

Turkey: Full of surprises?

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Agenda

- 1 **Let's grow**
- 2 Turkey: Full of surprises?

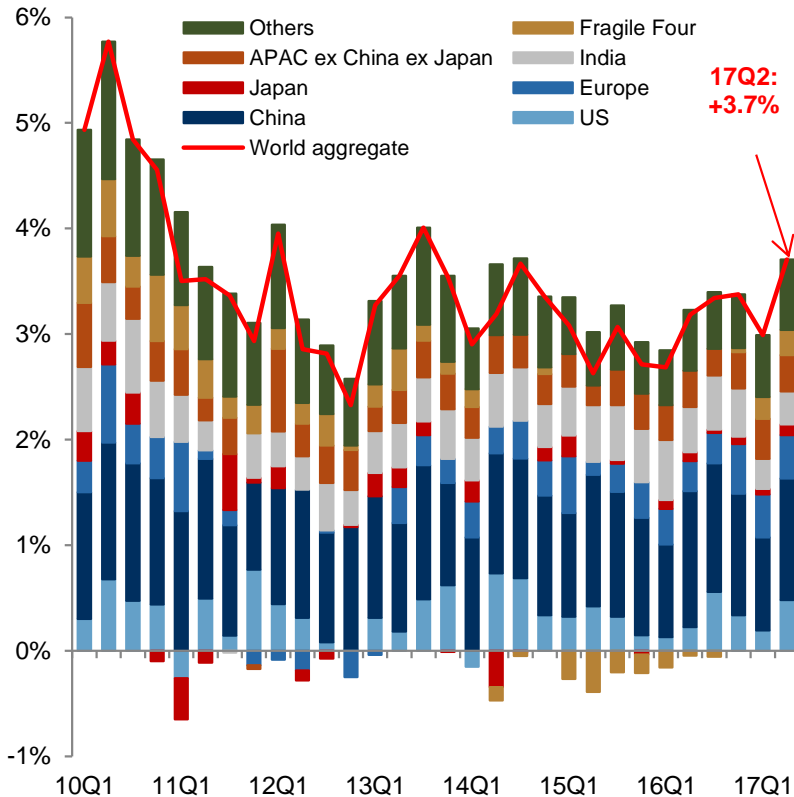
Turkey to benefit from accelerating world growth...

World growth is accelerating in a more synchronized manner.

Upward revisions outweigh downward revisions on growth.

World GDP growth, q/q annualized

Fragile four are Brazil, Russia, Turkey and South Africa



Sources: IHS, Euler Hermes

Global GDP growth forecasts (%)

| | 2015 | 2016 | 2017 | | 2018 | |
|-------------------------|------|------|-----------------|----------------|-----------------|----------------|
| | | | Latest forecast | Revision (pps) | Latest forecast | Revision (pps) |
| World GDP growth | 2.9 | 2.6 | 3.0 | 0.1 | 3.0 | 0.1 |
| United States | 2.9 | 1.5 | 2.0 | -0.2 | 2.2 | -0.1 |
| Latin America | -0.3 | -1.3 | 1.2 | = | 2.2 | = |
| Brazil | -3.8 | -3.6 | 0.8 | 0.2 | 2.0 | 0.1 |
| United Kingdom | 2.2 | 1.8 | 1.4 | = | 1.0 | = |
| Eurozone members | 2.0 | 1.8 | 2.1 | 0.2 | 1.8 | 0.1 |
| Germany | 1.5 | 1.8 | 2.2 | 0.3 | 2.0 | 0.3 |
| France | 1.0 | 1.1 | 1.7 | 0.2 | 1.7 | 0.2 |
| Italy | 0.7 | 1.0 | 1.4 | 0.2 | 1.1 | 0.1 |
| Spain | 3.2 | 3.2 | 3.0 | 0.2 | 2.3 | = |
| Russia | -2.8 | -0.2 | 1.5 | 0.2 | 1.9 | 0.3 |
| Turkey | 6.1 | 2.9 | 5.2 | 1.5 | 3.5 | 0.5 |
| Asia | 5.0 | 5.0 | 5.0 | = | 4.8 | = |
| China | 6.9 | 6.7 | 6.7 | = | 6.3 | = |
| Japan | 1.2 | 1.0 | 1.5 | 0.2 | 0.9 | = |
| India | 8.0 | 7.1 | 6.5 | -0.7 | 7.3 | = |
| Middle East | 2.5 | 4.5 | 2.1 | = | 2.6 | = |
| Saudi Arabia | 4.1 | 1.7 | 0.5 | -1.0 | 2.0 | = |
| Africa | 2.9 | 1.2 | 3.3 | 0.9 | 3.1 | = |
| South Africa | 1.3 | 0.3 | 0.6 | = | 1.2 | = |

* Weights in global GDP at market price, 2016

NB: The revisions refer to the changes in our forecasts since the last quarter

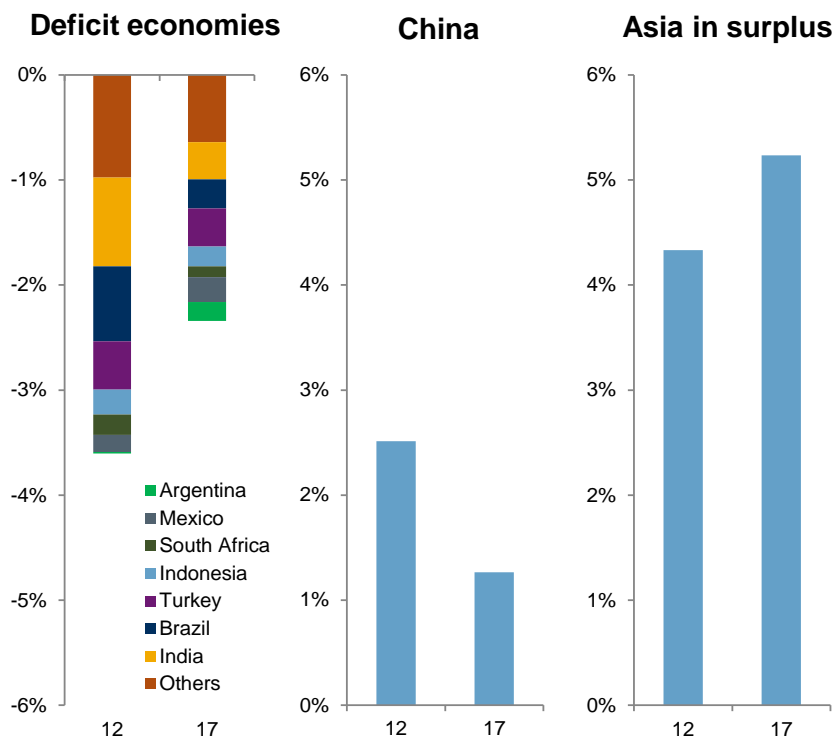
Sources: Bloomberg, Euler Hermes, Allianz Research

... and country risk worldwide...

