

## Executive Summary

We estimate that Turkish economy contracted by around 10 percent in the first quarter. We observe an increase in monthly industrial production index from March to April, for the first time after 11 consecutive months. Moreover, capacity utilization rate increased by 2.4 percent from March to April and by 2.6 percent from April to May. All these signs imply that the economy may have reached the bottom in the second quarter. Assuming that the economy contracted by 10 percent in the first quarter and that we have reached the bottom in the second quarter, we estimate that Turkey economy will contract by 6 percent annually in 2009. If so, the number of unemployed will exceed 4 million and this will affect the outcomes of the 2011 elections inevitably.

As the uncertainty regarding a possible IMF agreement grows, the downwards pressure on the exchange rate gains strength and the appreciation of Turkish Lira stagnates. An IMF agreement or a credible and substitutable medium term fiscal plan will determine the future trend of the exchange rate. The current account deficit is no longer a problem thanks to the economic contraction. If oil prices are set around the 70 USD level and the domestic demand slightly picks up in the second half of 2009, it is possible that a 15 billion USD current account deficit will emerge in the forthcoming 12 months.

We estimate a 7 percent increase in the budget deficit to GDP ratio and a 5 to 6 point rise in the debt ratio in 2009. These numbers point to a financial situation which is bleak enough to affect the expectations adversely in the absence of an intervention. Although relatively low debt ratio provides some room for maneuvering, interest rates which are considerably high and the structural rigidity of the expenditures signal that the debt ratio may continue to increase in 2010 depending on the growth path. The expenditures need to be curbed in the second half of 2009 (The first signs of such a check can be seen in May budgetary figures). On the other hand, measures should be taken to ensure a primary surplus without generating any doubts on the sustainability of debt in 2010 and later. The 2009 budget deficit should be financed by international funds. How to achieve this without an IMF agreement remains uncertain. Whether or not a fiscal plan would provide the necessary credibility is also doubtful.

Disinflation continues. The year-end target of 7.5 will almost surely be attained. In the base scenario, a 6 percent decrease in yearly CPI is highly probable. However, there are three main risks which may reverse this downward inflation trend. First of all, if an IMF agreement is not signed and the government cannot design a credible medium-term plan, the Turkish currency will depreciate further. If so, the inflationary effects of the exchange rate will be unavoidable. Second risk pertains the timing of the inflation pass through. As aggregate demand recovers, firms may simply reflect their accumulated costs in prices. Finally, as the markets recovers from the global crises, disinflation in energy and commodity prices will also come to an end.

We believe that the CBRT's interest rate cuts has come to an end. Hereafter, the course of the monetary policy will be shaped by the fiscal policy and the inflationary pressures as the economy recovers. Fiscal policy should be tightened considerably in the second half of 2009 in order to sustain a loose monetary policy. Budget deficit will reach 68 billion USD with a 6 percent economic contraction and a mild slowdown in expenditures/consumption. Trying to finance most of this deficit without international funds will cause the macroeconomic structure of low real interests and competitive exchange rates to collapse. This structure is what actually maintains growth. Higher exchange rates and interest rates will restrict growth. Therefore, a credible medium term fiscal plan is needed urgently.

