

Turkey Business Forecast Report Q2 2014

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Abstracts

Core Views

Although we believe Turkey has strong long-term growth potential, our real GDP growth forecasts remain well below consensus in 2014 and 2015. Tightening global liquidity conditions and rising domestic interest rates will stifle investment and credit growth, an important driver of the Turkish economy.

Political instability and social tensions will remain elevated in the run-up to general elections in 2015, further weighing on business and consumer confidence.

With relatively healthy budget and debt dynamics, the government is in a position to provide a more pronounced fiscal boost to the economy. However, we expect fiscal discipline to remain relatively high on the government's agenda.

While the government's debt load is low by regional standards, the private sector's rampant external borrowing in previous years has greatly increased macroeconomic risks.

After substantial widening of external imbalances in 2013, we expect Turkey's current account deficit to narrow only gradually in coming years owing to the country's dependence on imported energy. Turkey will remain reliant on short-term foreign capital inflows to cover the sizeable current account shortfall, leaving it prone to shifts in international risk sentiment and leaving open the potential for financing crises.

A major corruption scandal and increased incidences of popular protest have highlighted the fact that major political challenges still face the country over the medium term. In particular, the ruling Justice and Development Party will take an increasingly unilateral approach as it struggles to maintain support. We expect the party to face

growing and more vocal public opposition, with the potential for further unrest. Moreover, Turkey faces a challenging foreign policy environment amid heightened regional tensions as the government attempts to cement its role as an economic and political power in the region.

Major Forecast Changes

We have revised down our 2014 real GDP forecast for Turkey on the back of tightening monetary conditions and our expectation for a less amenable global environment for emerging market growth. We now expect growth of 1.5% in 2014, from a previous forecast of 2.6%. Nevertheless, if the Turkish authorities are able to weather the rebalancing process and the challenging external financing environment over the next few quarters, the country's long-term growth story remains an attractive one.

We now expect the general government budget deficit to come in at 2.7% of GDP in 2014, from a previous forecast of 2.2%, based on a deteriorating short-term growth outlook and our expectation that the government will look to support economic growth in the run-up to crucial elections in 2014 and 2015.

Key Risks To Outlook

The major risk to Turkey's macroeconomic trajectory stems from its external financing requirement. Turkey's large current account deficit and dearth of foreign direct investment inflows leaves the country vulnerable to external shocks and a major outflow of foreign capital. As such, while we see potential upside risks to our short-term forecasts should global risk appetite and demand for emerging market assets show a robust recovery, we believe risks are weighted primarily to the downside.

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Political instability and social tensions will remain elevated in the run-up to general elections in 2015, when we cannot rule out Prime Minister Recep Tayyip Erdoğan amending party rules to run for a fourth consecutive term. The adoption of increasingly authoritarian measures to stifle opposition has damaged relations with the EU, with negative implications for Turkey's long-term investment climate, and we expect a high degree of policy continuity as long as Erdoğan remains a leading figure in government.

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Turkey's moderate Islamist Justice and Development Party (AKP) will continue to press ahead with reforms to the country's political and social system for the foreseeable future. Although the AKP continues to enjoy broad popular support, there is growing and increasingly visible opposition from the traditional secular establishment that threatens to trigger a wider backlash. In terms of foreign policy, we expect Turkey to continue rebalancing its interests away from the West in favour of closer ties with the former Soviet Union and the Middle East and North Africa.

CHAPTER 2: ECONOMIC OUTLOOK

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In the context of tightening global liquidity and rising political uncertainty, Turkey's externally leveraged growth model will suffer in the coming years as financial account inflows slow and domestic interest rates remain elevated in order to sustain demand for

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Despite a sharp slowdown in domestic demand, Turkey's current account deficit will remain uncomfortably high in 2014 at 6.0% of GDP owing to relatively inelastic demand for imported energy. Turkey will continue to rely on short-term capital flows for external financing, implying that the financial account will remain susceptible to volatility in global investor risk sentiment.

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Fiscal discipline will take a back seat to supporting growth in 2014 as Turkey's ruling Justice and Development party struggles to maintain popular support amid a corruption scandal. However, a decade of conservative fiscal management has left the government with ample space for counter-cyclical spending in the coming quarters, with minimal damage to its sovereign profile.

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term will be necessary to set the groundwork for productivity gains beyond 2015. Significant risks will remain, however, especially as underlying social tensions between secularists and moderate Islamists are unlikely to disappear in the next decade. This has contributed to our view that Turkey will not join the EU any time over our forecast period.

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