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Turkey Economic Outlook

1st Quarter 2018

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January 2018

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Key messages

1. The global demand continues to improve with better forecasts for the US, China and the Eurozone, while the policy normalization of global central banks is ongoing
2. The policy impulse and the resilience of the economy pushed the Turkish economy to strong growth dynamics. We expect GDP growth to reach 7% in 2017 and moderate towards 4.5% this year
3. The labor market is finally benefiting from strong growth while the degree of slack in the economy is dying out
4. Inflation will remain high during most of the year on inertia, robust domestic demand and lagged effects of exchange rate depreciation. It will moderate to 9% at the end of 2018
5. The Central Bank of Turkey (CBRT) will maintain the tight stance waiting for clearer signs of disinflation and expectations to ease. The fiscal policy will remain accommodative in 2018
6. Current account deficit should be monitored as it is already above 5% of GDP and the pick up in investment and the new oil prices scenario pose some upward risks

GLOBAL

Global growth confirmed and
short-terms risks moderated

Global growth consolidates & monetary policy normalization is ongoing

01 **Projections for the U.S., China and Eurozone improve**
There is less uncertainty in the short run

02 **More positive perspectives for emerging economies**
Better global demand and higher commodity prices

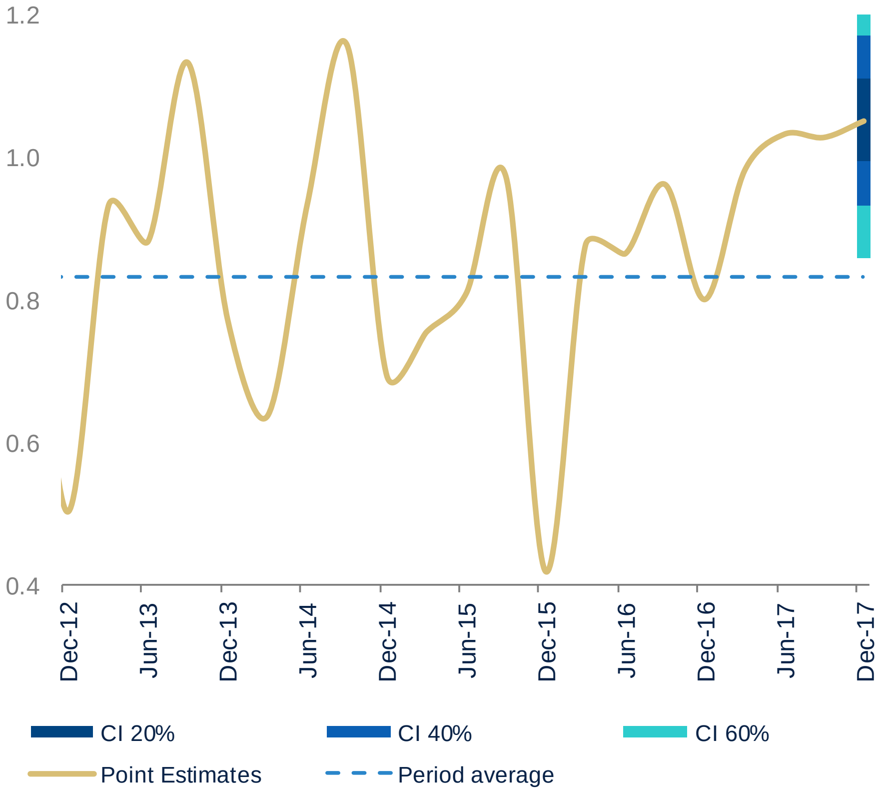
03 **Greater caution in financial markets**
Expectations of less liquidity might reduce flows to emerging economies

04 **Central Banks continue progressing towards normalization**
Motifs to withdraw stimulus are materializing in the midst of a contained core inflation

05 **Global risks**
Less significant in the short run; without changes in medium to long run

Robust and sustained global growth…

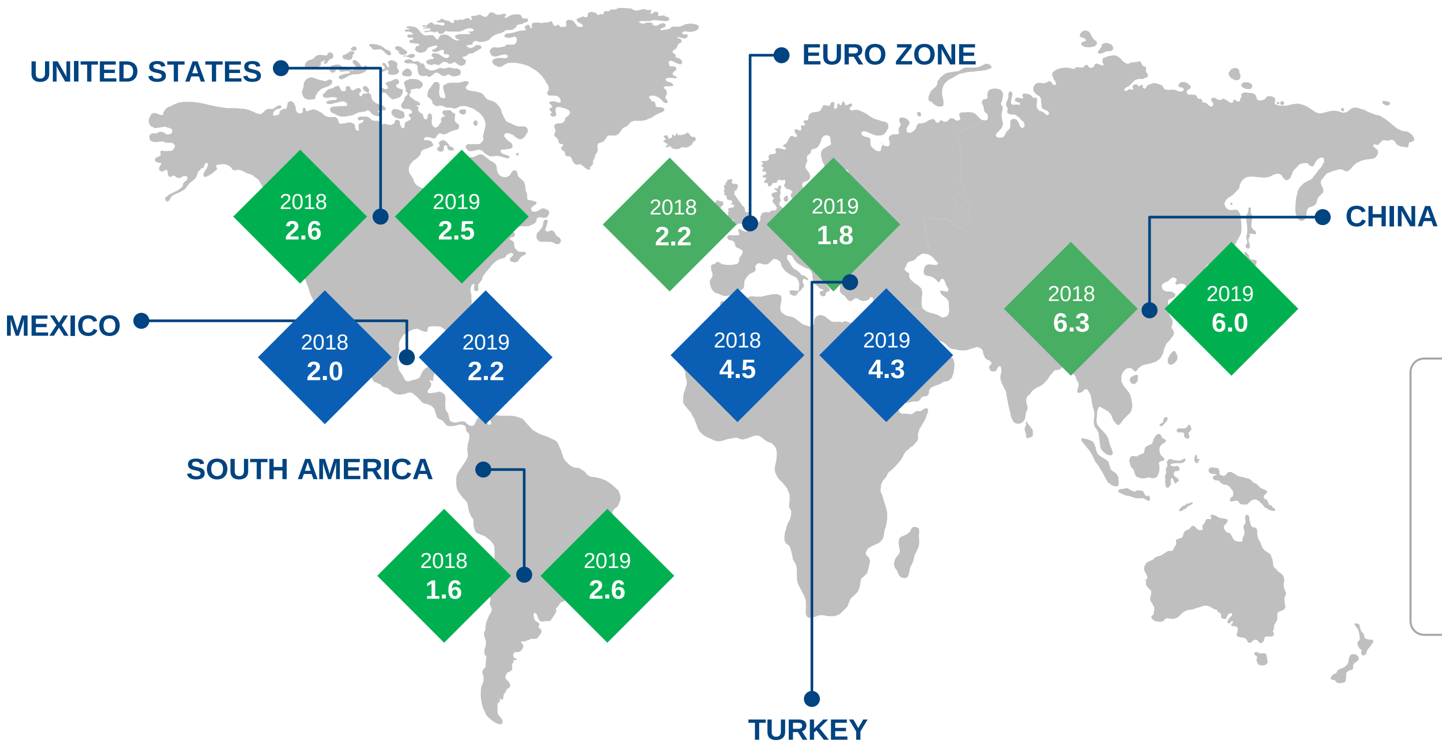
World GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)

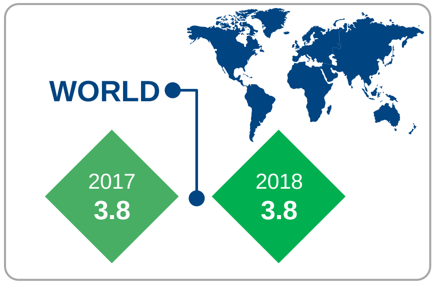


- The global economy continues to grow, supported by the recovery of the industrial sector
- Confidence indicators continue to improve, and anticipate the outlook will continue to be positive
- Private consumption keeps sustaining growth in advanced economies and gains momentum in emerging economies