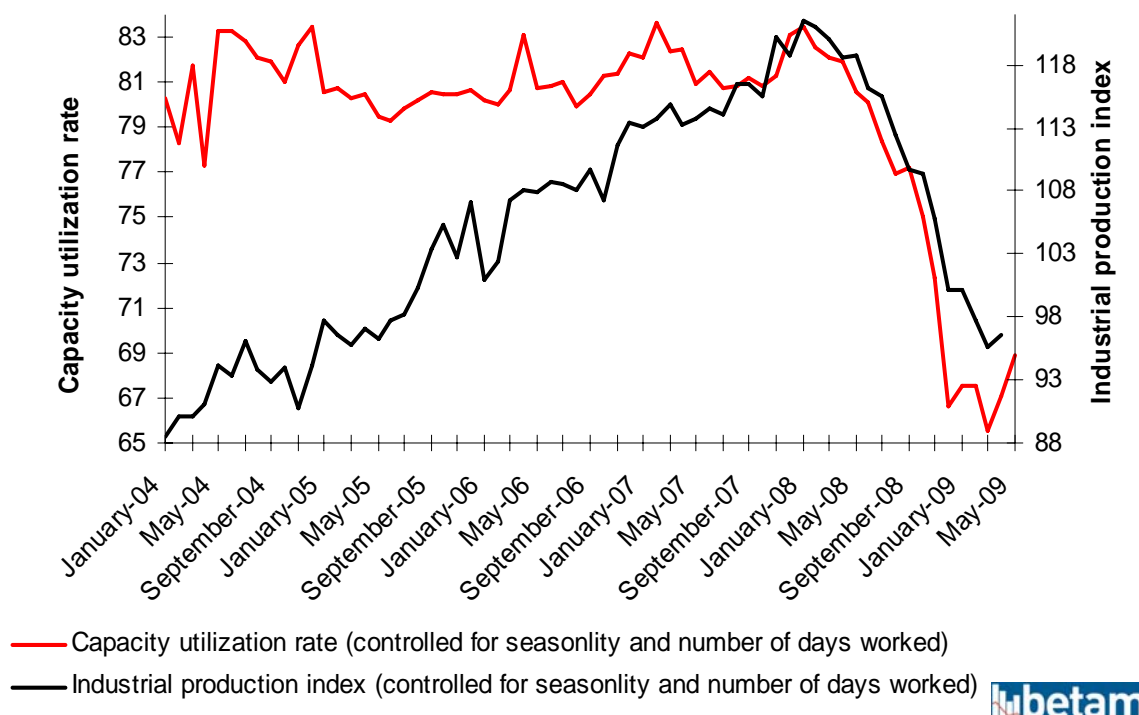
## Growth and employment

**We estimate that Turkish economy contracted by around 10 percent in the first quarter. Assuming that the economy contracted by 10 percent in the first quarter and that we have reached the bottom in the second quarter, we estimate that Turkey economy will contract by 6 percent annually in 2009. Under these circumstances, it is inevitable that the number of unemployed will exceed 4 million.**

In the Macroeconomic Outlook 2 that we prepared in March, we estimated a 4 percent contraction in the fourth quarter of 2008. At 6.2 percent, the fall was beyond our expectations. Selling out of stocks had a large effect in this sizeable shock. We estimate that the economy contracted by about 10 percent given the current industrial production and the capacity utilization rate. This is compatible with the CBRT's two digit contraction estimate. Assuming that the economy contracted by 10 percent in the first quarter, that we have reached the bottom in the second quarter and will slowly grow from one quarter to the next, we estimate that Turkey economy will contract by 6 percent annually in 2009.

Figure 1 presents the deseasonalized series of the capacity utilization rate and the industrial production index. These are major indicators which reflect the effects of global crisis on the Turkish economy. In April, the industrial production index decreased by 18.5 percent on an annual basis. However, when we take the seasonal effects into account and adjust for the number of working days, we find that the monthly industrial production index increased by 1 percent, which is the first increase for the past 11 months. The increase in the capacity utilization rate (2.4 percent from March to April and 2.6 percent from April to May) points in the same direction. All these signs strengthen the possibility that the economy has reached the bottom in the second quarter.

**Figure 1 The Capacity Utilization Rate and The Industrial Production Index (Deseasonalized and working day adjusted)**



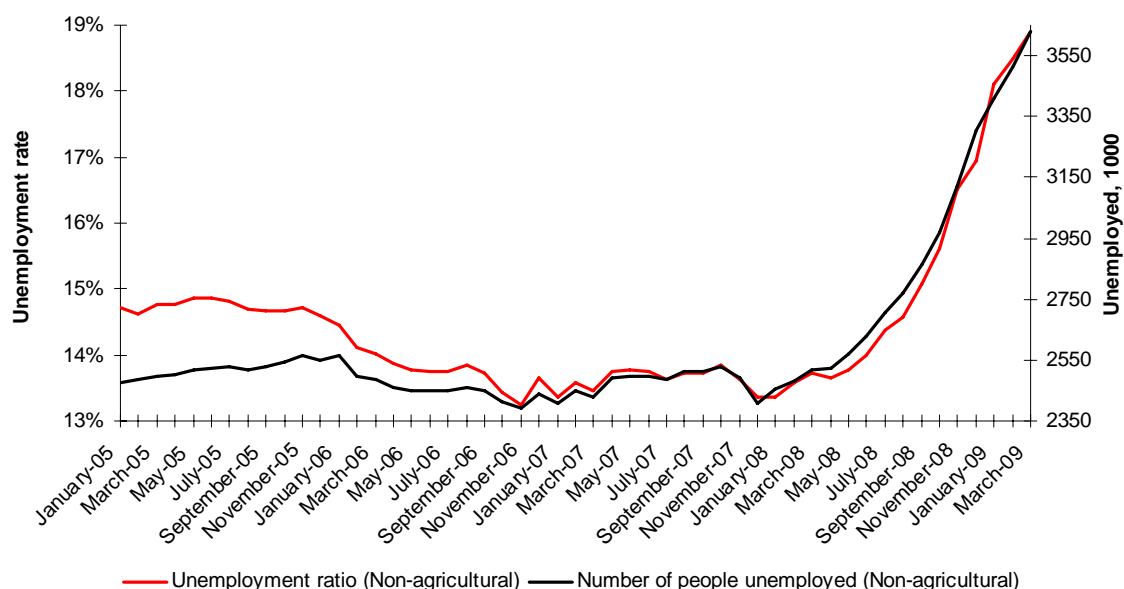
Source: TURKSTAT and **betam**

An annual 6 percent contraction is far deeper than the government's estimate of 3.6. The authorities also accept they are underestimating and they are about to revise their estimates. The size of the negative growth is of critical importance for fiscal policy. As it will be discussed further in the fiscal

policy section, economic contraction increases budget deficit through reducing tax revenues and adversely affects the degree of fiscal tightening in medium-term.