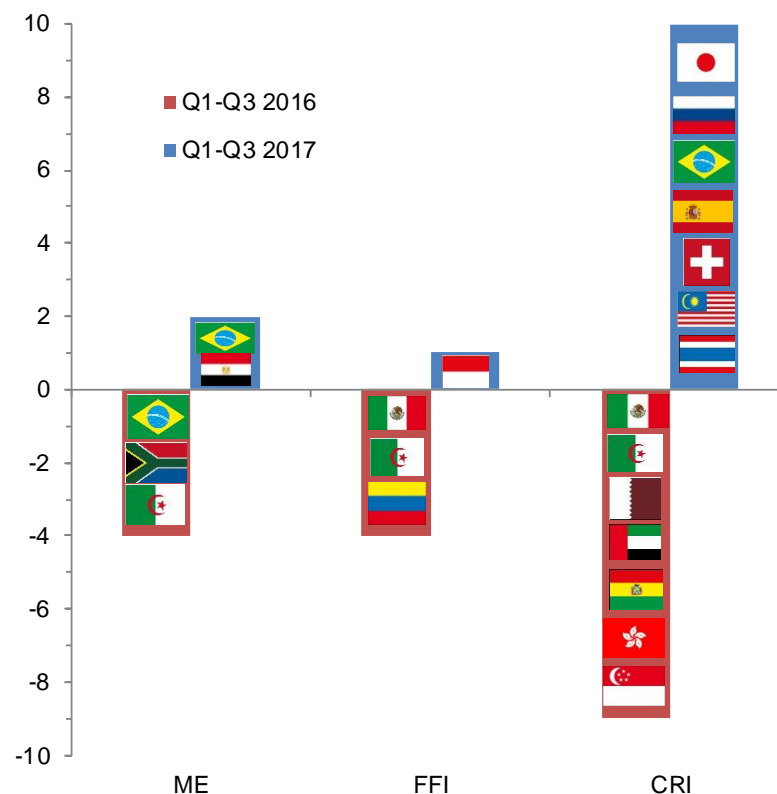
Current account deficits decreased in deficit economies, and surpluses even increased in Asian surplus economies (except China).

As a result of rebalancing or higher surpluses, country risk reversed its trend in 2017: now, it's clearly improving.

Emerging Economies: Current account balances
(% of GDP for each country group)



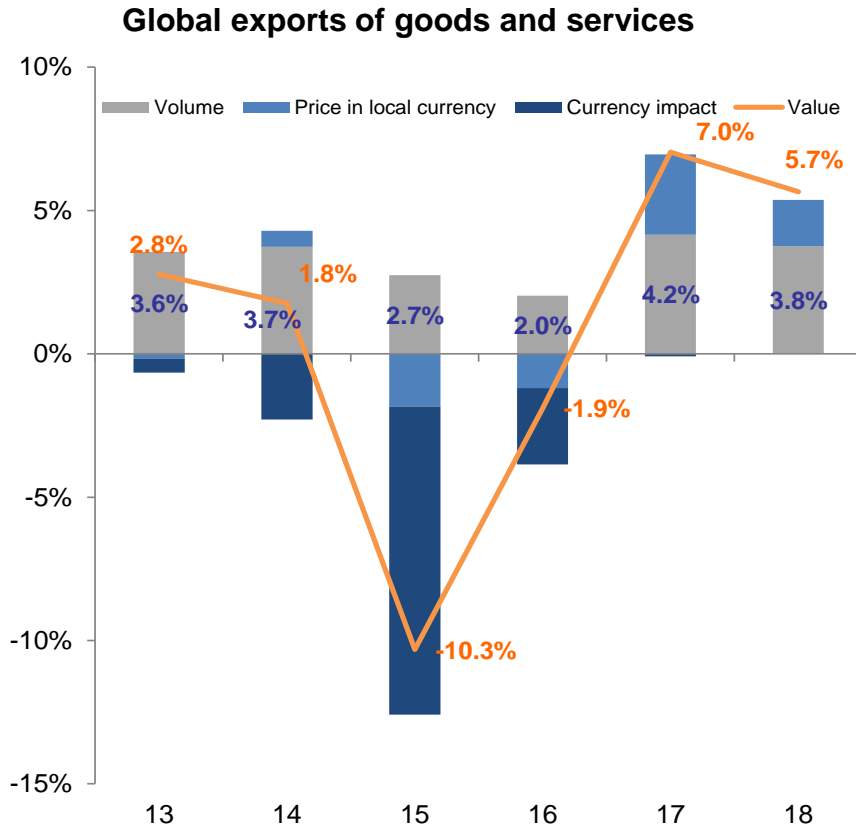
Country risk: sub-components' changes
+/- = upgrade/downgrade