Source: BBVA Research

…with a broad-based revision





Up

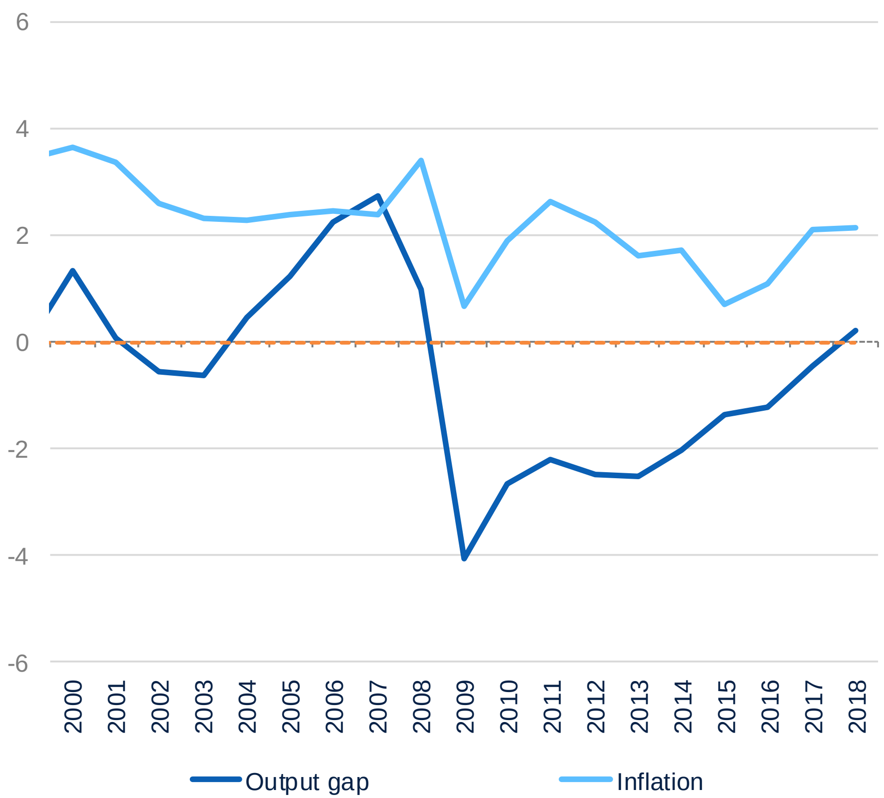
Unchanged

Down

Source: BBVA Research

A weaker Phillips Curve but still something to monitor

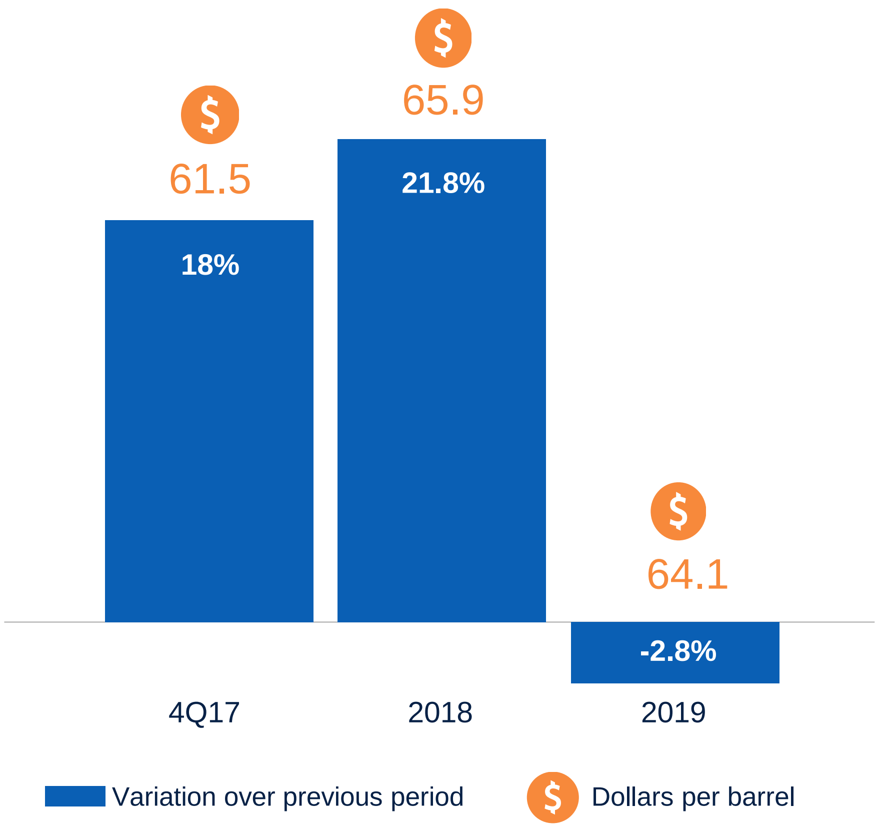
OECD: Production gap and inflation
(% of potential GDP, % YoY)



- Reduction in the economies' output gap, but with room to grow without strong inflationary pressures
- Less price reaction to the increase in activity, for several reasons:
  - Globalisation
  - Increased flexibility in the labour market
  - Low inflationary expectations
  - Reduced productivity growth
- The increase in the price of oil will push up inflation in the short term, facilitating central banks to move towards normalisation in developed economies

A better outlook for emerging economies but also for oil prices

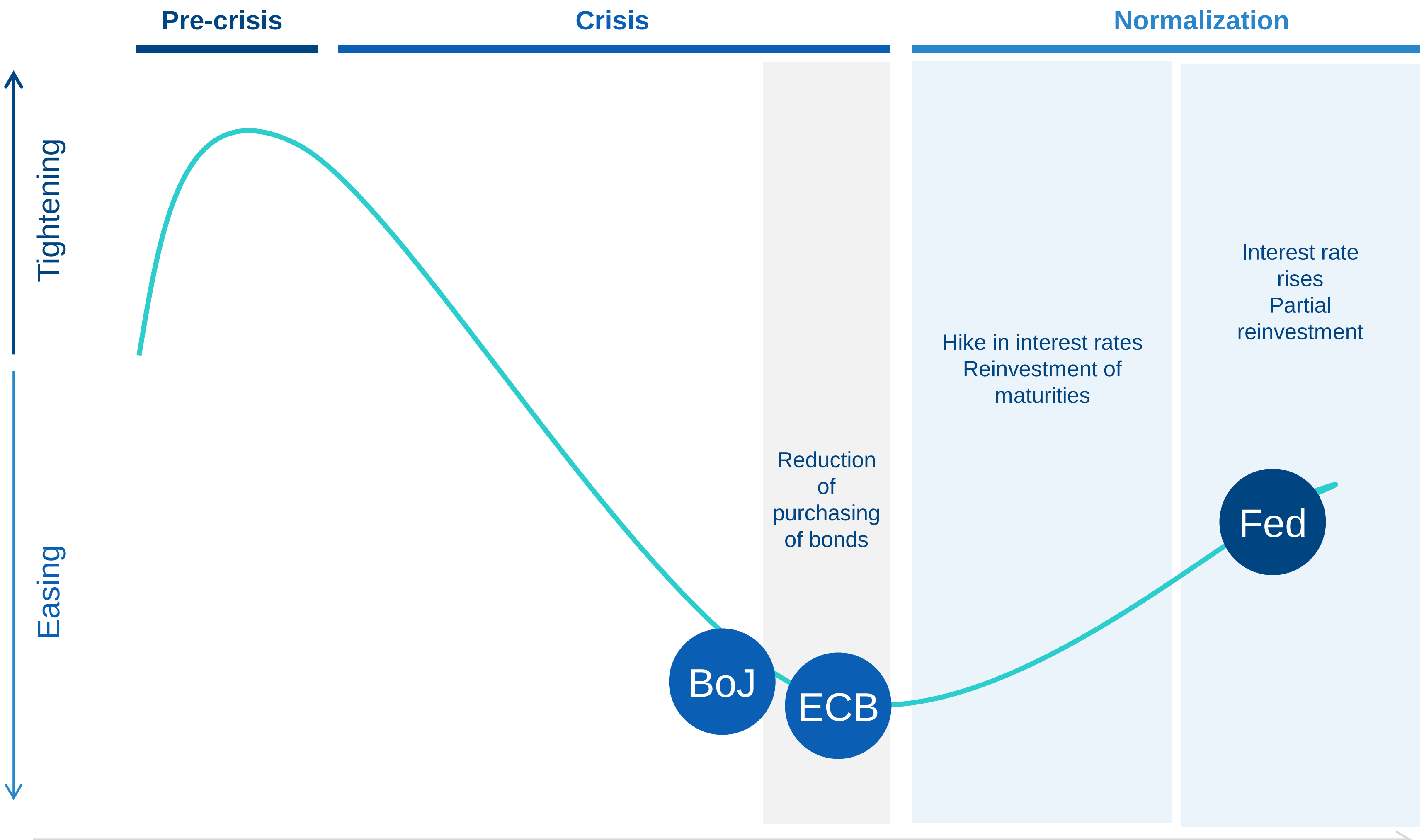
Price of oil
(Dollars per barrel,%)



- The increase in oil prices reflects a greater global demand, which would account for 60% of such increase
- But this is also due to supply factors, linked to geopolitical risks and the correction of inventories
- Positive and significant impact on emerging economies that produce raw materials
- However, we still expect prices to converge to $60 per barrel in the medium term, due to increased competition and structural changes in the energy sector

Source: BBVA Research

Withdrawal of non-conventional monetary policy measures is ongoing



Monetary policy normalization: accelerated in the case of the Fed, gradual in the case of the ECB

FED

Tightening cycle and reduction of the balance in progress

Estimated rise of 75pbs in 2018 to 2.25% and reduction of the balance by 500,000 million dollars

Focus: gain room for manoeuvre

ECB

QE reduction, but extension until September 2018

No rate hikes are expected until 2019

Focus: avoid sudden acceleration of long-term rates

Elements of uncertainty:

Politics: changes in government ministries (Fed, ECB)