Another consequence of economic contraction is an increase in unemployment. The unemployment has increased tremendously. Two different dynamics are behind this increase: The economic stagnation decreases employment, mainly industrial employment. Due to the crisis, non-agricultural labor supply exceeds its usual trend. The added worker effect results from the labor market entry of men and women, who have not been in the labor market, but who are able to work. As the breadwinners of the household face higher risks of job loss, additional members start entering the labor market. As shown in Figure 2, these dynamics resulted in enormous increases both in the number of unemployed and the unemployment rate. For a more detailed labor market analysis, see **betam** Research Notes 32 and 34.<sup>1</sup> Our final estimates are that unemployment rate will be 16.8% percent in 2009 (The unemployment rate was 13.6 percent in 2008) and that the number of unemployed will reach 4.3 million by year-end. What is distressing is that the unemployment will not decrease in 2010 or in 2011, even under a limited positive growth assumption. This will affect the outcomes of the 2011 elections inevitably.

**Figure 2 Non-agricultural Unemployed and The Non-Agricultural Unemployment Rate<sup>2</sup> (Seasonally adjusted)**



Source: TURKSTAT and **betam**



## External balance and exchange rate

**As the uncertainty regarding a possible IMF agreement grows, the downward pressure on the exchange rate gains strength and the appreciation of Turkish Lira stagnates. An IMF agreement or a credible and substitutable medium term fiscal plan will determine the future trend of the exchange rate. The current account deficit is no longer a problem thanks to the economic contraction. If oil prices are set around the 70 USD level and the domestic demand slightly picks up in the second half of 2009, it is possible that a 15 billion USD current account deficit will emerge in the forthcoming 12 months.**

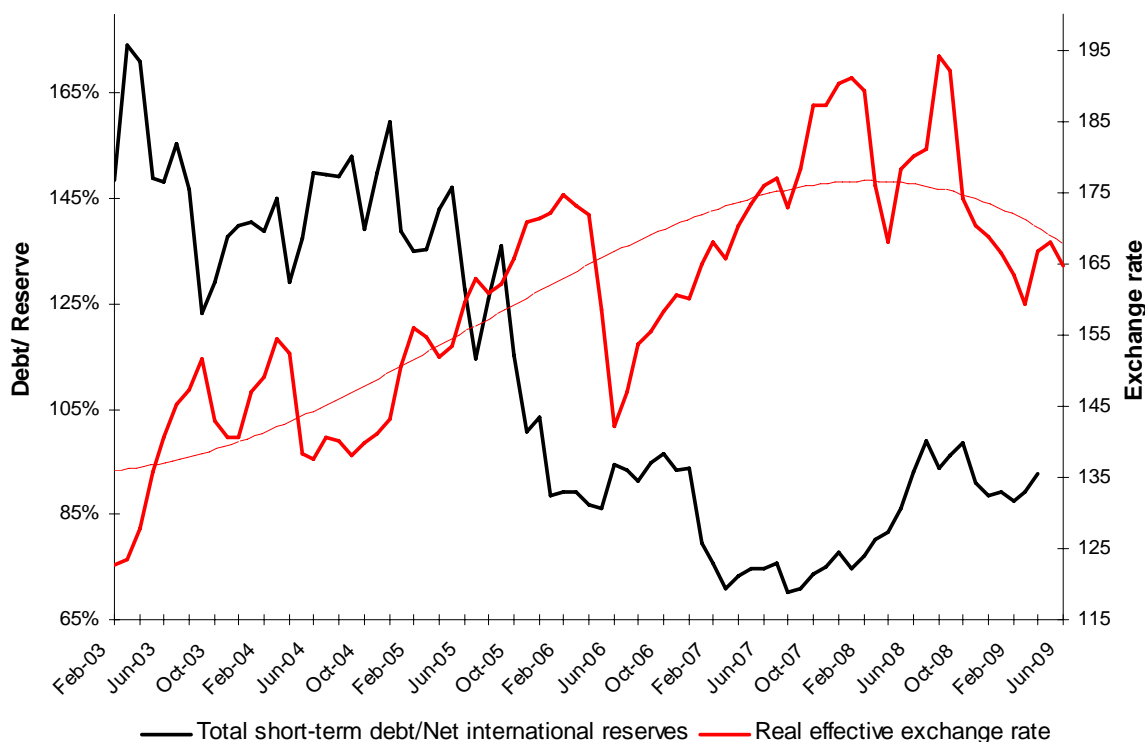
In August, following the trial of Justice and Development Party and before the financial crisis, the value of Turkish Lira was at its highest level with 2.85 TL against the 1 USD + 1Euro basket. In our previous reports, we noted that the exchange rate was 20 percent overvalued compared to the long term trend (Figure 3). The depreciation of TL reached 30 percent in October and the value of the basket settled around 3.70 TL until March. In March, the value of the basket reached 4 TL following the increases in domestic and external uncertainty. The possibility of signing with the IMF decreased currency basket

<sup>1</sup> <http://www.betam.bahcesehir.edu.tr>

<sup>2</sup> January and February data are computed by using the annual growth rates of the new data set to extend the old data set.

value to its previous level. It is difficult to estimate the short-term course of the exchange rate. The stress on the exchange rate will persist unless an IMF agreement or a credible medium term fiscal plan is established.

