Turkey Economic Outlook

1st Quarter 2018
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

UNITED STATES
- 2018: 2.6
- 2019: 2.5

MEXICO
- 2018: 2.0
- 2019: 2.2

SOUTH AMERICA
- 2018: 1.6
- 2019: 2.6

EURO ZONE
- 2018: 4.5
- 2019: 4.3

TURKEY
- 2018: 6.3
- 2019: 6.0

CHINA
- 2018: 2.2
- 2019: 6.0

WORLD
- 2017: 3.8
- 2018: 3.8

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

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

- **Pre-crisis**: Tightening
- **Crisis**: Easing
  - BoJ
  - ECB
- **Normalization**: Tightening
  - Fed
  - Interest rate rises
  - Partial reinvestment
  - Hike in interest rates
  - Reinvestment of maturities
  - Reduction of purchasing of bonds
Monetary policy normalization: accelerated in the case of the Fed, gradual in the case of the ECB

Elements of uncertainty:

**Politics:** changes in government ministries (Fed, ECB)

**Macro:** possible surprises in inflation

**Markets:** Long-term rates and slope of the curve
Cautiousness in financial markets, with gradual moderation in flows to emerging economies

Appetite for risk indicator
1\textsuperscript{st} Factor (global), analysis of capital flows EPFR

Source: BBVA Research, EPFR
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)

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
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<tbody>
<tr>
<td></td>
<td>Mean May Jun Jul Aug Sep Oct Nov Dec</td>
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<tr>
<td>Industrial Production</td>
<td>3.9 4.2 2.2 7.7 7.7 13.8 8.6 9.6</td>
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<tr>
<td>Non-metal Mineral</td>
<td>17 2.7 0.9 8.2 8.4 14.2 7.7 8.7</td>
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<tr>
<td>Electricity Production</td>
<td>4.5 6.6 4.5 8.4 8.5 12.2 9.5 9.7</td>
</tr>
<tr>
<td>Auto Sales</td>
<td>3.5 -13.3 -9.7 2.4 7.1 14.6 7.3 -14.</td>
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<tr>
<td>Tourist Arrivals</td>
<td>2.1 26.5 36.5 45.5 45.2 38.2 31.0</td>
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<tr>
<td>Number of Employed</td>
<td>5.5 16.1 10.5 6.1 15 -0.8 -5.1</td>
</tr>
<tr>
<td>Number of Unemployed</td>
<td>3.5 2.0 2.7 3.5 4.3 4.5 4.8</td>
</tr>
<tr>
<td>Auto Imports</td>
<td>5.1 -13.9 -14.4 -6.7 -3.4 3.1 -0.9 -8.4</td>
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<tr>
<td>Auto Exports</td>
<td>9.2 32.4 24.0 23.2 9.8 5.9 33.3 28.9</td>
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<tr>
<td>Financial Conditions</td>
<td>75.4 30.8 35.6 40.5 35.4 38.9 26.1 10.0</td>
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<td>13-week Credit Growth</td>
<td>17.8 37.2 29.2 20.1 17.6 14.5 14.5 13.4</td>
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<tr>
<td>Retail Sales</td>
<td>3.6 0.1 0.8 1.8 2.0 1.5 1.3 1.9</td>
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<tr>
<td>Real Sector Confidence</td>
<td>106.1 104.8 116.8 107.7 102.2 111.2 122 129.8</td>
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<tr>
<td>MICA Forecast GDP YoY</td>
<td>5.4% 11.8% 11.1% 9.1% 6.7%</td>
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Turkey Economic Outlook – 1Q 2018

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, %)

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<th>10%</th>
<th>11%</th>
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<td>Oct-13</td>
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<tr>
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**Output Gap Models and Core inflation**

( Output 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: Turkstat and BBVA Research
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
Turkey Outlook
The Base Scenario and The Balance of Risks
Strong growth set to moderate but with balanced risks

- 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 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 Funding 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

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

*F* = forecast. (*) realization.
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