Macro : possible surprises in inflation

Markets: Long-term rates and slope of the curve

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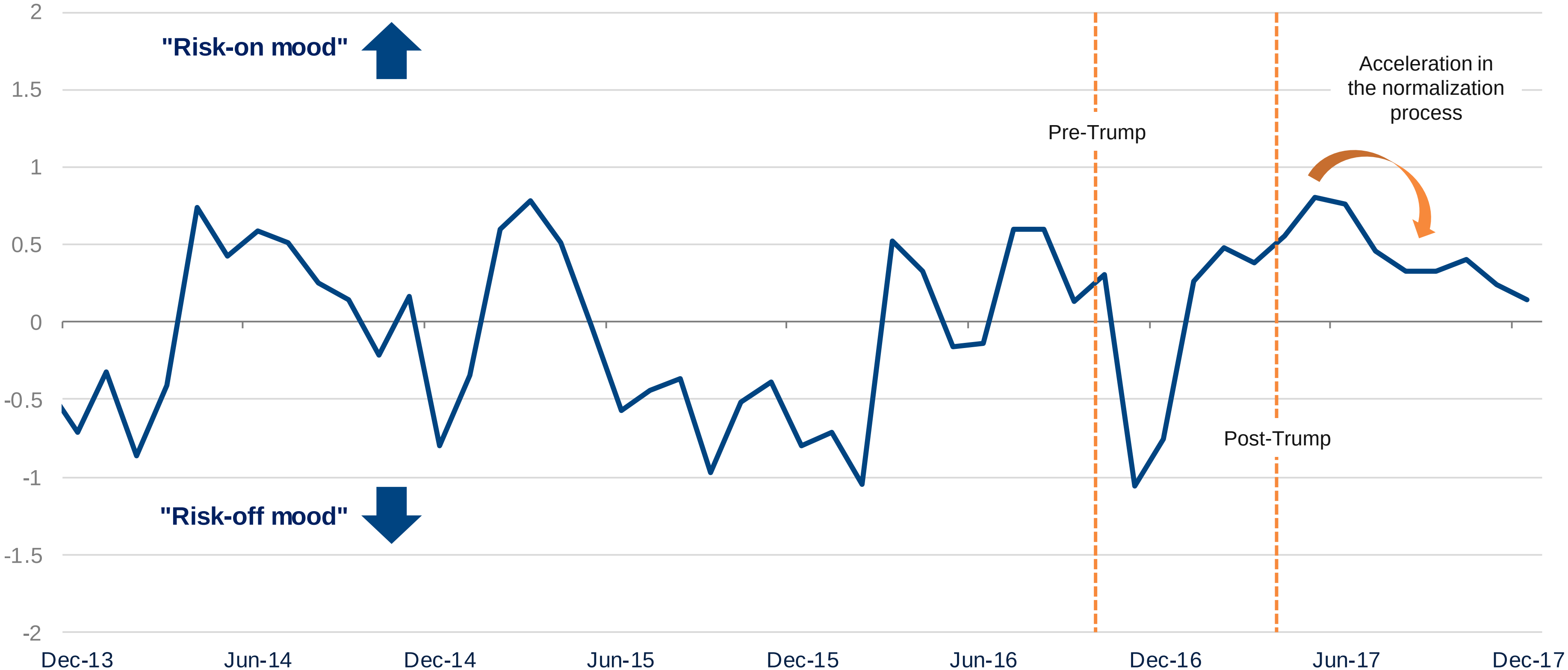
Cautiousness in financial markets, with gradual moderation in flows to emerging economies

Appetite for risk indicator

1st Factor (global), analysis of capital flows EPFR



Source: BBVA Research, EPFR

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Turkish Economy

Strong Growth and Inflation

The Turkish economy during the last quarter

01 Exchange rate depreciated on Global & Geopolitical woes

High exchange rate volatility at the end of the year

02 Strong growth and declining unemployment

Labor market is finally benefiting from strong growth

03 Inflation remain high on both supply and demand factors

High inflation will recede but remain at high levels

04 Tight Monetary Policy

The Central Bank tightened monetary policy with words & deeds

05 Fiscal Policy loosened but lower than expected

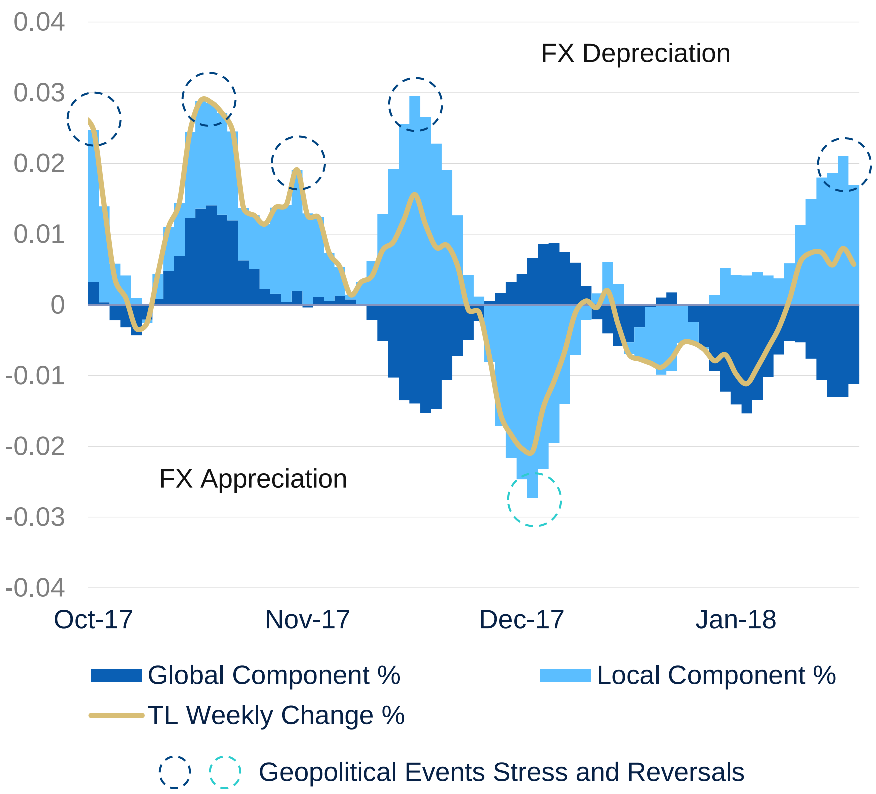
Strong nominal growth supported revenues

06 The current account deficit should be monitored

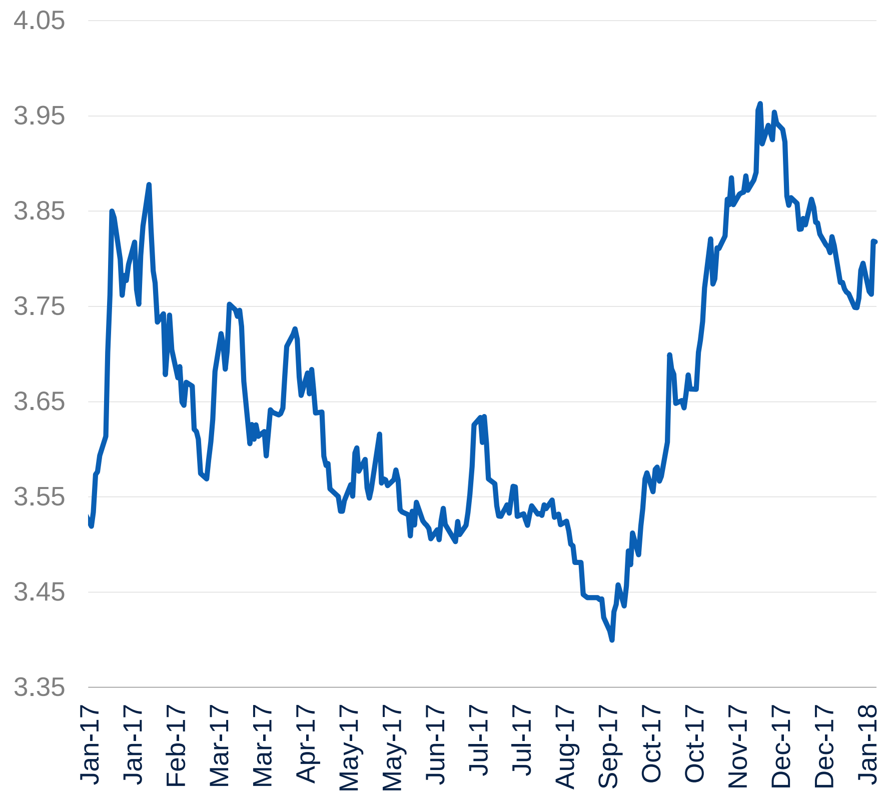
Again above the 5% mark on investment recovery, oil prices and gold imports

The volatility of Turkish Lira increased on geopolitical factors while global factors started to be more supportive

Lira Exchange Rate : Global & Local
(contribution to % weekly change from different factors)



Turkish Lira vs USD
(TRL/USD)