**Figure 3 CPI-based Real Exchange Rate and the Ratio of Total Short Term Debt to International Reserves**



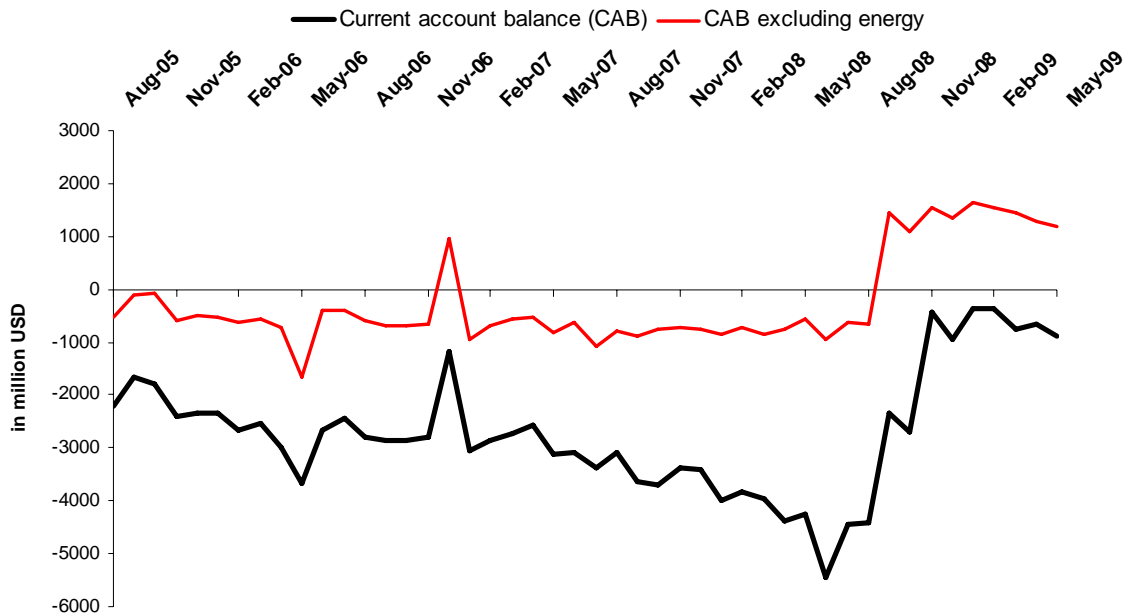
Source: Turkey Data Monitor and **betam**

Despite the decrease in exports, economic contraction and the global deflation imply that the current account deficit ceases to be a problem. Deseasonalized monthly current account deficit series indicate that the current account deficit is 1 billion USD, it was about 4 billion USD before the global crisis (Figure 4). This monthly deficit signals that in the forthcoming 12 months, the deficit may reach 15 billion USD if the increase in the oil prices is limited and if there is a partial increase in demand. A deficit of 15 billion USD will not be hard to finance if there are no net outflows of capital, the net portfolio flows are positive though limited and the foreign direct investment flows continue. We observed that the foreign direct investments continued to flow in the last quarter of 2008 and the first quarter of 2009, though in smaller amounts. Nevertheless, there was a net outflow of credits and portfolio investments due to the global crisis (Figure 5). This trend needs to be reversed for the financing of the deficit not to exert a pressure on the exchange rate. Although the recovery from the crisis will generate an environment encouraging capital flows, it will be challenging to change the direction of portfolio investments without an effective medium term roadmap.

At this point, an IMF agreement proves to be essential. Without the IMF, only a credible and sustainable domestic fiscal plan may affect the direction of capital flows. We have not observed such a will power yet. As long as the uncertainty regarding an IMF agreement continues, the pressure on the exchange rate and the interest rates will persist. However, even in the worst case scenario, we do not expect a dramatic increase in the exchange rate. The ratio of short-term liabilities to CBRT reserves continues to decrease. Inflationary expectations are under control. Under these circumstances, we expect a shift from foreign currencies to the domestic currency, as it was experienced recently. This shift will prevent dramatic increases in the exchange rate. We think that there is a resistance level around 1.70-1.80 TL against the USD.