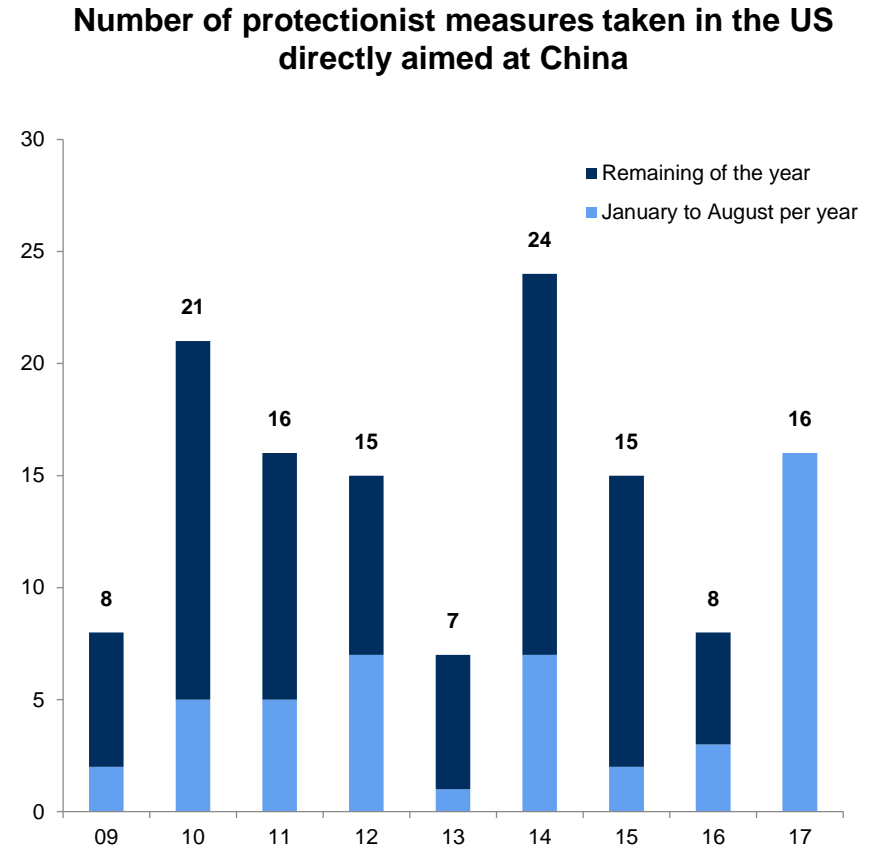
Global trade is back and protectionism contained

Dollar depreciation is driving values a bit further up. Volume growth is only back to 2013-14 figures.

US protectionist measures against China have increased notably in 2017.



Sources: Bloomberg, Euler Hermes, Allianz Research



Sources: GTA, Euler Hermes, Allianz Research

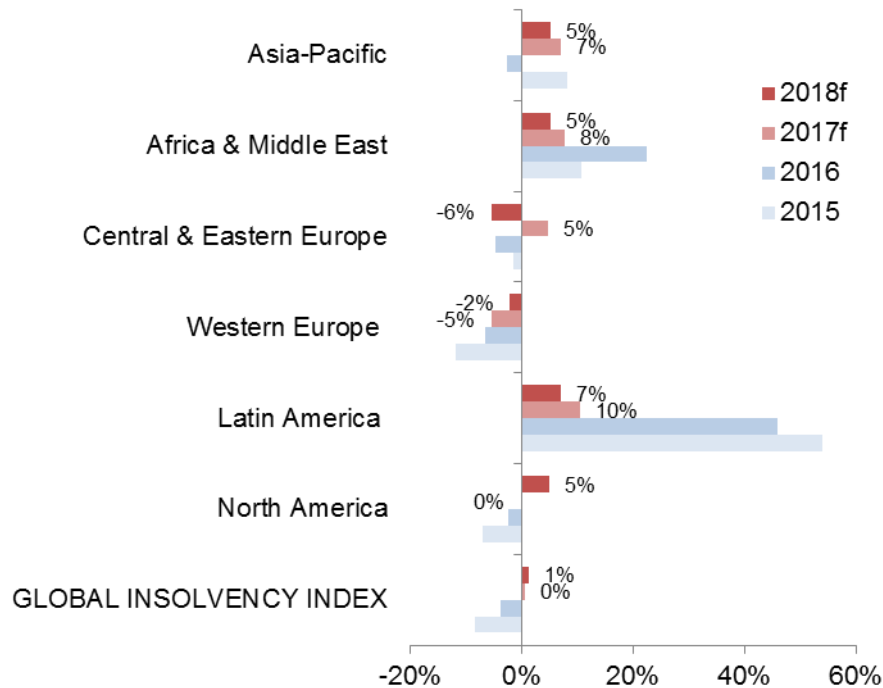
Each recovery comes with its risks: Look for the invisible bank, suppliers' credit

Mind corporate balance sheets: insolvency forecasts are tilted to the upside in the US in 2018.

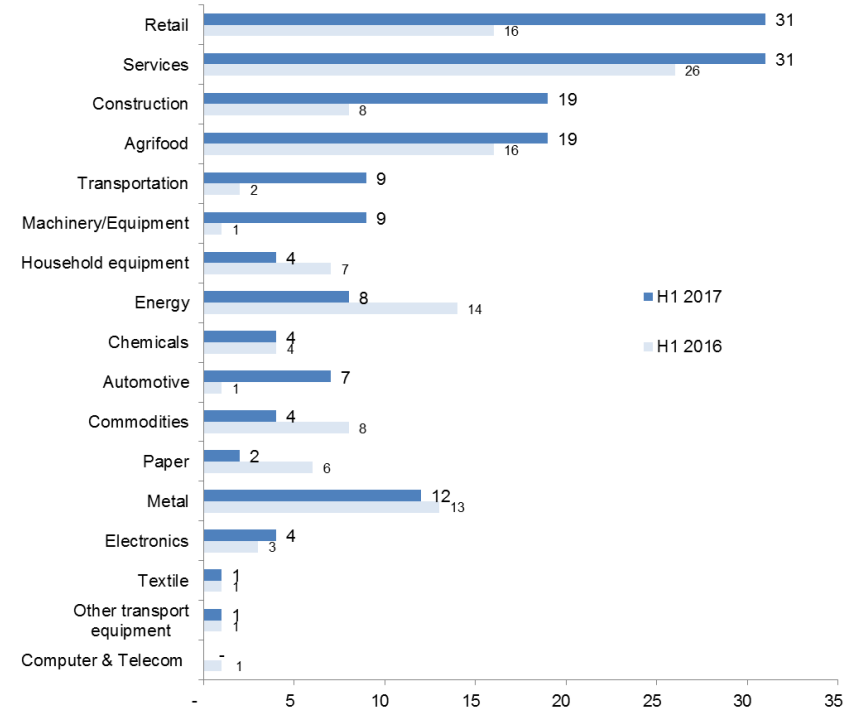
Major failures increased in **Retail** (+15 cases in H1, +11 in the US), and **Construction** (+11 cases, +9 in Western Europe).