Economic growth skyrocketed in 3Q thanks to low base impact and working day adjustments but remained promising in 4Q, consistent with our 7% GDP growth forecast for 2017

Activity Indicators

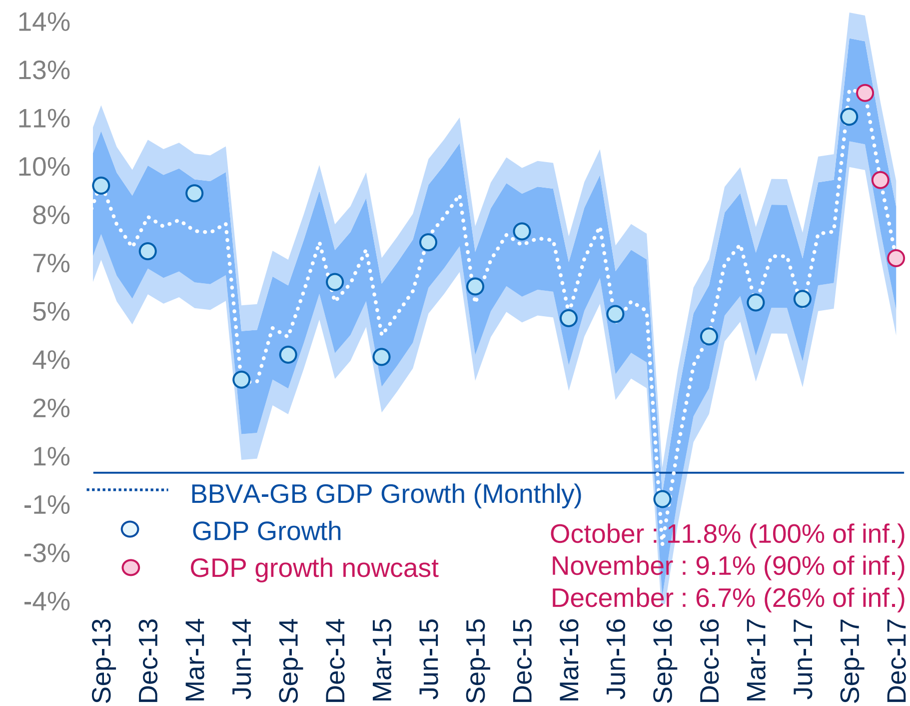
(%YoY 3MA)

		2017							
	Mean	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Industrial Production	3.9	4.2	2.2	7.7	7.7	13.8	8.6	9.6	
Non-metal Mineral	17	2.7	0.9	8.2	8.4	14.2	7.7	8.7	
Electricity Production	4.5	6.6	4.5	8.4	8.5	12.2	9.5	9.7	6.5
Auto Sales	3.5	-10.3	-9.7	2.4	7.1	14.6	7.3	-14	
Tourist Arrivals	2.1	26.5	36.5	45.5	45.3	38.2	31.0		
Number of Employed	5.5	16.1	10.5	6.1	1.5	-0.8	-5.1		
Number of Unemployed	3.5	2.0	2.7	3.5	4.3	4.5	4.8		
Auto Imports	5.1	-13.9	-14.4	-6.7	-3.4	3.1	-0.9	-8.4	
Auto Exports	9.2	32.4	24.0	23.2	9.8	5.9	33.3	28.9	
Financial Conditions	75.4	30.6	35.6	40.5	35.4	38.9	26.1	10.0	15.2
13-week Credit Growth	17.8	37.2	29.2	20.1	17.6	14.5	14.5	12.0	13.4
Retail Sales	3.6	0.1	0.8	1.8	2.0	1.5	1.3	1.9	
Real Sector Confidence	106.1	104.8	108.8	107.7	110.2	111.2	112.2	109.8	109.2
MICA Forecast							11.8%	9.1%	6.7%
GDP YoY			5.4%			11.1%			

Contraction	Slow-down	Growth	Boom

Turkey: GDP Monthly Indicator

(% YoY mov. avg. 3m)

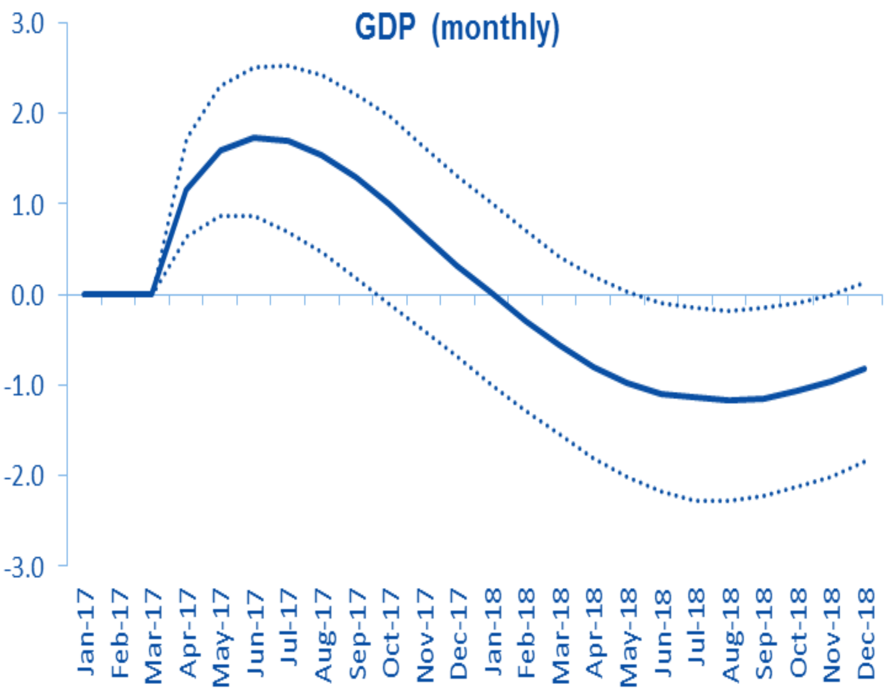


Source: BBVA Research Nowcasting Model

The Credit Guarantee Fund (CGF) has proved to be an efficient counter-cyclical tool, but not a “free lunch”

The Effects of a “Credit Supply Shock” to the Economy*

(Shock of CGF, 5 times standard deviation in loans shock. Variables in 3-Month Moving Average)

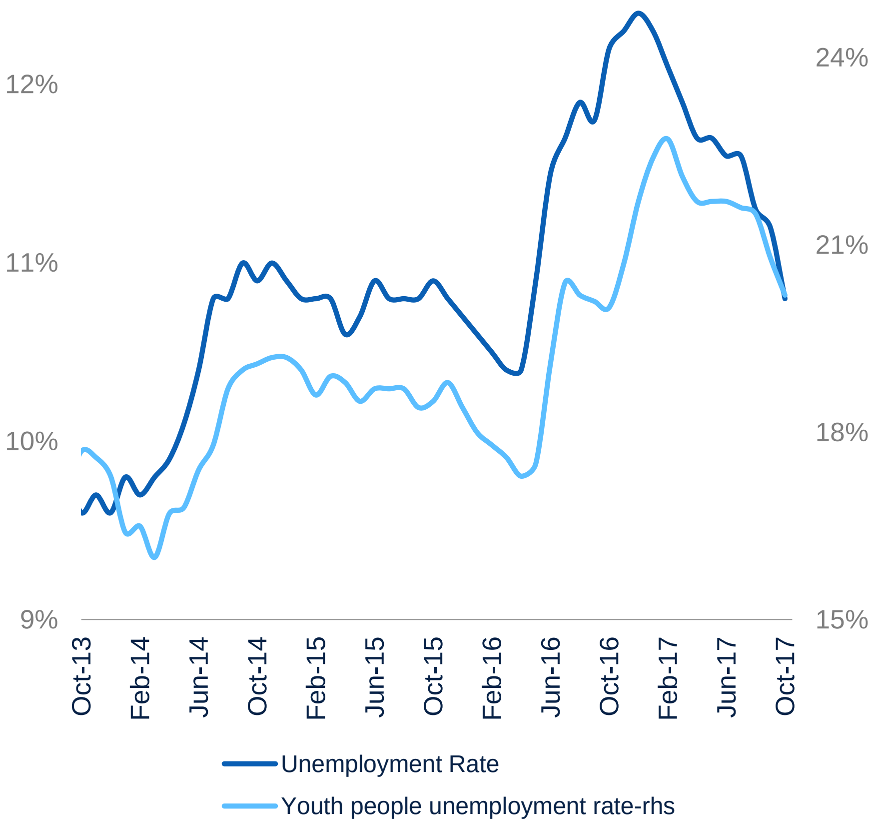


- The CGF had a positive contribution to growth between 1.0-1.5pp in 2017 with a somewhat delayed impact on inflation once the domestic demand side of the economy reacted
- There is some uncertainty about the magnitude of the negative/positive base effect in 2018 depending on the allocation of remaining funds, the roll-over of last year´s program or the existence of new programs
- The economic outlook will also matter. Household and Corporate demand and Banks’ willingness to supply also depend on the macroeconomic conditions surrounding the program