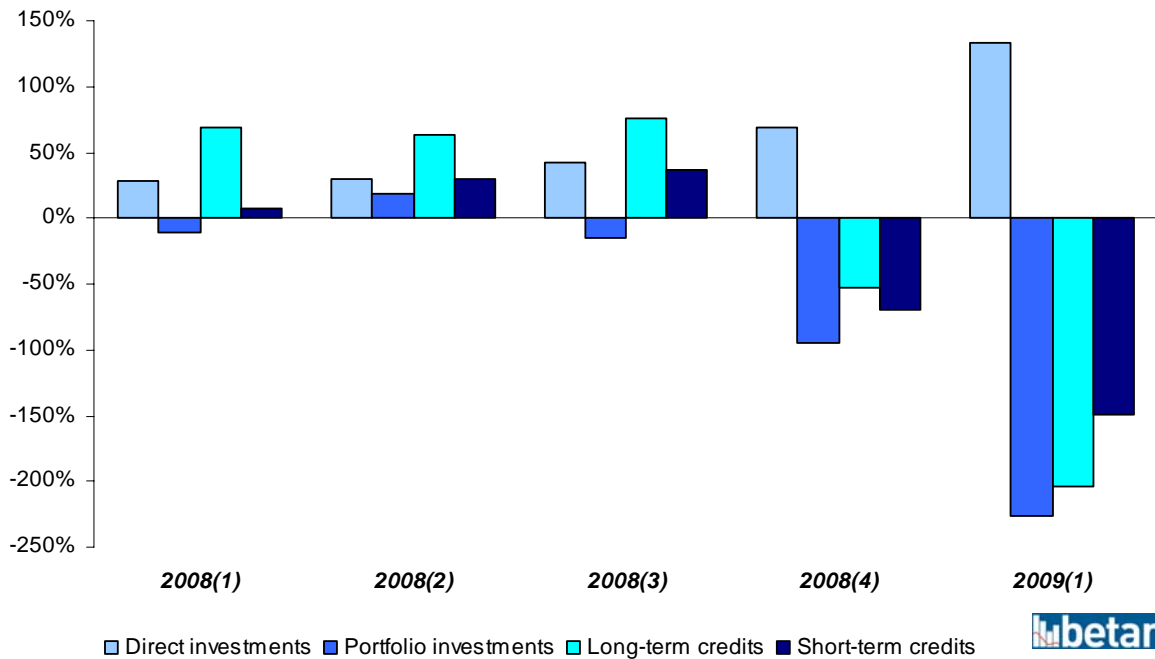
In the case that the government signs with the IMF, we expect a moderate appreciation in TL (around 1.45 TL against 1 USD). Major obstacles for the appreciation of the TL are the narrow international liquidity and low TL interest rate.

**Figure 4 The Current Account Deficit (monthly, seasonally adjusted, in millions of USD)**



Source: CBRT, TURKSTAT and **betam**

**Figure 5 Financing of the Current Account Balance**



Source: CBRT and **betam**

## Fiscal policy

**We estimate a 7 percent increase in the budget deficit to GDP ratio (exceeding the official estimate in the Pre-Accession Economic Program prepared by the Government in April) and a 5 to 6 point rise in the debt ratio in 2009. The expenditures need to be curbed in the second half of 2009. The first signs of such a check can be seen in May budgetary figures.**

Fiscal account deteriorated even beyond the adjusted government budget, which was revised in April in the Pre-Accession Economic Program. Taking into account a possible negative 6 percent growth rate and the budget realizations of the first 5 months (Table 1), we estimate that budget deficit will exceed 48 billion TL and reach 68 billion TL with a 7.1 percent budget deficit (Table 2). We also expect the primary surplus to turn into a deficit of size 1.18 percent. Main reasons behind this deterioration in the fiscal outlook are the remarkable increase in the expenditures along with a dramatic decrease in the tax revenues due to the negative 6 percent growth rate. During the first 4 months of 2009, we observed a 17 percent real increase in expenditures. Although some part of this increase is related to the local elections, a 6.2 percent real increase in April verifies that structural defects are the main driving force behind this increase. On the other hand, there was an unexpected 2.7 percent real decrease in May in primary expenditures. This significant slowdown in government expenditures seems suspicious. When the expenditure components are examined more closely, it can be seen that the decrease is mainly due to narrowing social security spending along with decreasing SEE's operational losses and national defense expenses. We believe that this slowdown occurred following an accrual of some of these items and postponing the payments to the upcoming periods. Still, government expenditures may have actually slowed down. With these facts in mind, we assumed a 10 percent increase in government expenditures when estimating the budget deficit. This figure indicates that the real increase in primary expenditures will be limited to 6 percent in the last 8 months of 2009.

Within this framework, assuming a 6 percent interest rate on average, a 5 to 6 points leap is inevitable in the amount of public debt stock. These numbers point to a financial situation which is bleak enough to affect the expectations adversely in the absence of an intervention. Although, many countries may face budget deficits and increased public debt stocks under the conditions of the global crisis, the sustainable amount of debt is limited depending on each country's macroeconomic conditions. Although relatively low debt ratio provides some room for maneuvering, interest rates which are considerably high and the structural rigidity of the expenditures signal that the debt ratio may continue to increase in 2010 depending on the growth rate.