EH Global and Regional Insolvency Indices

(y/y, %)



Major failures*
(number of companies by sectors)



(*) Companies with a turnover exceeding EUR50mn

Business cycles: not in sync but room to grow for all

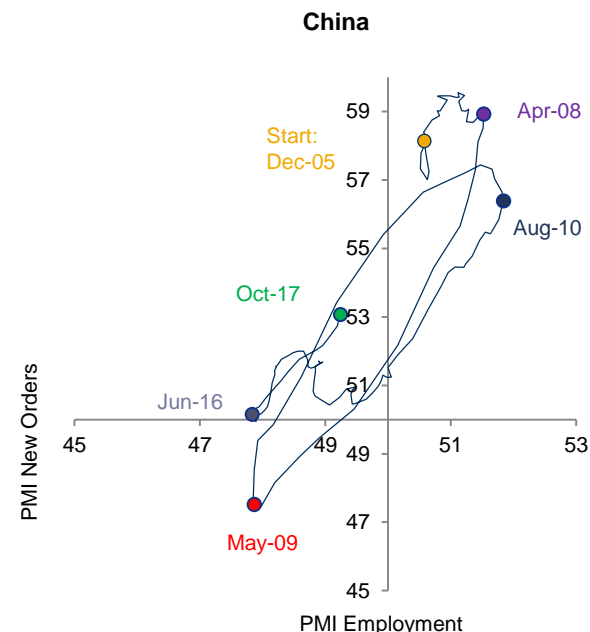
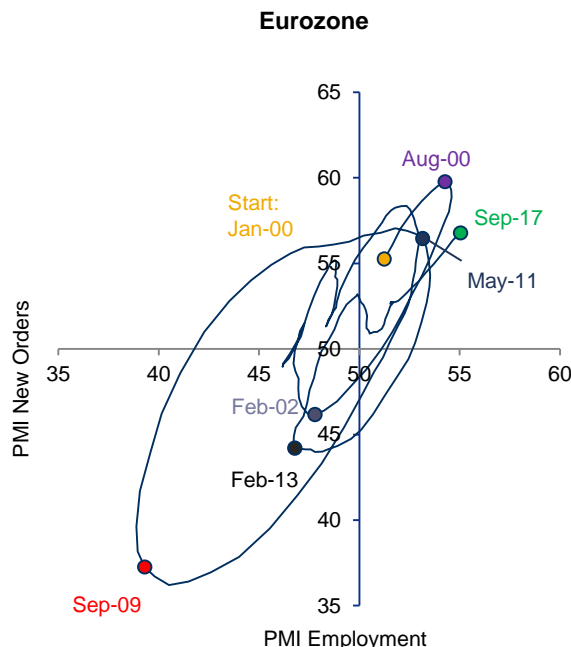
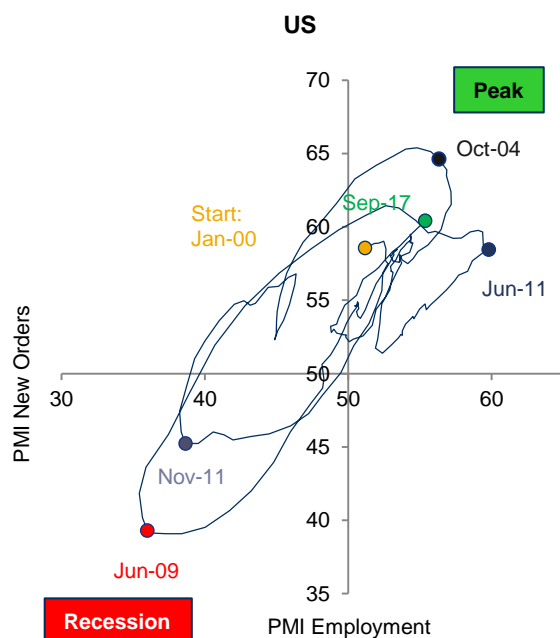
US: Close to peak growth as new orders and job creation continue to grow

Eurozone: Cyclical uptick reaches all-time highs

China: Stuck in the middle of its cycle

Business cycles clocks:

Manufacturing PMI: sub-indices (12m rolling average)



| | Max values of the couple | | Current to max distance (i.e room) | |
|----|--------------------------|----------------|------------------------------------|----------------|
| | PMI Employment | PMI New Orders | PMI Employment | PMI New Orders |
| US | 56.3 | 64.6 | 1.0 | 4.2 |

| | Max values of the couple | | Current to max distance (i.e room) | |
|----------|--------------------------|----------------|------------------------------------|----------------|
| | PMI Employment | PMI New Orders | PMI Employment | PMI New Orders |
| Eurozone | 55.0 | 56.8 | 0.0 | 0.0 |

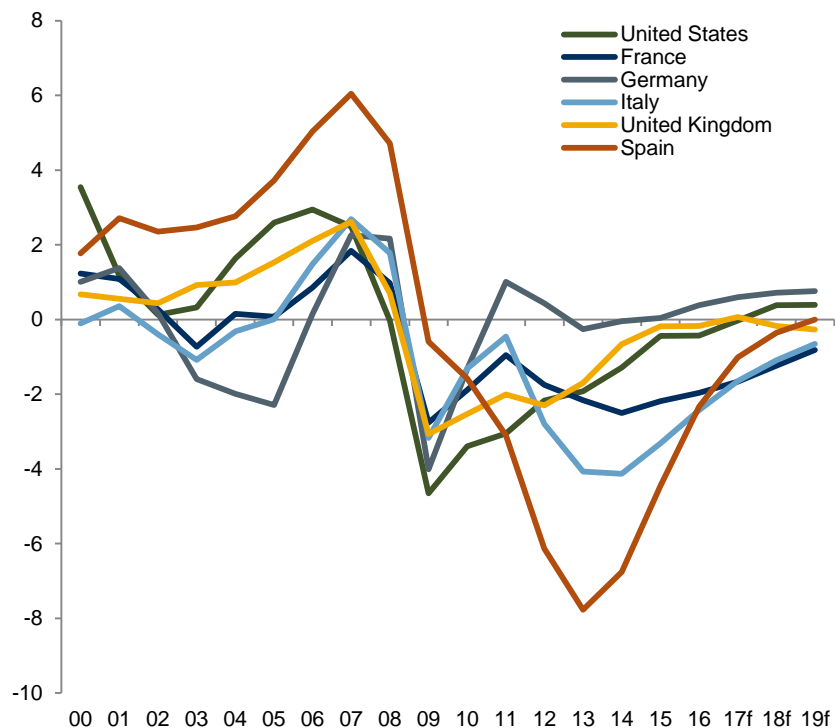
| | Max values of the couple | | Current to max distance (i.e room) | |
|-------|--------------------------|----------------|------------------------------------|----------------|
| | PMI Employment | PMI New Orders | PMI Employment | PMI New Orders |
| China | 51.5 | 58.9 | 2.3 | 5.9 |