* See the detailed analysis in the following link
Source: BBVA Research

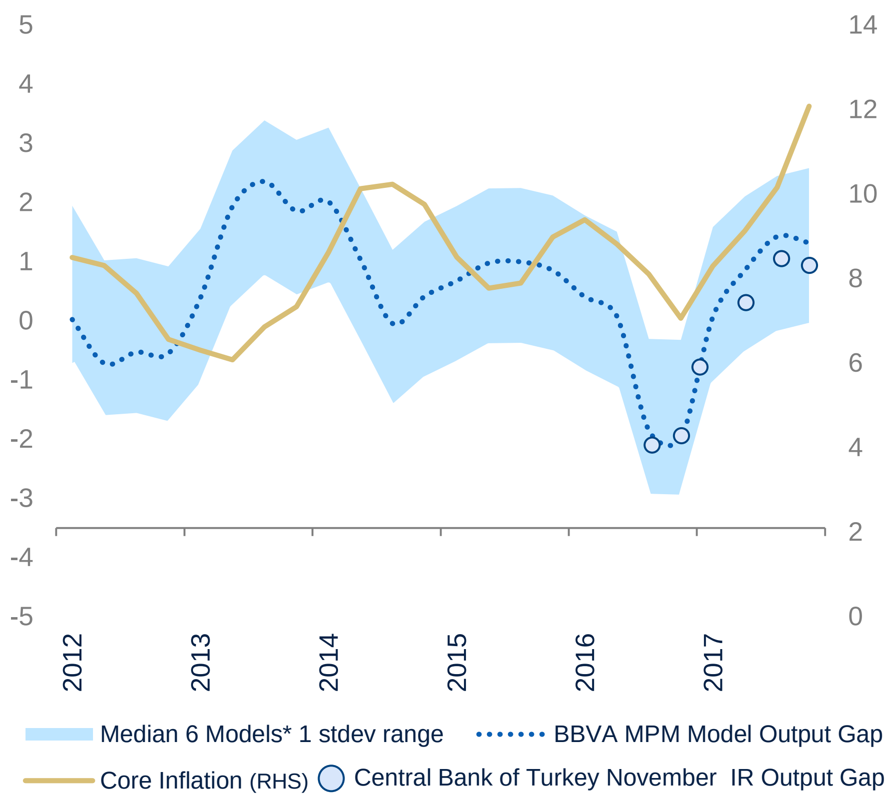
Strong domestic demand has finally benefited the labor market while the amount of slack has now disappeared

Unemployment Rate
(SA, %)



Source: Turkstat and BBVA Research

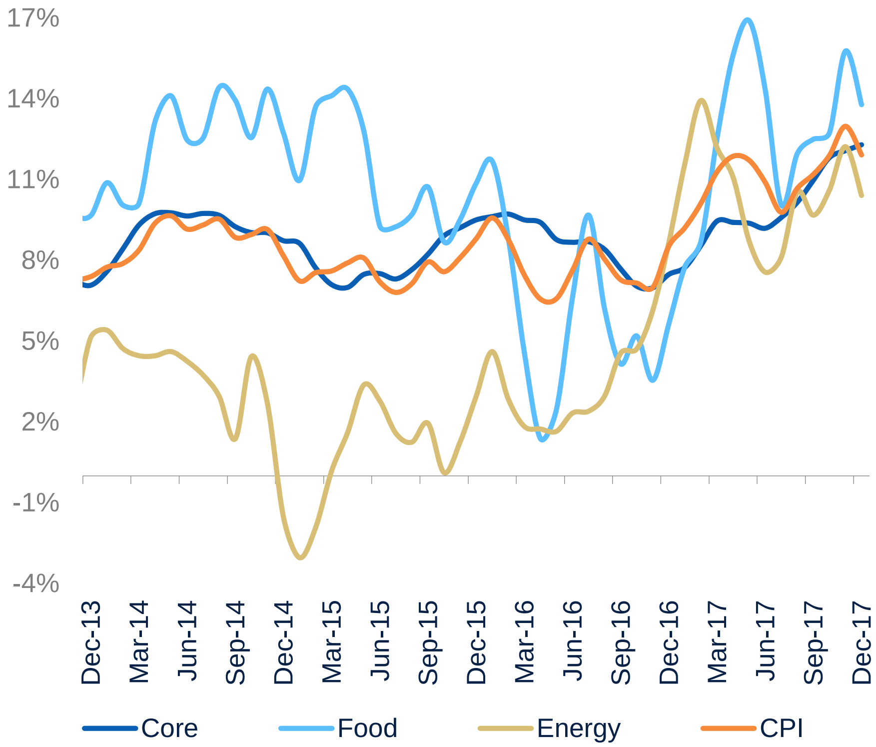
Output Gap Models and Core inflation
(Ouput gap % of GDP (left) and Core Inflation B YoY ,right)



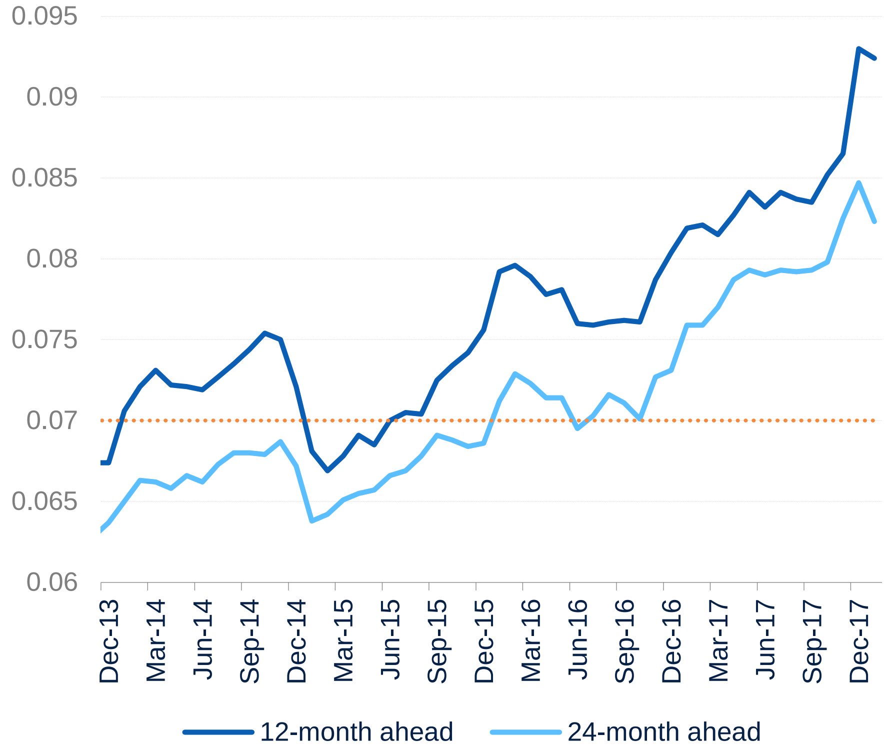
* Output gap one standard deviation range includes: Linear Model, Capacity Utilization, Hodrick-Prescott Filter (1600), Credit Neutral (Borio et al), Multivariate Filter Model , Open Economy NK Model.
Source: BBVA Research & CBRT Inflation Report

Favorable base effects on food will help inflation fall sharply in the short term but it will navigate on high levels due to still high domestic demand, inertia and lagged effects of exchange rate depreciation

CPI Inflation & Its Components
(YoY)



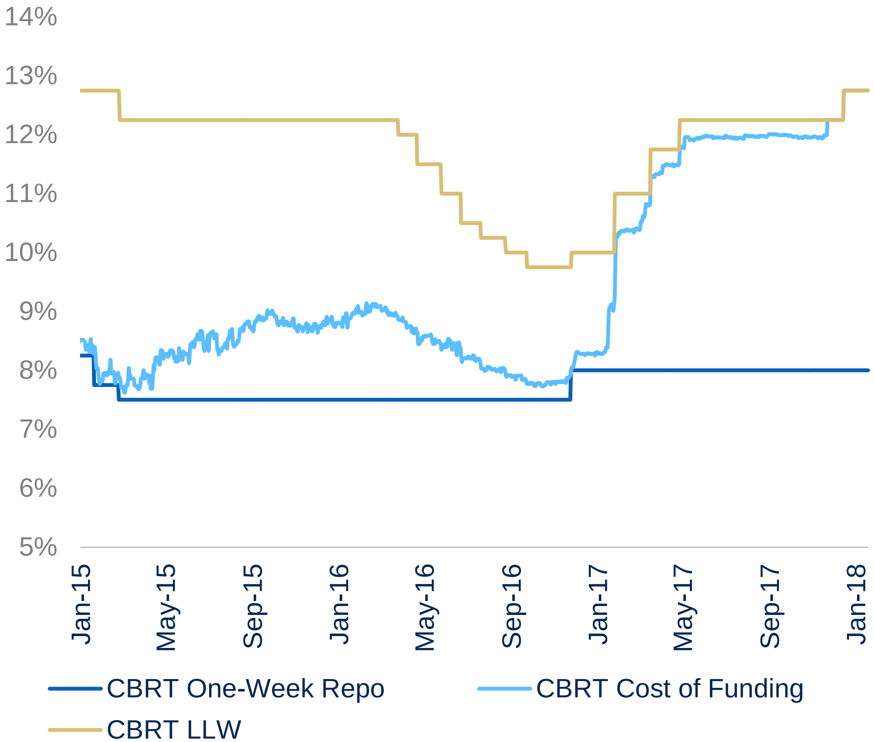
Inflation Expectations
(YoY)