**Table 1 Central Government Budget Realizations in January to April (in Millions TL)**

	Sum of Jan to April			May		
	2008	2009	Real* (%)	2008	2009	Real (%)
<b>Central Government Revenues</b>	<b>64,750</b>	<b>67,363</b>	<b>-2.0</b>	<b>19,211</b>	<b>18,853</b>	<b>-6.7</b>
<b>Tax Revenues</b>	<b>53,160</b>	<b>50,959</b>	<b>-9.7</b>	<b>16,902</b>	<b>15,275</b>	<b>-14.1</b>
Direct Tax Revenues	19,792	19,799	-5.8	7,915	7,225	-13.2
Indirect Tax Revenues	33,368	31,160	-12.0	8,987	8,050	-14.9
<b>Other Revenues</b>	<b>11,590</b>	<b>16,404</b>	<b>33.3</b>	<b>2,309</b>	<b>3,578</b>	<b>47.3</b>
<b>Central Government Expenditures</b>	<b>70,197</b>	<b>87,434</b>	<b>17.3</b>	<b>15,822</b>	<b>19,463</b>	<b>16.9</b>
<b>Primary Expenditure</b>	<b>52,282</b>	<b>66,307</b>	<b>19.5</b>	<b>14,141</b>	<b>14,473</b>	<b>-2.7</b>
<b>Interest</b>	<b>17,915</b>	<b>21,127</b>	<b>11.1</b>	<b>1,681</b>	<b>4,990</b>	<b>18.21</b>
<b>Budget Balance</b>	<b>-5,447</b>	<b>-20,071</b>	<b>247.1</b>	<b>3,389</b>	<b>-610</b>	<b>-</b>
<b>Primary Balance</b>	<b>12,468</b>	<b>1,056</b>	<b>-92.0</b>	<b>5,070</b>	<b>4,380</b>	<b>-17.9</b>

\* When calculating the 4-month real changes, we use the April 2008 and April 2009 CPI change of 6.2%.

Source: **betam** and Turkish Data Monitor



A budget deficit of this amount raises questions on funding issues. Financing this deficit with domestic funds will exert a great pressure on the interest rates. Increased interest rates could extensively neutralize the loose monetary policy. Under these circumstances the desired increase in domestic demand will be restricted. Budget deficit could not be financed by CBRT's open market operations either. This financing method will significantly increase the money supply. Therefore, even though it



could be used moderately during an economic crisis, it may affect the inflation expectations adversely if overused. It is obvious that the expenditures should be curbed in the second half of 2009. On the other hand, measures should be taken to ensure a primary surplus without generating any doubts on the sustainability of debt in 2010 and later. The 2009 budget deficit should be financed by international funds. How to achieve this without an IMF agreement remains uncertain. Whether or not a fiscal plan would provide the necessary credibility is also doubtful.

**Table 2 Central Government Budget Plan and estimations by betam (in millions TL)**

	2008	2009 betam estimates	Nominal %	Real %
<b>Central Government Revenues</b>	<b>208,898</b>	<b>194,240</b>	<b>-7.0</b>	<b>-12.3</b>
<b>Tax Revenues</b>	168,087	164,670	-2.0	-7.6
Direct Tax Revenues	59,021	61,127	3.6	-2.3
Indirect Tax Revenues	109,157	103,543	-5.1	-10.5
<b>Other Revenues</b>	40,811	29,570	-27.5	-31.6
<b>Central Government Expenditures</b>	<b>225,967</b>	<b>261,881</b>	<b>15.9</b>	<b>9.3</b>
<b>Primary Expenditure</b>	175,309	204,381	16.6	10.0
<b>Interest</b>	50,661	57,500	13.5	7.1
<b>Budget Balance</b>	-17,069	-67,642	296.3	268.70
<b>Budget Balance / GDP (estimated)**</b>	-1.8	-7.1		
<b>Primary Balance</b>	33,592	-10,142	-130.2	-128.5
<b>Primary Balance / GDP (estimated)**</b>	3.5	-1.1		

Note that we use 2009 end-of-year inflation estimate 6.0% of the CBRT for calculating the real changes. Our estimate for the growth rate for 2009 is -6.0%.

\* We used our estimate of -10.0% for the growth rate in the first quarter of 2009 and the annual real changes in the direct and indirect taxes to calculate the elasticities. Then we incorporated our annual growth rate estimate of -6.0%.

\*\* In the first 4 months of 2009, the central government primary expenditures has increased by 17.3% on real terms. However, we observe an unexpected real decrease in the non-interest expenditures in May. It is too early to say whether this is a temporary adjustment. We assume that the expenditures will be curbed (an average of 6% real increase) and that the increase in expenditures will be limited to 10%.

Source: General Directorate of Budget and Fiscal Control , Turkey Data Monitor and betam



## Inflation

***Disinflation continues. The year-end target of 7.5 will almost surely be attained. In the base scenario, a 6 percent decrease in yearly CPI is highly probable. However, there are risks which may reverse this downward inflation trend.***