Monetary policy normalization is on the horizon but should not create havoc

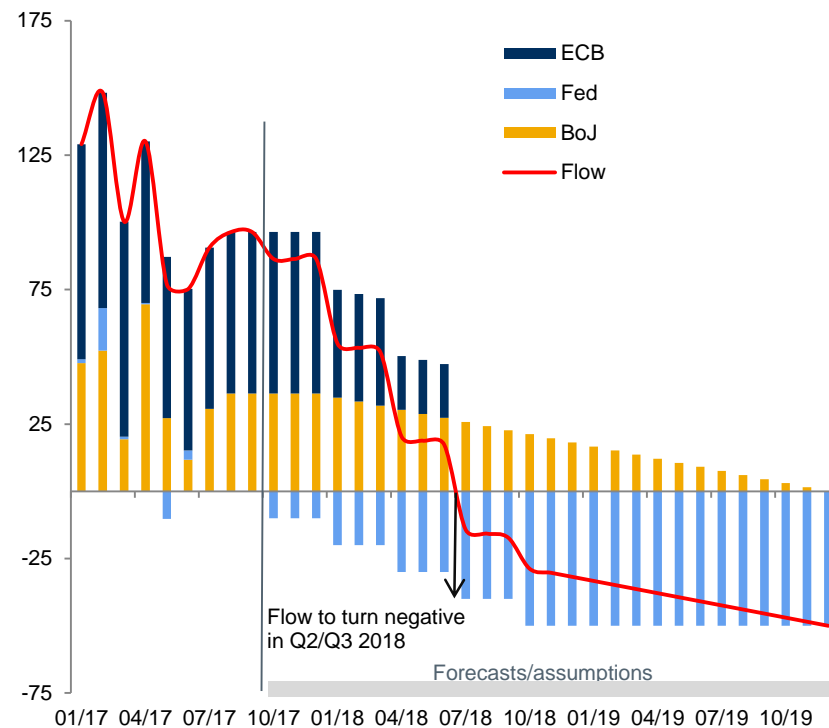
Inflation pressures should intensify: Output gaps in main economies are persistent, but should close by 2019.

This should go along with monetary policy normalization. Along with interest rate hikes, global liquidity will be tapered.

Output Gaps
(% of GDP)



Central Banks Balance Sheet monthly changes
(USD, bn)

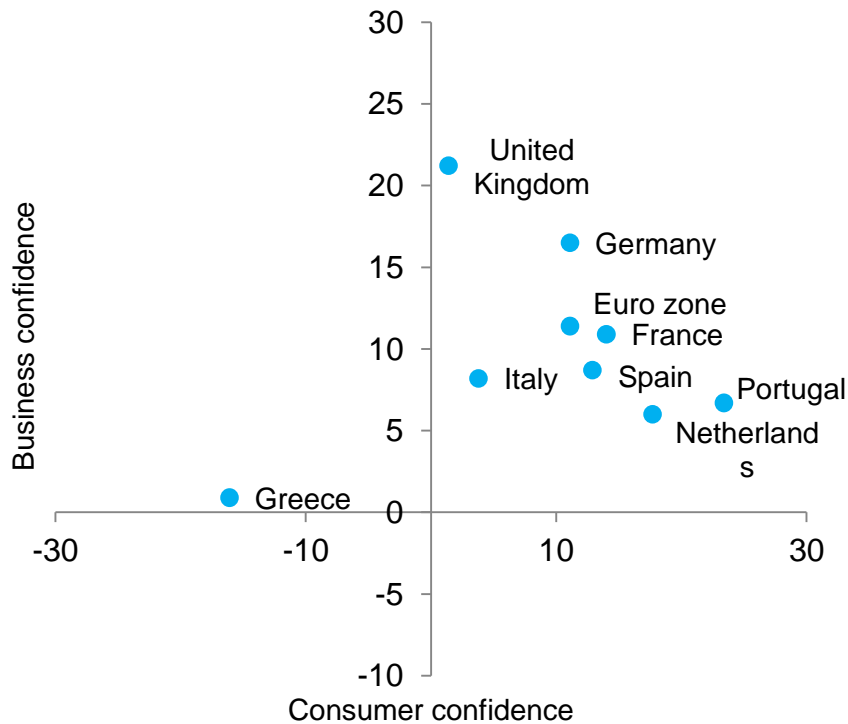


Strong upside surprises from the Eurozone, while Emerging Markets acceleration was expected

There are good reasons to get bullish on the Eurozone: Sentiment indicators are above long-term average.

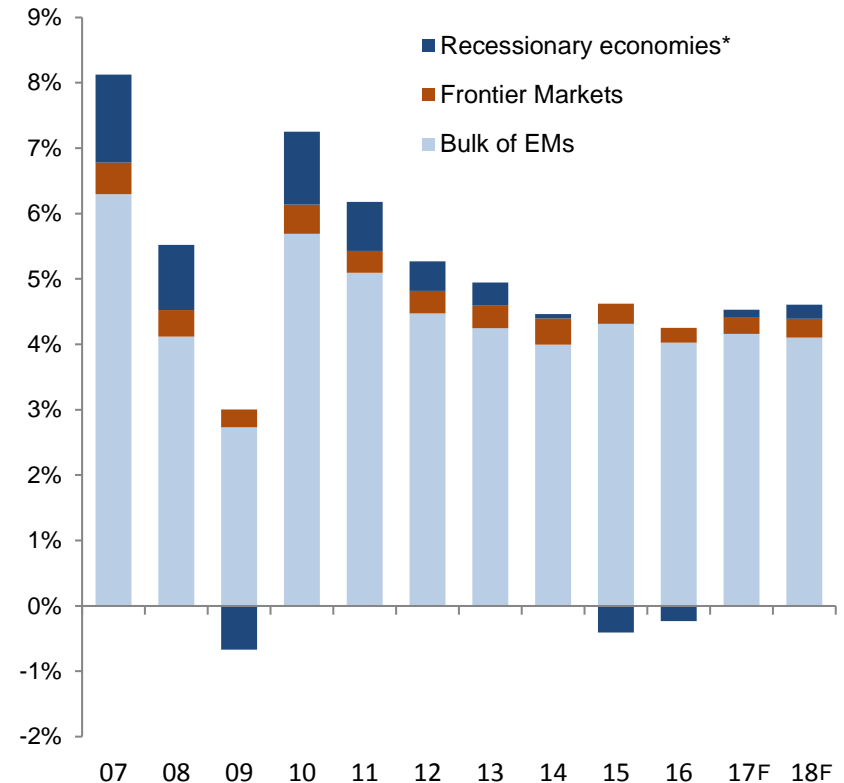
Emerging economies formerly in recession are back to (low) growth; yet Emerging Markets are not accelerating broadly speaking.