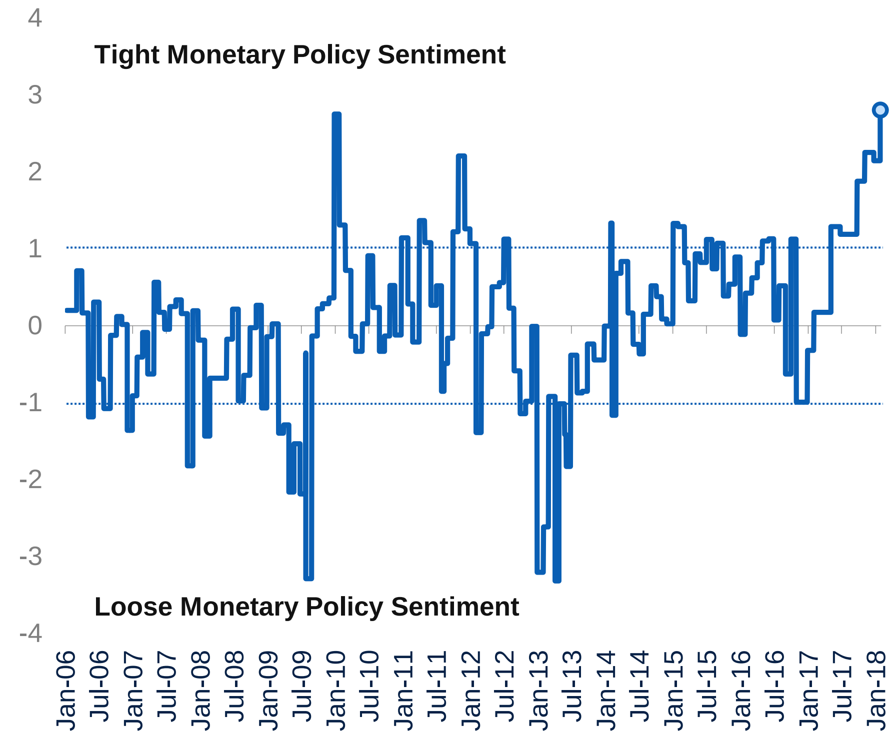
Source: Turkstat and BBVA Research

The CBRT tightened monetary policy by 75 bps at the end of 2017 with additional «verbal tightening» during the last meetings

CBRT Interest Rates
(Annual Level, %)



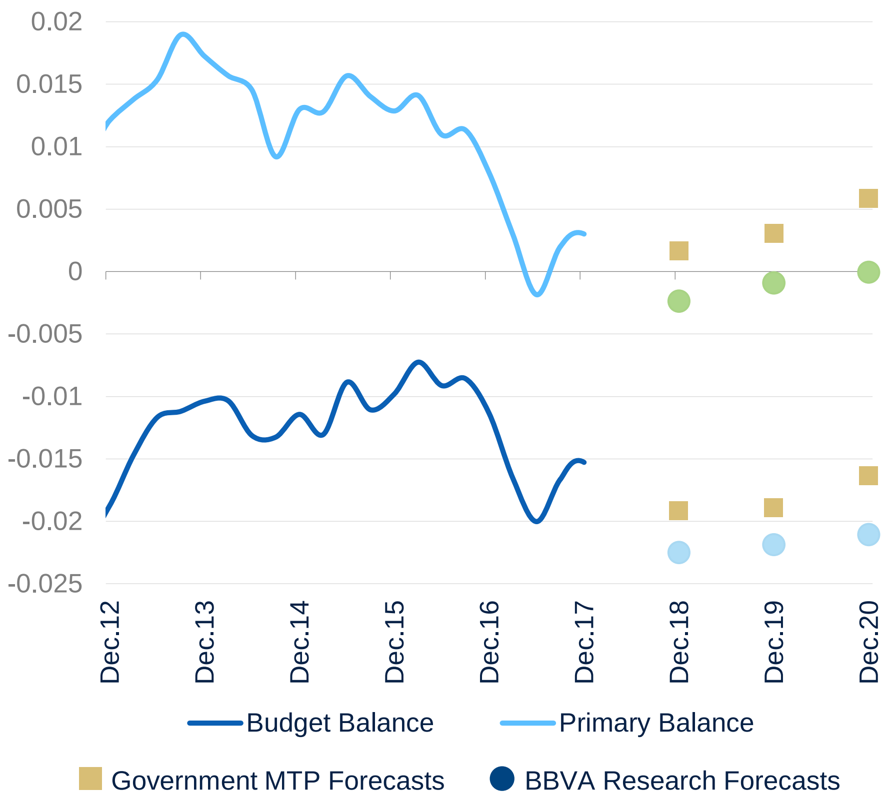
CBRT Monetary Policy Statement Sentiment
(Standardized, estimated through Big Data LDA Techniques from Minutes & Statements)



Source: CBRT and BBVA Research

Strong nominal growth boosted revenues supporting a better than expected Central Government deficit of 1.5% of GDP in 2017

Budget and Primary Balance
(% GDP, *4Q GDP data is a forecast)

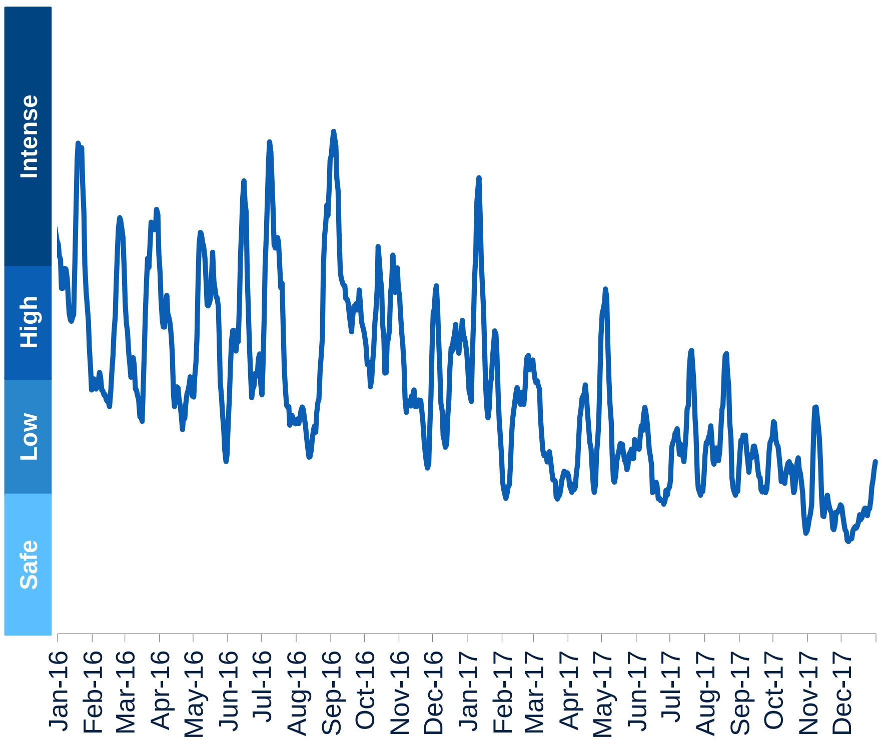


- We expect some deterioration in fiscal balance on the back of lower nominal revenues and some upward pressures on expenditures
- Better than expected budget deficit in 2017 opens the door for more fiscal consolidation
- However, we think that the Government will stick to the programmed Medium Term Plan given some pressures on some expenditure items (i.e defence and security)

