Euler Hermes Economic Research

Country Report

Turkey

Like a roller-coaster

General Information

GDP	USD718bn (World ranking 18, World Bank 2015)
Population	78.7mn (World ranking 18, World Bank 2015)
Form of state	Republican Parliamentary Democracy
Head of government	Binali YILDIRIM (Prime Minister; AKP)
Next elections	2019, legislative

Strengths

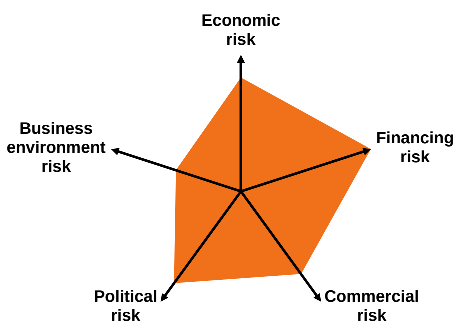
- Important geostrategic position that has historically always ensured aid when needed
- Public finances
- Adequate business environment (though deteriorating)
- Potential as regional hub between Europe, MENA and Asia

Weaknesses

- Exchange rate vulnerability to domestic and external shocks
- Economic policy responsiveness
- Persistently large current account deficits, largely financed through short-term external debt which has consequently risen to a high level
- (External) debt refinancing risk of weaker companies and banks
- Deep-rooted division in society between secularists and religious conservatives
- Geopolitical risks

Country Rating

C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	9%	1	12%	China
United Kingdom	7%	2	10%	Germany
Iraq	6%	3	10%	Russia
Italy	5%	4	5%	United States
United States	4%	5	5%	Italy

By product (% of total)

Exports		Rank		Imports
Road vehicles	13%	1	15%	Chemicals
Basic metals	12%	2	11%	Basic metals
Textiles	9%	3	10%	Road vehicles
Clothing	9%	4	10%	Machinery and equipment
Machinery and equipment	8%	5	5%	Fuels

Source: Turkstat (2015)

Economic Overview

Rebound in early 2017, but for how long?

A series of shocks slowed economic growth sharply to +2.9% in 2016 from +6.1% in 2015. Notably, the failed coup attempt in July damaged confidence so that real GDP dropped by -1.3% y/y in Q3. And a severe drop in tourist arrivals (see Figure 2) against the backdrop of numerous terrorist attacks and a Russian travel ban (implemented in late 2015, repealed in July 2016) sent real exports down by -2% in full-year 2016.

In Q1 2017 growth rebounded to +5% y/y, beating consensus and our expectations. Unexpectedly strong rises in private consumption and exports were the main triggers for the surprising Q1 gains. Private consumption was up by +5.1% y/y on the back of accelerating credit expansion and strong wage gains, although the strong increase surprised, given the deepening drop in retail sales, at -2.3% in Q1 (after -1.7% in Q4), and ongoing weak consumer sentiment (Turkstat's consumer confidence index averaged 66.8 in Q1, vs. 68.8 in Q4 and an average 73.0 since 2011; see Figure 3). Public spending surged by +9.4% y/y in Q1 while fixed investment edged up slightly to +2.2% y/y. The TRY's slide and new automobile production sent real exports soaring by +10.6% y/y in Q1, much faster than leading balance-of-payment data had indicated. In contrast, import growth was weak at +0.8% y/y despite booming domestic demand. As a result, net exports added +2.1pp to Q1 growth. We have revised up our full-year growth forecasts to +3.7% in 2017 and +3% in 2018.

Exchange rate and inflationary pressures

Annual inflation has been volatile over the past ten years, fluctuating markedly around an average 8.2%. The volatility was mostly driven by the ups and downs of food and energy prices as well as bouts of strong exchange rate movements. The TRY itself is highly vulnerable to external and political shocks, reflecting the risks associated with continued large current account deficits predominantly financed through short-term capital inflows, which are subject to sudden reversal in the event of economic or political turbulences (see Figure 4).

The policy responsiveness of the Central Bank of Turkey (CBT) has not been convincing. The CBT has shifted back and forth between orthodox and unorthodox measures; and at times has appeared hesitant or – in recent years – politically restrained to take the appropriate measures to tackle negative price and currency developments in good time.

