Euler Hermes Economic Research

Country Report

Turkey

Rising political uncertainties weigh on the economy

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

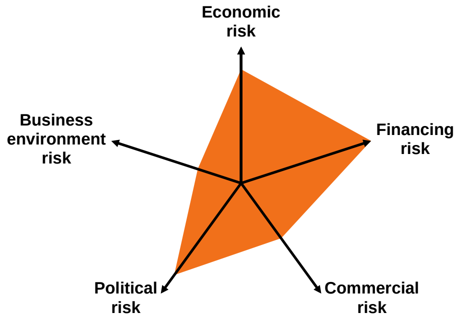
- Important geostrategic position that has historically always ensured aid when needed
- Public finances
- Adequate business environment
- Well-educated workforce and competitive economy
- Regional hub between Europe, MENA and Asia

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 rapidly risen
- (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

Sluggish investment and exports weigh on growth

Real GDP growth decelerated to +3.1% y/y in Q2 2016 from +4.7% in Q1. The breakdown reveals that Q2 growth was again entirely driven by strong consumer spending (+5.2% in Q2, albeit down from +7.1% in Q1) and very strong public spending (+15.9%, after +10.9% in Q1). Although the election year 2015 is over, the government continues with strong fiscal stimulus. However, annual fixed investment growth weakened further into contraction territory (-0.6%, after 0% in Q1) and inventories subtracted -0.6pps from Q2 growth (-0.3pps in Q1). Moreover, real export expansion came to a near-standstill at +0.2% y/y in Q2 (+2.4% in Q1) while imports remained strong (+7.7%, up from +7.3% in Q1) so that the negative contribution of net exports to growth rose to -2.3pps in Q2 (-1.6pps in Q1).

Early indicators suggest a further deterioration of business confidence (manufacturing PMI) and economic activity (industrial production and retail sales contracted in July) in Q3. Euler Hermes expects that the economic slowdown will continue in H2, resulting in full-year real GDP growth of about +3% in 2016 (after +4% in 2015). The forecast for 2017 is +3.2%. The balance of risks to these forecasts is correlated to the level of perceived political uncertainty which may further increase (downside risk to growth) or gradually abate (upside risk).

Weak monetary policy responsiveness

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 Turkish lira (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.

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.

Since May 2014, the CBT has pursued a path of monetary easing, initially by lowering the key policy rate in five steps by a cumulative 250bps to 7.5% in February 2015, and from March to August 2016 by reducing the overnight lending rate in six steps by a cumulative 225bps to 8.5%. This relatively loose monetary policy stance combined with ongoing large current account deficits and rising political uncertainty since 2015 have sent the TRY nose-diving. On average, the TRY depreciated by -22% y/y against the USD in 2015 and by -11% y/y in 2016 year-to-date.

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

Public finances remain adequate, for now

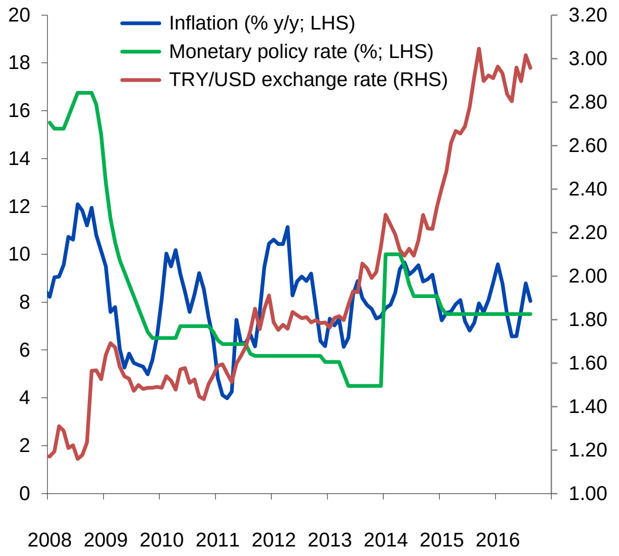
The fiscal position has markedly improved since the domestic economic crisis in 2001. The annual fiscal deficit has been below -2% of GDP since 2011 and the public debt-to-GDP ratio has more than halved from almost 80% in 2001 to 33% in 2015.

Figure 1: Key economic forecasts

	2014	2015	2016f	2017f
GDP growth (% change)	3.0	4.0	3.0	3.2
Inflation (%, end-year)	8.2	8.8	7.2	7.0
Fiscal balance (% of GDP)	-1.2	-1.0	-2.0	-2.2
Public debt (% of GDP)	33.5	32.6	33.0	33.5
Current account (% of GDP)	-5.5	-4.4	-4.8	-4.9
External debt (% of GDP)	53.4	59.3	61.0	62.0