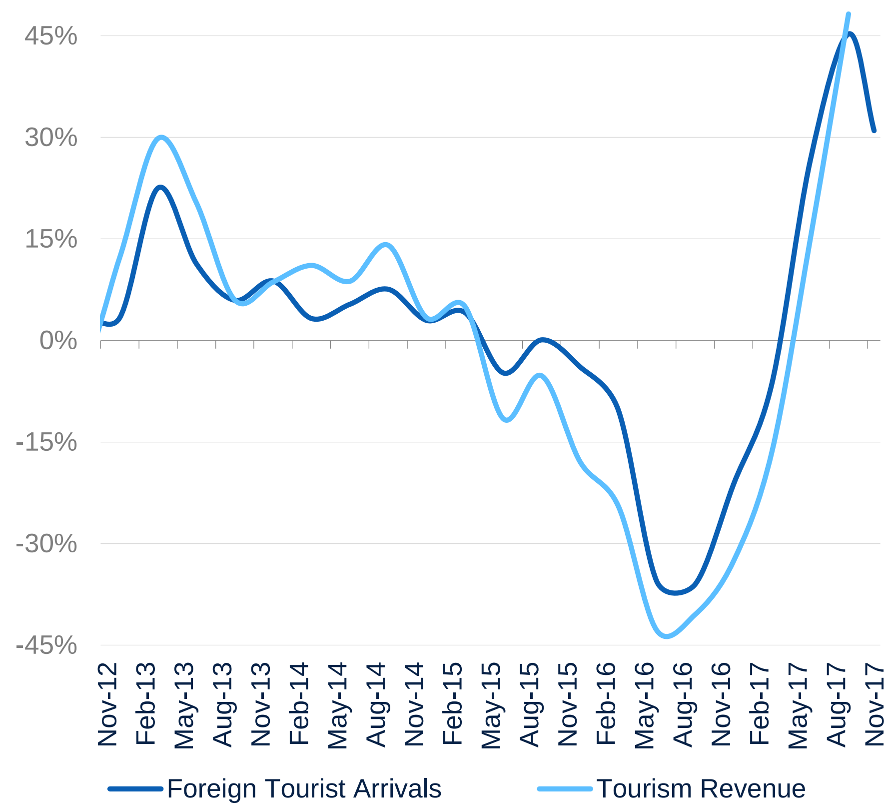
Source:Turkstat, Ministry of Finance

The security climate has improved markedly allowing tourism arrivals and revenues to recover

Turkey: Conflict Index
(Conflict News op Total News in News Media)



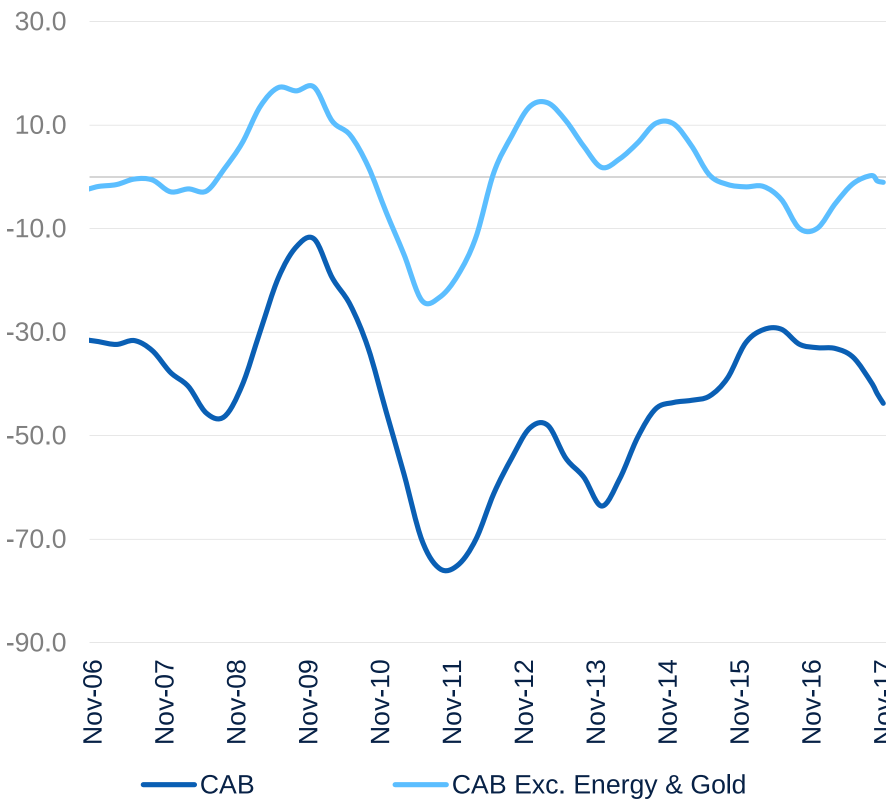
Number of Tourists and Tourism Revenues
(3MA, YoY)



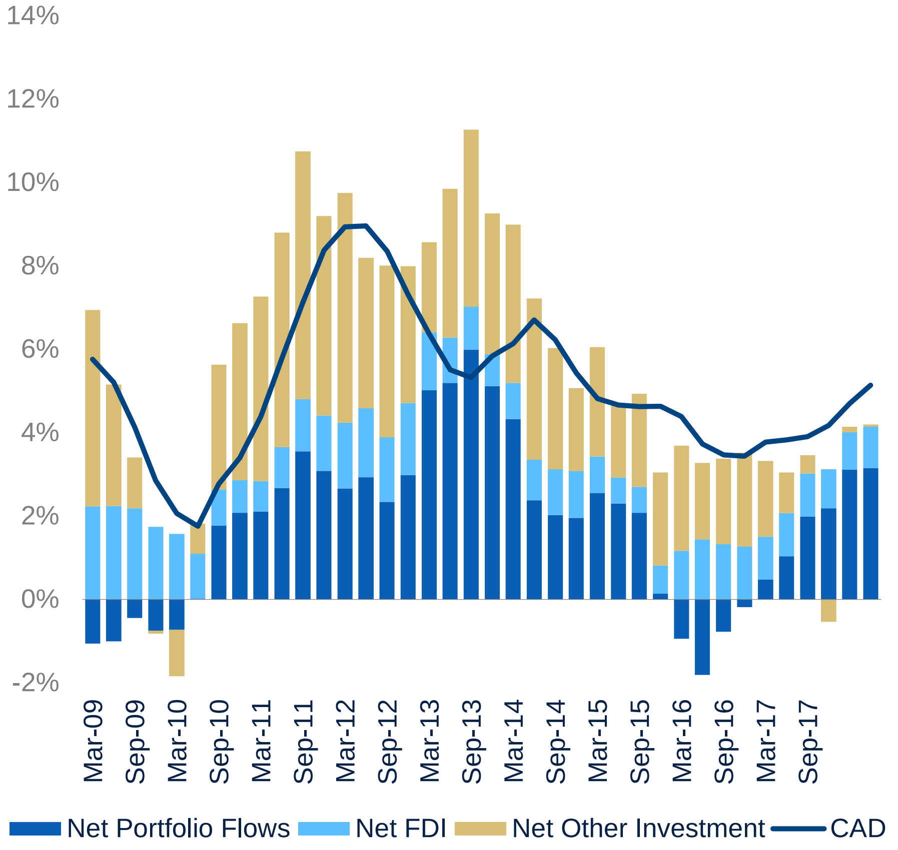
Source: BBVA Research,, GDELT, Turkstat

Strong domestic demand, higher energy prices and gold imports led current account deficit to rise above 5% of GDP again

Current Account Balance
(12M sum, bn USD)



Current Account Financing
(12M sum, % GDP)



Source: CBRT, Turkstat and BBVA Research

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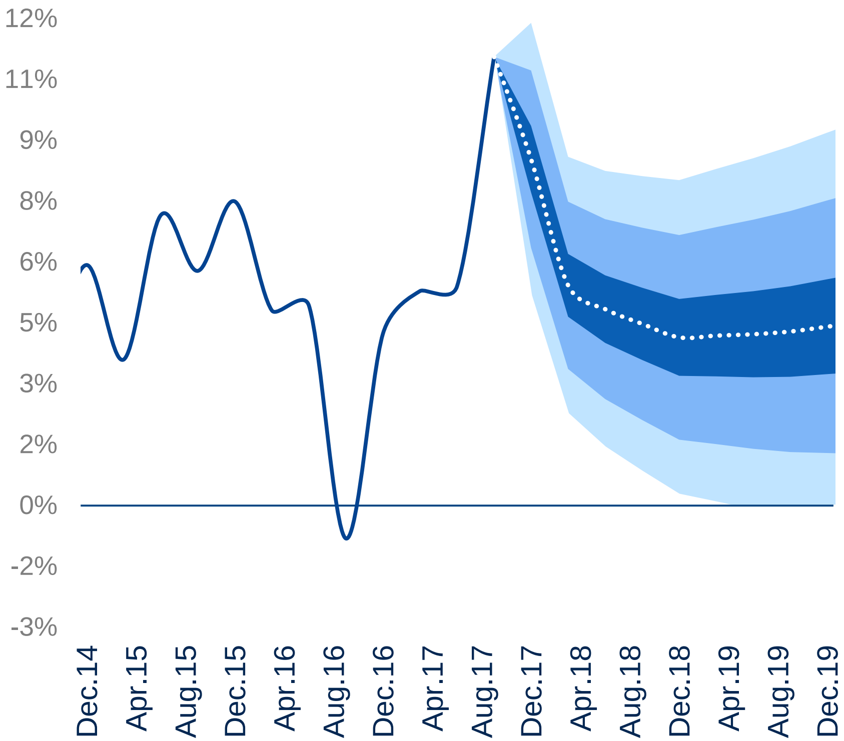
Turkey Outlook

The Base Scenario and
The Balance of Risks

Strong growth set to moderate but with balanced risks

GDP Forecasts
(YoY)

