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Macro Trends in the Turkish and World Economy

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General outlook

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World economies went through 2018 overshadowed by developments such as trade wars that broke out between the US and China, the Brexit tension and the embargo on Iran. The data released in the last quarter of the year strengthened concerns about a slowdown in global growth along with global geopolitical uncertainties.

For now, the trade wars between the US and China seem to have been put on hold with terms for an agreement to be renegotiated in the first quarter of 2019. On the other hand, the uncertainties around the UK's exit from the European Union, the Brexit process, have still not been fully overcome. It is hard to say that the new year has been met with enthusiasm in developed economies in view of a weakened Merkel government in Germany and the "Yellow Vests" demonstrations in France.

When we look at the emerging economies, we see that they are relying on capital flows with a strengthening perception that the US Federal Reserve (Fed) will be slow to raise interest rates. However, in the financial markets of emerging economies with hefty external debt payments in 2019 as in 2018, the concern that volatility may remain high throughout the year, is still alive.

Turkey, on the other hand, was caught in the midst of a challenging economic storm particularly beginning since the second half of 2018. When the foreign currency exchange crisis instigated by the crisis over the American Pastor Brunson was compounded by rising unemployment and inflation, Turkey suffered serious losses in growth performance in the third and fourth quarters of the year.

From The World Bank to the International Monetary Fund, institutions that closely follow the global economy predict that Turkey will show weaker performance in 2019 than it did in 2018. Considering the volatility in the world economy and capital flows, the idea that Turkey faces an increased risk of financial contraction in 2019 is gaining traction.

Rounding off 2018 with an inflation rate beyond 20%, the Turkish economy is trying to steer its way out of the doldrums through a slew of economic support packages announced over the past months for both the private sector and consumers.

At this point, the CBRT's firm stance is still vital for inflation and price stability. In particular, there is concern that an early interest rate cut in the first quarter may trigger a new storm in exchange rates.

All of these go to show that 2019 will be a challenging path to walk for both the global and the Turkish economy. Governmental economy policies and market measures will determine which economies will find themselves short of breath while trudging through this path.

I wish everyone a year full of health, peace and profits.

Overview of the global economy

- While data released in the last quarter of 2018 point to increasing downside risks for the global growth outlook, geopolitical uncertainties remained high. Preliminary data such as the Purchasing Managers' Index (PMI) confirm the slowdown in economic activity in the last quarter of the year. Therefore, the risk appetite in the global financial markets remained weak, while a demand for safe havens was strengthened. In this environment of uncertainties, capital flows to emerging economies followed a fragile trend.

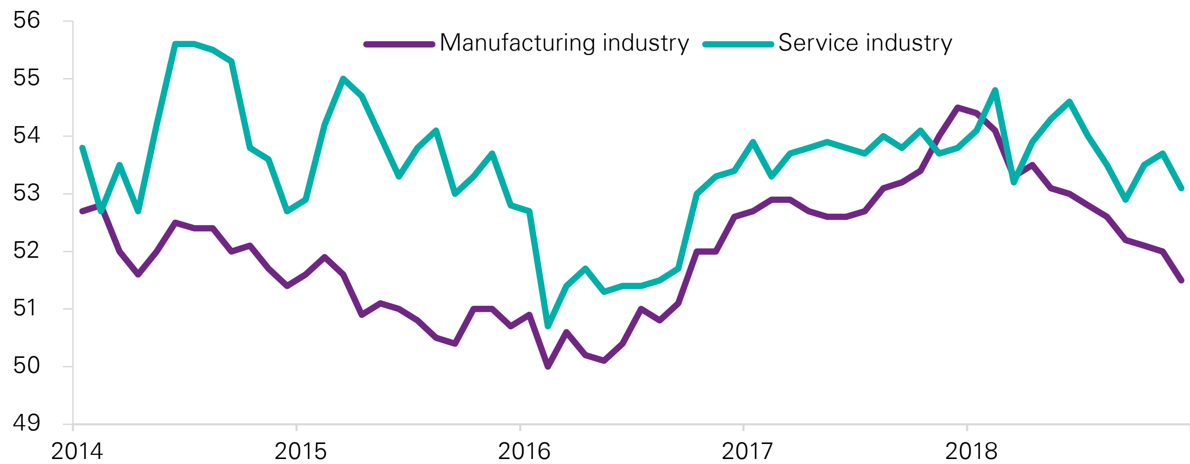
- Data from the US economy sends mixed messages regarding the growth outlook. The limited inflationary risks and the political developments have led to expectations that the US Federal Reserve (Fed) rate hikes may take place at a slower pace. The latest messages from the Fed indicate that medium and long-term rate hikes will remain limited. However, data from developed economies outside the US confirm the signs of a slowdown in growth.