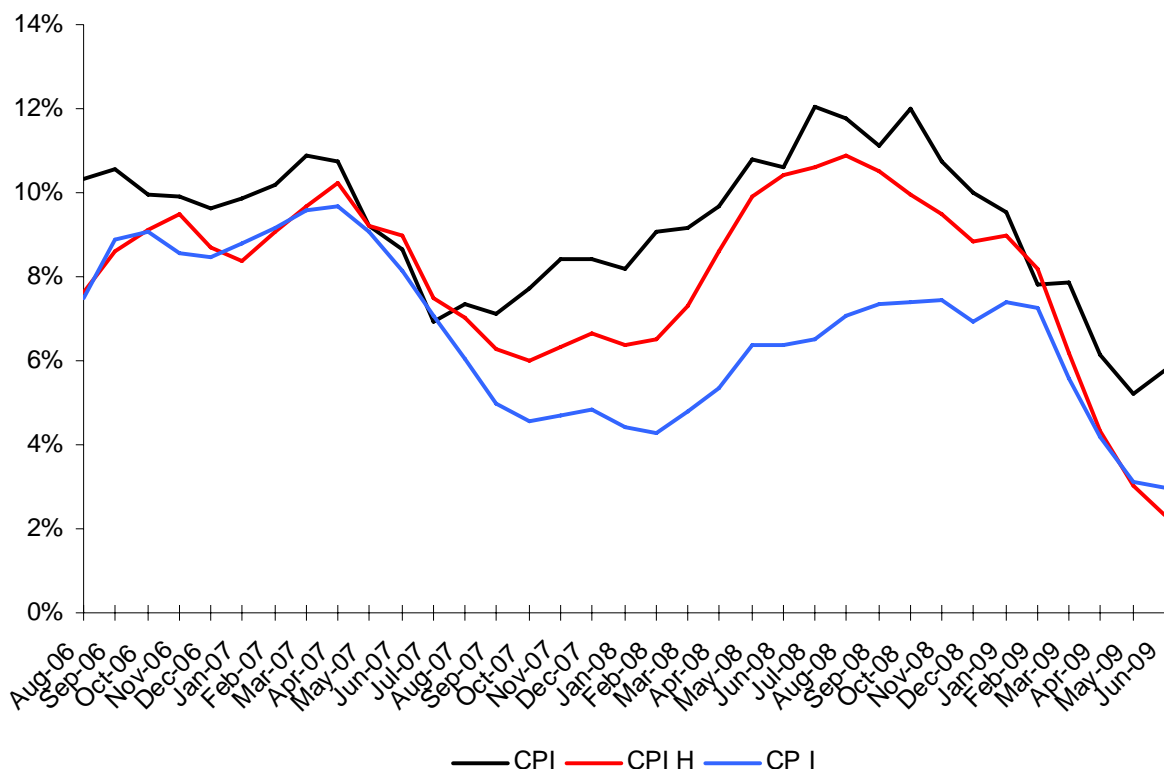
The strong disinflation caused by deflation in energy and commodity prices and economic recession continues. Annual CPI decreased from 7.9 percent to 5.2 percent in three months. We had foreseen this decrease in our March report. H and I indices, excluding prices which cannot be controlled through monetary policy, continued to decrease by 3.0 and 3.2 percent respectively (Figure 6). With these numbers in mind, an annual inflation of 6 percent is highly probable. In the past few months, Monetary Policy Committee did not hesitate to cut down the interest rates aggressively given that inflation below 5.5 percent will imply that the CBRT was unsuccessful (the target inflation is 7.5 percent).

Decreasing inflation despite a depreciation of TL may be surprising. The main reason is the low level of inflation pass through during an economic stagnation. Exchange rate fluctuations are automatically reflected in energy prices (Figure 7). However, increased production costs due to depreciated TL are not reflected in the prices of final goods given that the demand is already weakened due to the economic crisis. Nevertheless, there are three main risks which may reverse this downward inflation trend. First of all, if an IMF agreement is not signed and the government cannot design a credible medium-term plan, the Turkish currency will depreciate further. If so, the inflationary effects of the exchange rate will be unavoidable. Second risk pertains the timing of the inflation pass through. As

aggregate demand recovers, firms may simply reflect their accumulated costs in prices. Therefore, it is probable that we will observe the inflationary effects of the depreciation in TL over the medium term. Finally, as the markets recovers from the global crises, disinflation in energy and commodity prices will also come to an end. Actually, we believe that disinflation already ended in May with the significant increase in energy and commodity prices. The increases in H and I indices, which represent the core inflation, are worrisome in terms of future inflation. In May 2009, these indices decreased with a strong base effect on annual basis (they peaked in May 2008). However, their monthly values reached high levels at 1.4 percent and 1.8 percent, respectively (Figure 6).

An inflation of 6 percent presents an extraordinary opportunity. Fiscal and monetary policies should be compatible in order to sustain inflation at this level for a while. As we highlighted in the fiscal policy section, given the inflationary pressures, the monetary policy should be tightened unless a medium-term credible fiscal framework is established. In this case, the already weak economic growth will inevitably deteriorate further in 2010. This outcome will have dire effects on unemployment. Therefore, we would like to emphasize the critical importance of a fiscal plan yet again.

**Figure 6 Annual Inflation**



Source: TURKSTAT

## Monetary Policy

***We believe that the CBRT’s interest rate cuts has come to an end. Hereafter, the course of the monetary policy will be shaped by the fiscal policy and the inflationary pressures as the economy recovers.***

Taking disinflationary dynamics into account, the CBRT continued to cut the interest rates down to 8.75 percent, as we foresaw in our March report. Through high liquidity, the CBRT keeps money market interest rate close to the borrowing rate. We think that this policy is adequate. Markets chased these interest rate cuts initially and rates decreased (Figure 7). Hence, expected real interest rates receded to a historically low level of 5 percent on May 15<sup>th</sup>.