Europe: Consumer confidence vs. Business confidence*



* August 2017 value minus the respective average since 1990.

Emerging Markets: Growth per country group



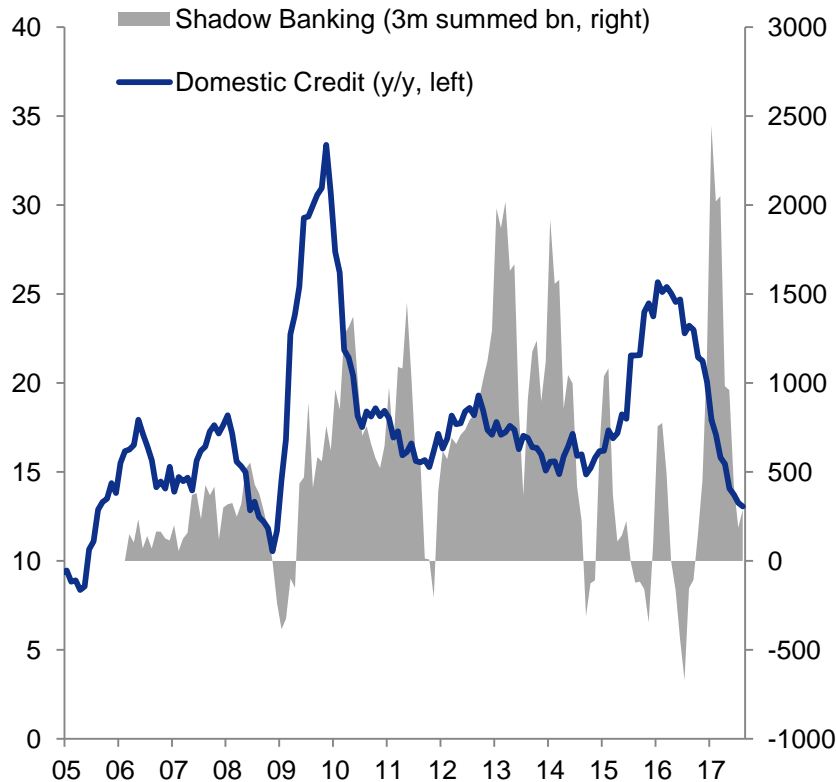
(*) = Brazil, South Africa, Russia and CIS

China: Financial tightening is starting to bear fruit

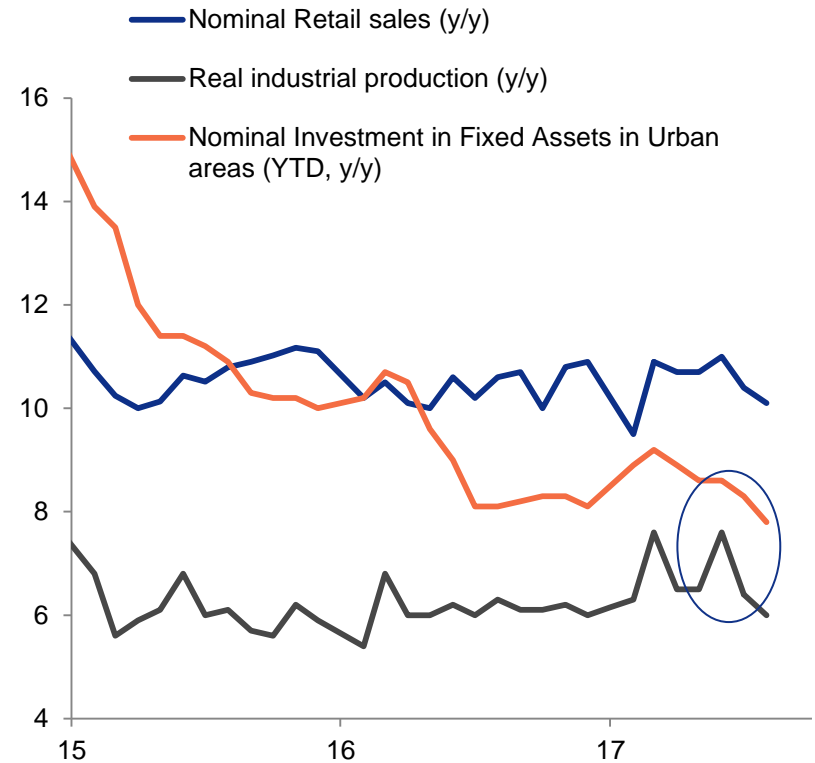
Financial imbalances start to reduce with more sustainable credit growth and lower risky credit flows.

The downside is that credit intensive activity expenditures are slowing.

Shadow banking and domestic credit



Industrial Production and Investment



This time around political risks are mainly in or from the US (and the UK) for a change

In the US: Critical deadlines for fiscal issues to return in December.