A relatively loose monetary policy stance since 2014 combined with ongoing large current account deficits and rising political uncertainty since 2015 have sent the TRY nose-diving, depreciating against the USD on average by -22% in 2015, -10% in 2016 and -19% in 2017 YTD. As a result, inflation has risen to just below 12% y/y in May 2017 and is expected to remain in double-digits for the rest of the year.

Overall, currency risk will remain a serious concern in the medium term, especially since short-term foreign capital inflows have remained substantial.

Another concern is the re-acceleration of private sector credit growth to +21% y/y in March. Excessive credit growth was a major risk factor in the past.

Public finances still adequate, for now

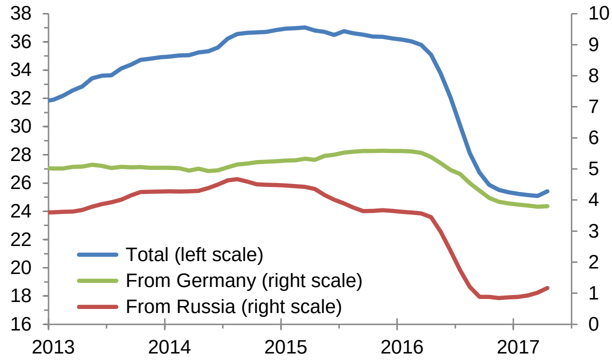
After five years of annual fiscal deficits below -2% of GDP, strong public spending growth, rising sovereign borrowing costs (downgrade to junk) and the impact of the TRY depreciation on FX-

Figure 1: Key economic forecasts

	2015	2016	2017f	2018f
GDP growth (% change)	6.1	2.9	3.7	3.0
Inflation (%, end-year)	8.8	8.5	10.0	8.0
Fiscal balance (% of GDP)	-1.2	-2.3	-3.0	-2.5
Public debt (% of GDP)	27.6	29.1	31.0	30.5
Current account (% of GDP)	-3.7	-3.8	-4.5	-4.4
External debt (% of GDP)	46.1	47.1	53.3	52.2

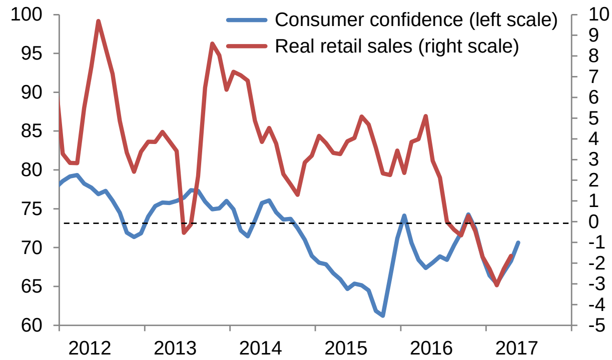
Sources: National statistics, IHS, Euler Hermes

Figure 2: Foreign visitors arrivals in Turkey (12-month moving average; million)



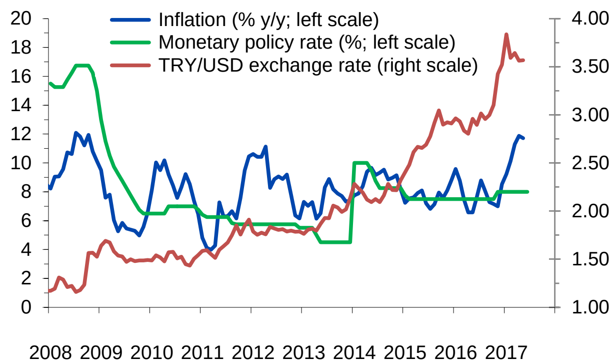
Sources: Ministry of Culture and Tourism, Euler Hermes

Figure 3: Real retail sales growth (% y/y) and consumer confidence index (3-month moving averages)



Sources: Turkstat, Euler Hermes

Figure 4: Monetary policy interest rate (%), inflation rate (y/y, %), and exchange rate



Sources: National statistics, IHS, Euler Hermes denominated debt have begun to reverse the previously positive trend in fiscal indicators. The fiscal deficit rose to -2.3% and public debt to 29.1% of GDP in 2016 and both are forecast to increase further in 2017. As these rates are low compared to peers, this is not a problem in the short term but perhaps in the medium term.

Current account deficit still worrisome...