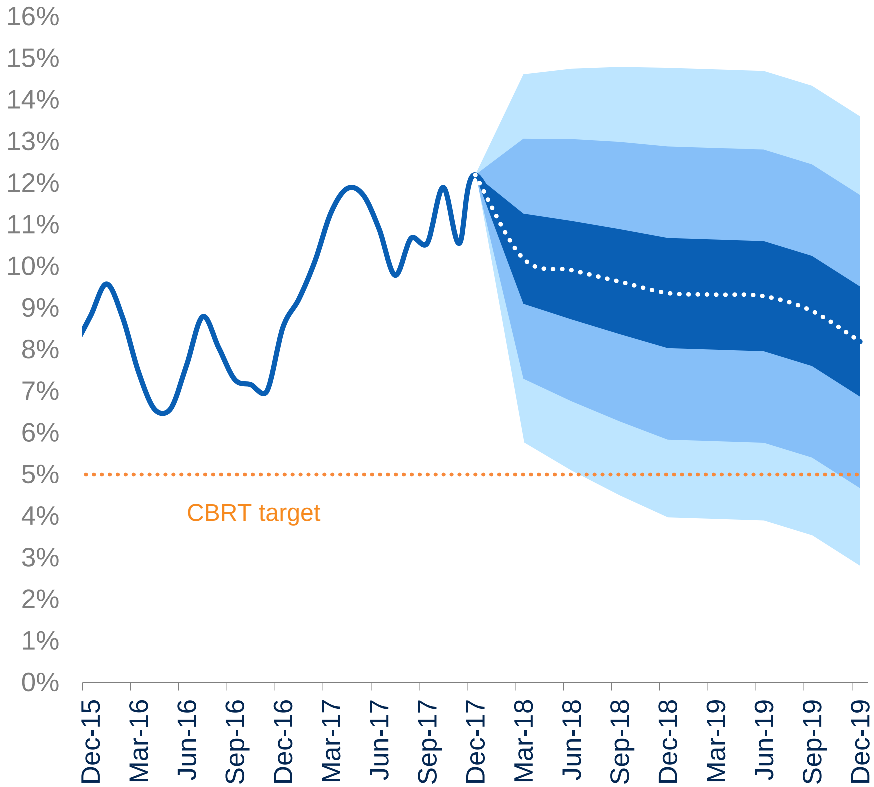


- Economic growth will moderate as last year´s stimuli fade away. We expect GDP to grow 4.5% in 2018 after the extraordinary growth rate of 2017 at 7.0%
- A positive outlook of the global economy, a sustained recovery of non-residential private investment and a new round of policy stimulus pose risks on the upside
- A more aggressive than expected Global Monetary Policy normalization and Geopolitical risks pose risks on the downside

Source: Turkstat & Garanti MPM Model

Inflation will remain high but the worst is over in our base case scenario

Inflation Forecasts
(3MA YoY baseline scenario)

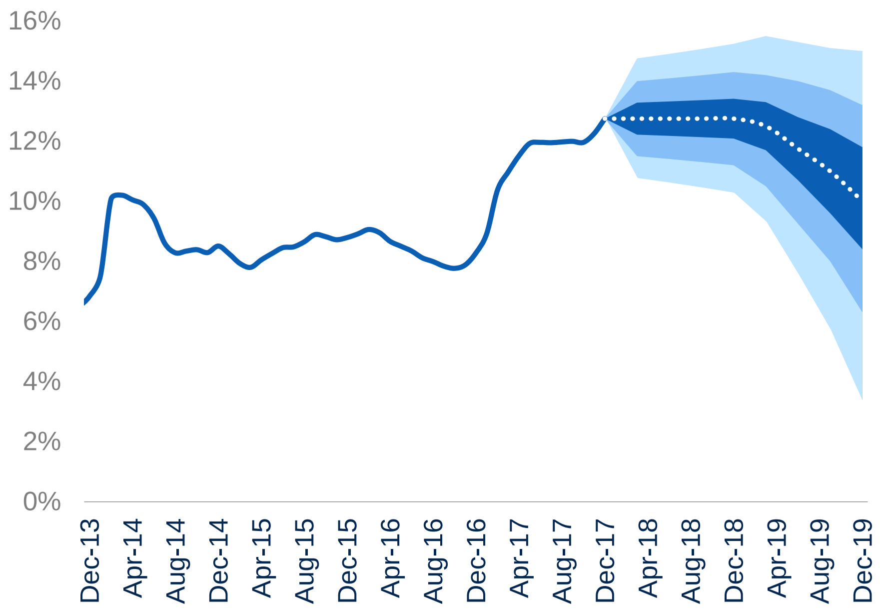


- Inflation will start to moderate soon (1Q) but will remain near 10% until 4Q before ending the year at 9.0%
- Risks are balanced. Exchange rate depreciation lower than expected and structural measures to reduce food price volatility may result in positive surprises
- Higher oil prices, strong inertia and new exchange rate shocks from global & geopolitical factors may pose upside risks

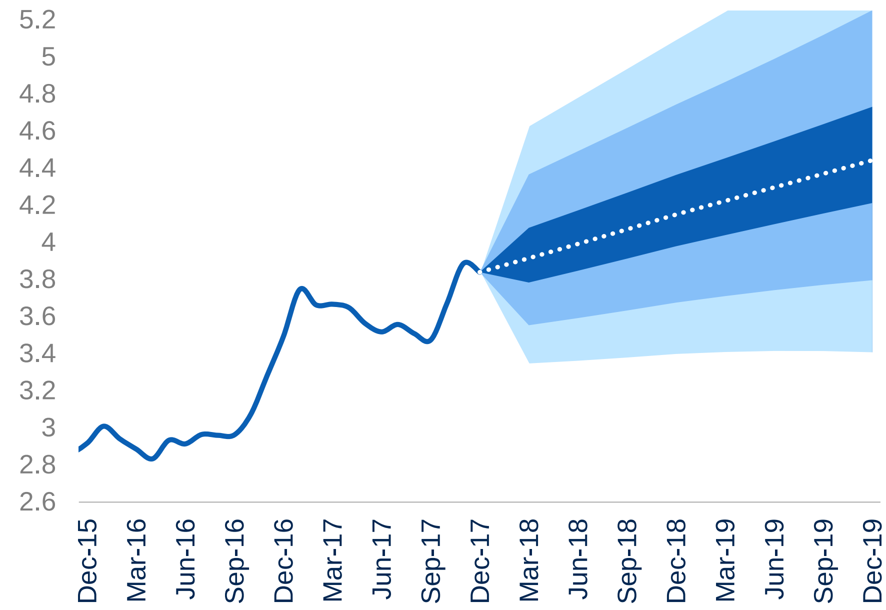
Source: Turkstat & Garanti MPM Model

The CBRT will maintain the current policy unless a new shock arises. Exchange rate will depreciate more moderately.

Monetary Policy Rate Forecasts
(% Average Funfing Cost)



Exchange Rate Forecasts
(USDTRY Level baseline scenario)



Elements of uncertainty:

Global: Normalization of Monetary Policies (Fed, ECB)

Macro : Domestic demand pressures and inflation risks

Risk Premia: Geopolitical risks

Baseline forecasts

	2016	2017e	2018f	2019f	2020f	2021f	2022f	2023f
GDP Growth (%)	3.2%	7.0%	4.5%	4.3%	4.5%	4.5%	4.5%	4.5%
Private consumption (%)	3.7%	6.2%	4.0%	3.6%	4.3%	4.1%	4.1%	4.3%
Public consumption (%)	*9.5%*	2.2%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Gross fixed investment (%)	2.2%	7.9%	3.0%	4.6%	5.1%	5.7%	5.6%	5.5%
Exports (%)	*-1.9%*	11.8%	8.4%	6.5%	6.0%	5.6%	5.6%	5.5%
Imports (%)	3.7%	6.1%	5.2%	5.6%	6.5%	6.5%	6.5%	6.5%
Inflation (end of period. YoY %)	8.5%	11.9%*	9.0%	8.0%	7.5%	7.0%	6.7%	6.0%
Exchange Rate vs US dollar (end of period)	3.52	3.77*	4.15	4.45	4.65	4.84	5.04	5.25
Exchange Rate vs US dollar (average)	3.02	3.65*	4.01	4.31	4.56	4.75	4.95	5.16
Official Interest Rate (end of period)	8.3%	12.8%*	12.8%	10.0%	8.3%	7.5%	7.5%	7.5%
Official Interest Rate (average)	8.4%	11.5%*	12.8%	11.6%	8.6%	7.8%	7.5%	7.5%
Current Account Balance (% of GDP)	-3.8%	-5.5%	-5.6%	-5.6%	-5.4%	-5.4%	-5.4%	-5.5%
Central Government Budget Balance (% of GDP)	-1.1%	-1.5%	-2.2%	-2.2%	-2.1%	-1.8%	-1.6%	-1.4%
EU Defined Public Debt (% of GDP)	28.3%	29.3%	30.9%	31.6%	31.7%	31.4%	31.1%	31.0%

F= forecast. (*) realization.

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

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