose to over 120% on average in the first half of the year (vs. the Treasury target for 2017 by 98%, with their own assumption of a 1.6% budget deficit to GDP ratio)**. The maintenance of a roll-over ratio over 100% will keep market interest rates under pressure, which will be also critical for the future monetary policy stance.** Hence, the more recent performance of economic activity, hinting at private demand recovery in a healthier way would help the Government bring back its fiscal expansion at least in the short term, in our view.

The current account deficit is expected to increase due to higher domestic demand

Although lower than initially expected oil prices and the relatively better performing tourism sector would imply that a lower current account deficit, potentially higher imports on top of improving domestic demand and credit expansion will offset this positive impact. Hence, **we forecast a rise in the current account deficit from USD 32.6bn (3.8% of GDP) in 2016 to USD 39.3bn (4.8% of GDP) in 2017, bringing the CAD/GDP ratio above the structural current account deficit** (4%, according to our estimations).

Table 3.1. Baseline Scenario: Forecast

	Variation 2015 / 2018			
	2015	**2016**	**2017**	**2018**
GDP (%, y/y)	6.1%	2.9%	5.0%	4.5%
Inflation (%, average)	7.7%	7.8%	10.5%	7.6%
Inflation (%, end of period)	8.8%	8.5%	9.0%	7.5%
Official Interest Rate (%, average)	8.4%	8.4%	11.0%	8.7%
Official Interest Rate (%, end of period)	8.8%	8.3%	10.3%	8.5%
Exchange Rate vs USD (average)	2.72	3.02	3.65	3.92
Exchange Rate vs USD (end of period)	2.92	3.52	3.70	4.05
Current Account Balance (% of GDP)	-4.5%	-3.8%	-4.8%	-5.3%
Fiscal Balance (% of GDP)	-1.0%	-1.1%	-2.1%	-1.6%

Source: BBVA Research and Garanti Research

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

BBVA | Research

This report has been produced by the Turkey, China and Geopolitics Unit

Chief Economist for Turkey, China and Geopolitics Unit
Alvaro Ortiz
alvaro.ortiz@bbva.com

Deniz Ergun
denizerg@garanti.com.tr
+90 212 318 10 59

Asuman Kemiksiz
asumankem@garanti.com.tr
+90 212 318 10 58

Seda Güler
sedagul@garanti.com.tr
+90 212 318 10 64

Ali Batuhan Barlas
Alibarl@garanti.com.tr
+90 212 318 10 67

Yiğit Engin
yigite@garanti.com.tr
+90 212 318 10 60

Gizem Önen
Gizemon@garanti.com.tr
+90 212 318 10 57

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems & Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

China
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research: Azul Street, 4. La Vela Building - 4 and 5 floor. 28050 Madrid (Spain). Tel.:+34 91 374 60 00 y +34 91 537 70 00 / Fax:+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com