- While trade wars between the US and China have been put on hold, with terms of an agreement to be negotiated in the first quarter of 2019, political and geopolitical tensions remain at the forefront of the global economy. Even if the European Union and the UK agree on Brexit, there is still a risk of the UK crashing out of the union without a deal. While Italy agreed on a more cautious budget with the EU after lengthy discussions, anti-austerity demonstrations in France dramatically increased political uncertainties in the country.

- The emerging economies are trying to tackle the uncertainties regarding the growth outlook of developed economies in addition to those surrounding the Fed's approach to rate hikes this year. Furthermore, in the financial markets of economies with hefty external debt payments in 2019 as in 2018, there is concern that volatility may remain high throughout the year.

- In 2017, the overall recovery in the global economy led to a positive outlook for 2018, unlike today. However, current trade wars and political/geopolitical uncertainties point to a relatively negative set of expectations for 2019. While the world economy is expected to slow down, capital flows are also expected to remain fragile even if the Fed slows down the rate hikes.

Global purchasing managers' indices (PMI)

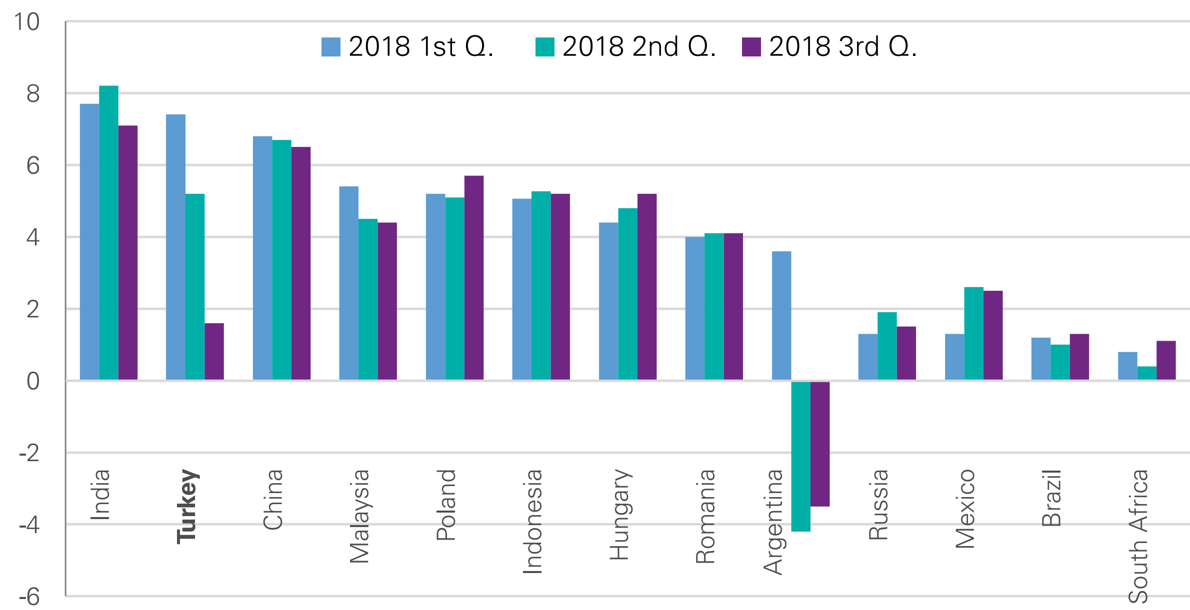


Source: Bloomberg

Overview of the Turkish economy

- The Turkish economy set off with a robust start in 2018, propped up by strong global demand. Thus, while Turkey became the second fastest growing economy among major developing economies in the first quarter, the downward trend in unemployment continued. While the improvement in inflation was limited due to fluctuations in food and energy prices, the expansion in the current account deficit continued due to the commodity prices and strong domestic demand.
- With the second quarter, the improvement in the labor market remained limited, while inflation increased with the rise in exchange rates. Expansion in the current account deficit stopped on the other hand, with strong performance in tourism. Regarding the monetary policy of the CBRT, the impact of steps taken towards simplification and interest rate hikes remained limited.
- As a result of the turbulence experienced in the third quarter, the increase in inflation gained momentum and the CBRT had to massively increase the interest rates. As the growth slowed down sharply, the employment growth stopped and unemployment started to increase. The current account deficit started to decrease on the back of weakening domestic demand and good tourism revenues. During the high tourism season (summer months), Turkey's economy posted a successive current account surplus for the first time after many years.
- In the last quarter, inflation was slightly improved thanks to the measures taken by the government, the decline in oil prices, relative normalization of the exchange rates and the slowdown in domestic demand. While the increase in unemployment figures continued with the loss of acceleration in growth, the narrowing of the current account deficit continued.
- Turkey's economy is expected to show a weaker performance in 2019. Considering the volatility in the world economy and capital flows, Turkey faces an increased risk of financial contraction in 2019. Therefore, it is estimated that unemployment may continue to rise. On the other hand, although the improvement in inflation and current account deficit is expected to continue for a while, the extent of the recovery and whether it is here to stay is likely to be dependent on the course of foreign exchange rates and foreign demand.