However, we have been observing a significant pressure on market rates during the past months due to the uncertainty of an IMF agreement. Expected real interest rate increased by 0.5 points as the benchmark interest rate increased (Figure 7).

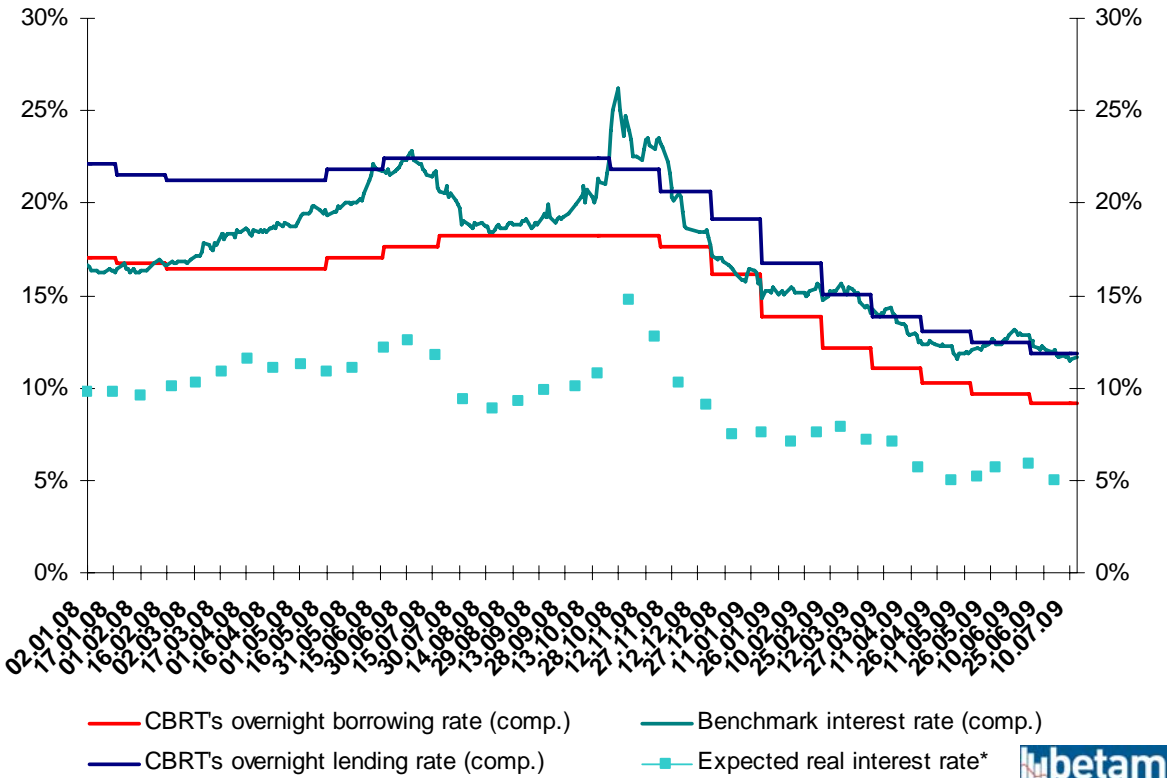


We believe that a decrease in the bank loan interest rates is unavoidable as the economy recovers. A decrease in the bank loan interests and a recovery in domestic demand as a result of increasing confidence may trigger the inflation pass through we discussed above. Moreover, without an IMF agreement or a credible fiscal plan, the CBRT may find it necessary to increase the interest rates. It is true that CBRT is in a good position in terms of inflation targeting, it has room for maneuvering. However, if the expectations start deteriorating, it is going to be increasingly difficult for the CBRT to hold the interest rates, nominal and real, at their current levels in the medium term.

From this aspect, the most critical issue is the fiscal policy. Fiscal policy should be considerably tightened in the second half of 2009 and even further in 2010, in order to sustain a loose monetary policy. As mentioned in the fiscal policy section, budget deficit will reach 68 billion USD under the assumptions of a contraction of 6 percent and a mild slowdown in expenditures. Trying to finance most of this deficit without international funds will cause the macroeconomic structure of low real interests and competitive exchange rates to collapse. This structure is what actually maintains growth. Higher exchange rates and interest rates will restrict growth.

As we conclude, we would like to emphasize further the immediate necessity of an established medium-term fiscal framework and a reform program. How will they be attained? We still underline the facilitator role of an IMF agreement. On the other hand, we are not informed about IMF’s requirements and how realistic they are. If an agreement with IMF cannot be signed for a reason or another, the government should announce this instantly and declare its own stability program.

**Figure 7 Monetary Policy Indicators**



Source: Turkey Data Monitor and **betam**\*

\* Expected real interest rate =  $\frac{1+i}{1+\pi^e} - 1$  ( $i$  = annual benchmark interest rate and  $\pi^e$  = expected inflation)