US federal fiscal policy timeline

| Date | Policy Action needed / pledged | Risk of policy inaction and/or prolonged policy confrontation |
|--|---|--|
| December 8, 2017 (No hard deadline, as extraordinary measures will probably be used again) | Debt ceiling needs to be increased (Alternative option: Further suspension for a period of time) | Failure to raise debt ceiling would be unprecedented and represent a large negative demand shock; missed interest payments would send shock waves across global markets. |
| December 8, 2017 | Funding bill must be passed (Alternative option: Another temporary financing via a Continuing Resolution) | Failure to pass a funding bill would result in a partial government shutdown; GDP growth negatively affected as federal employees would be furloughed. |
| From late September | Debate on and release of a framework for individual/corporate tax cuts/reform | If tax reform is not implemented, growth above 2% would be hard to achieve next year. |

Sources: Bloomberg, Euler Hermes, Allianz Research

Rising threat of a military conflict in the Korean peninsula is a source of uncertainty.

Japan and Korea stock markets



Sources: IHS, Euler Hermes, Allianz Research

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GDP growth in **Turkey** surprised in H1 (+5.1% y/y); now forecast to pick up to +5.2% in full-year 2017

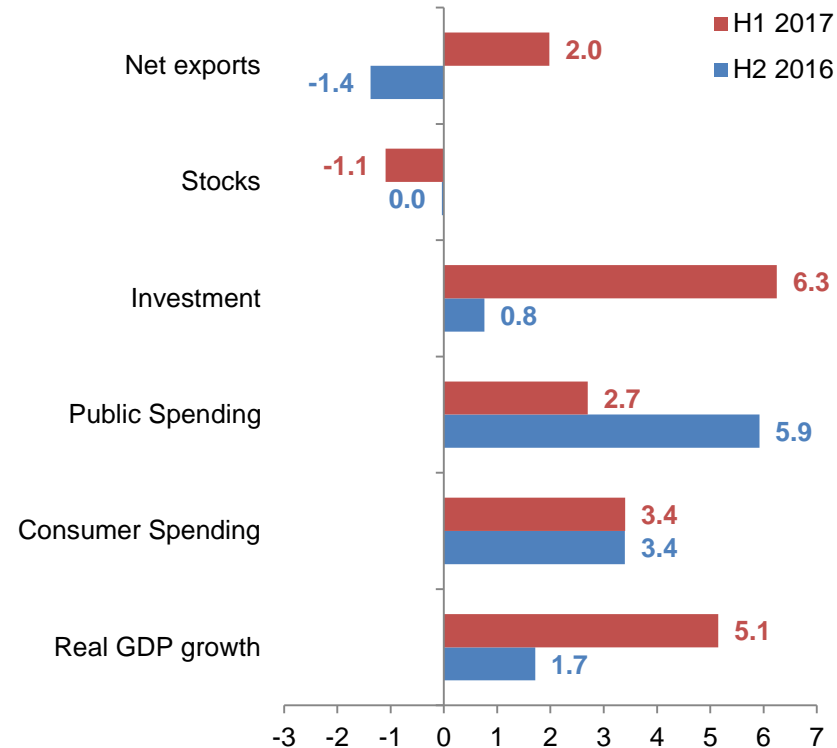
Strong public spending and public investment, as well as rebounding exports spur the economy. Slowdown in 2018 expected, in part due to base effects (waning impact of one-off fiscal stimulus measures)

| TURKEY: Key forecasts | 2015 | 2016 | 2017f | 2018f |
|-----------------------------|-------|-------|-------|-------|
| GDP | 6.1 | 3.2 | 5.2 | 3.5 |
| Consumer Spending | 5.4 | 3.7 | 3.5 | 3.0 |
| Public Spending | 3.9 | 9.5 | 5.0 | 5.0 |
| Investment | 9.3 | 2.2 | 6.0 | 2.0 |
| Stocks | * | -1.1 | 0.3 | -1.0 |
| Exports | 4.3 | -1.9 | 10.0 | 5.0 |
| Imports | 1.7 | 3.7 | 2.5 | 3.0 |
| Net exports | * | 0.6 | 1.6 | 0.4 |
| Current account (% of GDP) | -3.7 | -3.8 | -4.8 | -4.1 |
| External debt (% of GDP) | 46.1 | 46.9 | 51.9 | 51.2 |
| Employment growth | 2.7 | 2.2 | 4.0 | 2.5 |
| Unemployment rate | 10.3 | 10.9 | 11.3 | 11.2 |
| Inflation (eop) | 8.8 | 8.5 | 10.3 | 8.0 |
| Inflation (aop) | 7.7 | 7.8 | 10.9 | 9.0 |
| Fiscal balance (% of GDP) | -1.3 | -2.3 | -3.2 | -2.5 |
| Public debt (% of GDP) | 27.5 | 28.1 | 30.0 | 30.5 |
| TRY per USD (aop) | 2.72 | 3.02 | 3.63 | 3.99 |
| TRY per USD (aop, % change) | -24.3 | -11.0 | -20.1 | -10.0 |

Change in % y/y, unless otherwise indicated. * Contribution to GDP growth.

Sources: National sources, IMF, IHS, Euler Hermes

GDP growth (%) and contribution to growth (pp)

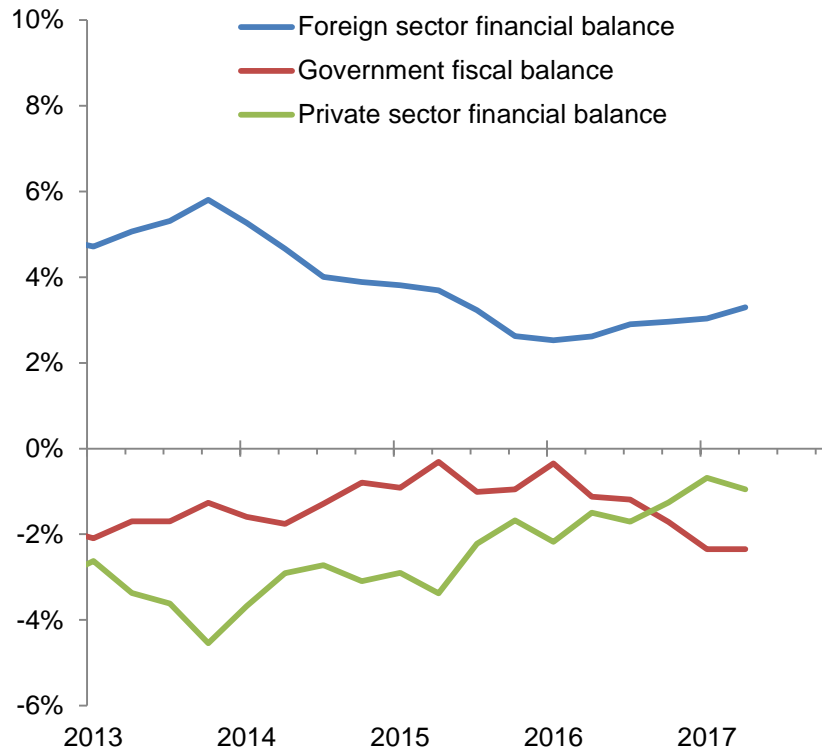


Sources: National sources, IMF, IHS, Euler Hermes

The question is who is financing the lifeline of Turkish growth?