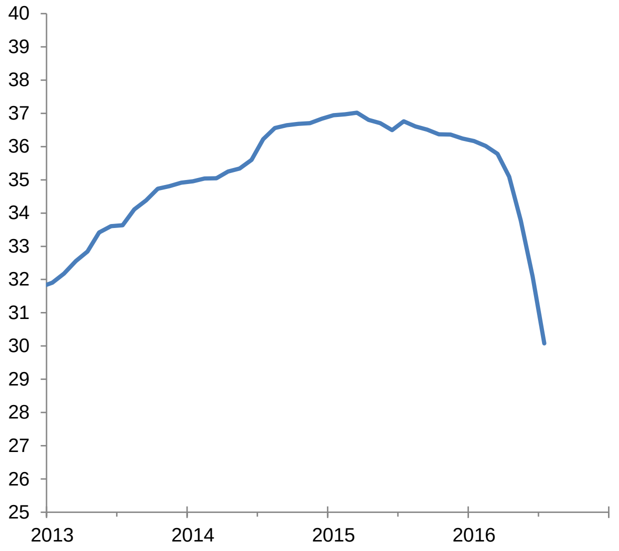
Sources: National statistics, IHS, Euler Hermes

Figure 2: Monetary policy interest rate (%), inflation rate (y/y, %), and exchange rate



Sources: National statistics, IHS, Euler Hermes

Figure 3: Foreign visitors arrivals in Turkey (million)



Sources: Ministry of Culture and Tourism, Euler Hermes

However, strong public spending growth (see above), rising borrowing costs (S&P downgrade) and the impact of the TRY depreciation on FX-denominated debt will likely reverse the positive trend in fiscal indicators. 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 -7% of GDP in 2010-2014 to -4.4% in 2015, thanks to lower energy import prices. However, it rose again to -5.4% in H1 2016, partly due to a sharp drop in tourism revenues (see Figure 3). Euler Hermes forecasts the annual shortfalls to remain high at a worrisome -5% or so of GDP in 2016-2017.

...and its financing a cause of concern

Net foreign direct investment (FDI) inflows have been modest in recent years (USD2.3bn or 0.6% of GDP in H1 2016), covering just 18% of the cumulative current account deficit from 2010 to mid-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 USD15bn (-2.2% of GDP) were registered, leaving a large financing gap of about USD17bn for the current account deficit (see Figure 4).

Noteworthy, gross FDI inflows have dropped since the start of 2016 (see Figure 5), indicating a loss of (foreign) investor confidence in the wake of rising political uncertainty.

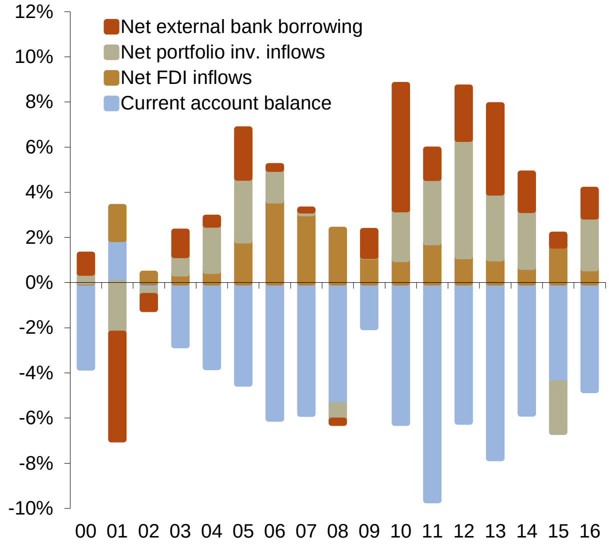
External debt large and rising

Total external debt has continued to rise to a record USD412bn in Q1 2016, equivalent to a hefty 60% of annual GDP or 200% of export earnings. Short-term external debt has fallen somewhat from a peak at end-2014 but, at USD107bn in Q2 2016, still accounted for 26% of the total (17% at end-2007).

Foreign exchange (FX) reserves require monitoring

Owing to central bank intervention to stabilize the TRY and partial reversals of earlier capital inflows, FX reserves fell from a record USD114bn in November 2013 to a 42-month low of USD93bn in January 2016 – reflecting Turkey's ongoing vulnerability to external and political events – before somewhat recovering to USD100bn in July 2016. While the current level of FX reserves still appears comfortable with regard to import cover (over five months), they 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%.

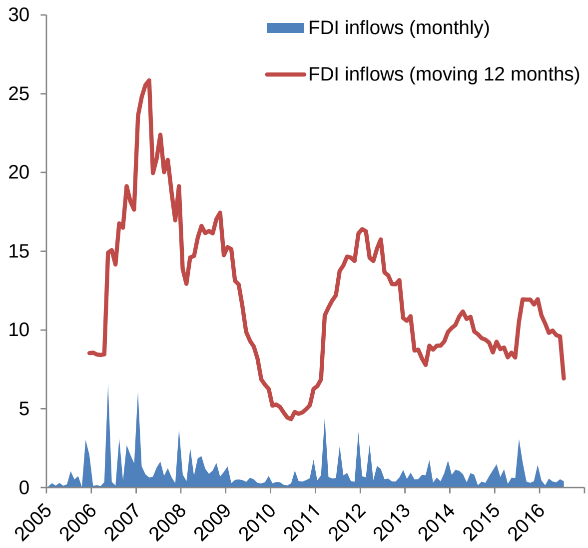
Figure 4: Current account and financing of deficits (% of GDP)



Note: 2016 data refer to H1 2016.

Sources: National statistics, IHS, Euler Hermes

Figure 5: FDI in Turkey (USD bn)



Sources: Central Bank of Turkey, Euler Hermes

Last review: 2016-09-14
Country Risk Analyst:
Manfred Stamer
manfred.stamer@eulerhermes.com