GDP annual growth rates (%)



Source: The Economist, Eurostat

Conclusion

- The recent data flow around the world reflects the negative effects of conservative tendencies in global trade, while weakening the risk appetite in financial markets. While this may cause the Fed to slow down rate hikes, global growth should be accelerated in order to stimulate capital flows to emerging economies in the medium term.
- The weakening of economic activity in Turkey became more pronounced in the fourth quarter along with global trends. While preliminary data points to the possibility that this situation may continue in the first quarter of 2019, the measures taken by the government are thought to have a limited effect. On the other hand, the deterioration in the labor market has been limited so far, limiting the weakening in total demand.
- While the weakness in domestic demand and a decline in oil prices led to a decline in imports, exports continue to increase due to the weak Turkish Lira. While this causes a sharp narrowing of the foreign trade deficit, a strong tourism industry allowed Turkey to post successive current account surpluses in the August-November period.
- In the last quarter, inflation was improved by a certain extent thanks to the measures taken by the government, relative normalization of the exchange rates, the decline in oil prices, and weak domestic demand. Nevertheless, inflationary risks still exist as there has not been any significant improvement in pricing behavior.
- In this environment, despite the weakening of economic activity, the CBRT should maintain its tight stance for a while, which is considered necessary in terms of inflation and price stability. It is considered that it would be beneficial for the CBRT to avoid an early interest rate cut in order to keep maintaining the stability of the Turkish financial assets intact and the balance in the economy.

Expectations for 2019

- Turkey's economy is expected to show a weaker performance in 2019. Although a growth rate of around 2 percent is reasonable for the entire year, it is considered that domestic demand may remain under pressure for a while due to the delayed effects of the increases in interest rates and exchange rates in 2018. Considering the limited playing field accorded to public finances to support growth and volatility in the world economy and capital flows, Turkey faces an increased risk of financial contraction in 2019.
- Rounding off the previous year with an inflation rate of 20.3%, the Turkish economy is thought to have averted upside risks in inflation due to weak foreign and domestic demand. Moreover, declining oil prices stand out as a factor that can have a dampening effect on spiraling costs. However, the improvement in pricing behavior and inflation outlook may be limited due to the high minimum wage increase and the tendency to take past inflation rates as a basis. Therefore, it is estimated that inflation may decrease to 15 percent at the end of 2019.
- Even though deterioration in the labor market was limited throughout the remainder of 2018, it is estimated that unemployment may continue to increase due to the sluggish Turkish economy. The average unemployment rate, which was 11.3% in 2018, is estimated to rise to an average of 12.5% in 2019.
- With the weakness in domestic demand and the decline in oil prices, the improvement in the current account deficit may continue for a while. However, in terms of this trend continuing, the course of oil prices and the performance of the tourism industry next year are considered to be important. In light of these dynamics, the current account deficit, which was around 28 billion dollars in 2018, is expected to remain at this level in 2019 if there are no rapid increases in oil prices.
- In addition to the size of the economic balancing, the performance of Turkish assets in 2019 will also depend upon whether the CBRT will make an early interest rate cut. An early interest rate cut by the CBRT may leave Turkish financial assets vulnerable at a time when jittery investors are seeking a safe haven from a potential global crisis. This may cause the volatility in TL to remain high again. If the CBRT can maintain its tight stance until a significant improvement in inflation is achieved, the TL is expected to gain real value. On that basis, the USD/TL annual average rate is estimated to be 5.70, and 6.00 at the end of the year. However, if the CBRT makes an early interest rate cut, there are concerns that the TL will once again become fragile.

Growth

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Inflation

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Foreign Trade

While the weakness in domestic demand and a decline in oil prices led to a decline in imports, exports continue to increase due to the weak Turkish Lira. This, in turn, brings about a sharp contraction in the foreign trade deficit.

Tourism

Tourism revenues are projected to increase to 27 billion dollars in 2019. It is estimated that there will be moderate increases in the number of tourists and tourism revenues throughout the year.

2019 GDP growth
2%

GDP 2019
725 billion USD

2019 foreign trade expectation
Exports 180 billion USD
Imports 240 billion USD

Markets

2019 year averages		End of 2019	
USD / TRY	: **5,70**	USD / TRY	: **6,00**
EUR / TRY	: **6,60**	EUR / TRY	: **7,05**
EUR / USD	: **1,15**	EUR / USD	: **1,175**
Brent oil	: **65 $**	Brent oil	: **75 $**

Unemployment

12,5%
(year average)

Inflation

15%
(end of 2019)
19%
(2019 year average)

Current Deficit

27,5
(billion USD)

*This data is based on market data dated January 15, 2019.

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