The annual current account deficit decreased from an average -6.3% of GDP in 2010-2014 to -3.8% in 2015-2016, thanks to lower energy import prices. However, it is set to grow again to around -4.5% of GDP in 2017-2018, partly due to rising energy and food prices but also because GDP in USD terms will fall owing to the TRY depreciation.

...and its financing a cause of concern

Net foreign direct investment inflows have been modest in recent years (USD9.1bn or 1.1% of GDP in 2016), covering just 20% of the cumulative current account deficit from 2010 to 2016. The large remainder of the shortfall was financed through new short-term external debt (net portfolio investment inflows and net external bank borrowing) which are subject to sudden reversals should investor sentiment deteriorate. This occurred in 2015 when net portfolio investment outflows of USD16bn (-1.8% of GDP) were registered and in 2016 when net bank debt outflows amounted to USD6bn (-0.7% of GDP), leaving large financing gaps of over USD16bn for the current account deficit in each year. Net bank debt outflows have continued in January-April 2017 (see Figure 5).

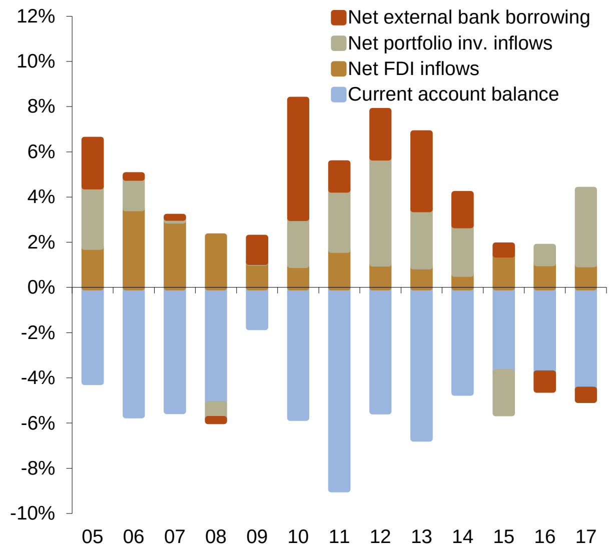
External debt burden remains heavy

Total external debt has declined slightly from a record USD419bn in Q2 2016 to USD404bn at end-2016, still large in relation to annual GDP (47%) or export earnings (216%). Short-term external debt has fallen somewhat from a peak at end-2014 but, at USD102bn in Q1 2017, still accounted for 25% of the total (17% at end-2007).

Watch out for declining FX reserves

Owing to central bank intervention to stabilize the TRY and partial reversals of earlier capital inflows, FX reserves have been on a continuous decline from a record USD114bn in November 2013 – reflecting Turkey's ongoing vulnerability to external and political events. After a temporary recovery in mid-2016, reserves have fallen again to a 58-month low of USD85bn in April 2017. While the current level of FX reserves still appears comfortable with regard to import cover (4.7 months), they continue to cover just about 60% of the estimated external debt payments falling due in the next 12 months, which is well below an adequate level of at least 100%(see Figure 6).

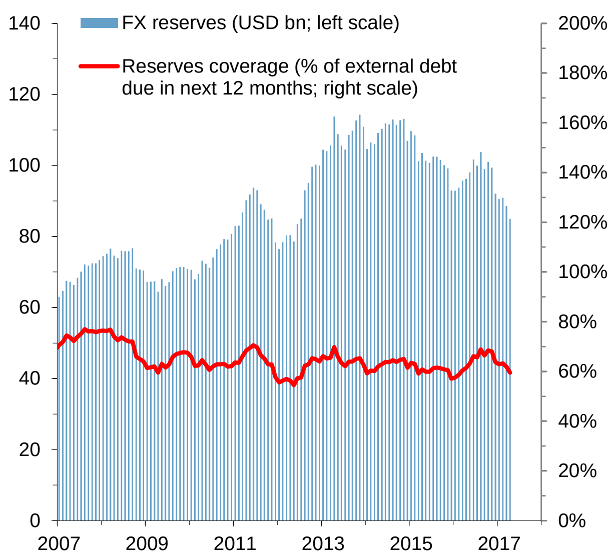
Figure 5: Current account and financing of deficits (% of GDP)



Note: 2017 data refer to January-April 2017.

Sources: National statistics, IHS, Euler Hermes

Figure 6: FX reserves and coverage of external debt payments falling due within 1 year



Sources: Central Bank of Turkey, IMF, Euler Hermes

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