The sharp downtrend of the government fiscal balance since the start of 2016 underscores that fiscal stimulus (public spending and public investment) has largely financed the lifeline of Turkish GDP growth over the past 18 months

Sectoral financial balances, 4 quarters cumulated (By definition, the three balances must net to zero)



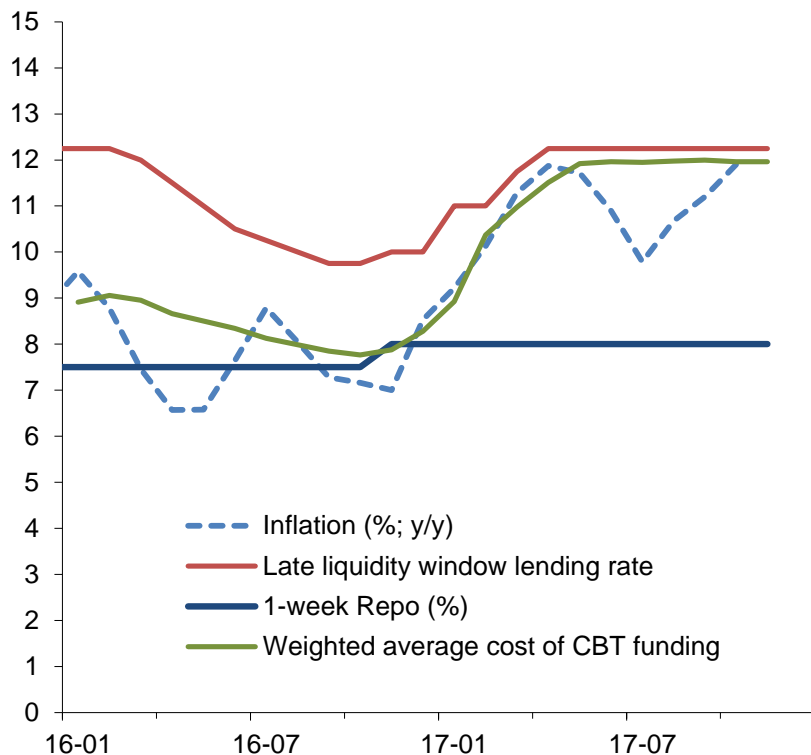
- The rise in the private sector financial balance (declining deficit) from mid-2015 to Q1 2017 reflected both less consumption (more savings) and sharply lower investment.
- GDP growth details support this view:
 - Consumer spending growth moderated from +5.4% in 2015 to +3.7% in 2016 and +3.4% y/y in H1 2017.
 - Fixed investment growth slowed down from +9.3% in 2015 to +2.2% in 2016 and +3.0% y/y in Q1 2017, before rebounding to +9.5% y/y in Q2.
 - The turnaround in Q2 2017 is also indicated by the Figure.

Sources: National sources, IHS, Euler Hermes

Unorthodox monetary policy tightening to counter inflationary and currency pressures...

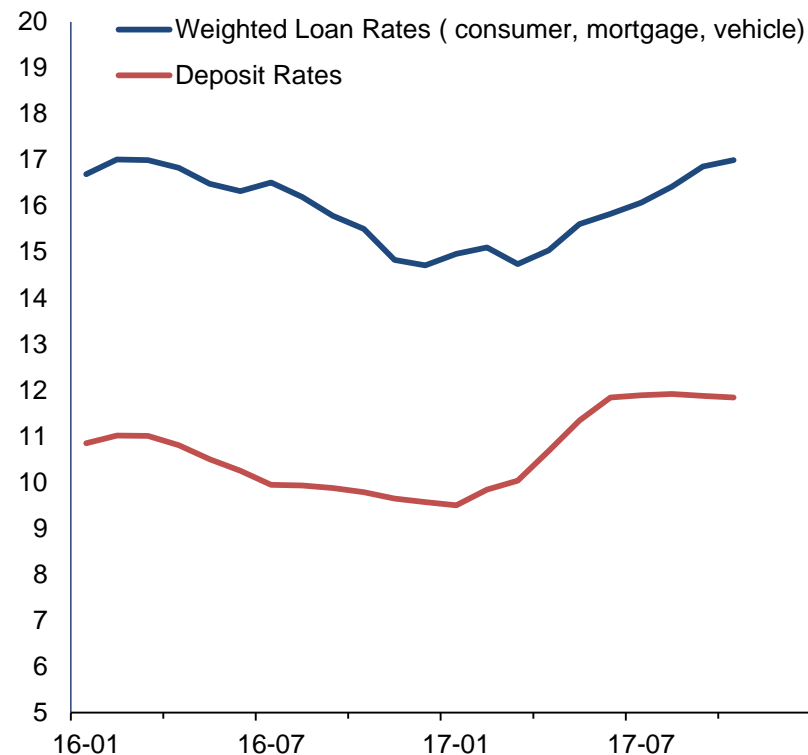
While keeping the official policy (1-week repo) rate unchanged at 8%, the Central Bank has funded the market mostly through its late liquidity window lending rate of 12.25% this year, putting upward pressure on loan rates and widening the loan-deposit rates spread

Inflation, monetary policy rates, and weighted average cost of Central Bank funding (%)



Source: Central Bank of Turkey, Euler Hermes

Weighted loan rates and deposit rates (%)



Source: Central Bank of Turkey, Euler Hermes

Despite higher market interest rates, credit growth to NFC has accelerated over the last year, helped by the revivification of the Credit Guarantee Fund in late 2016. The treasury is the main supporter of the now permanent mechanism to increase access to loans and export financing

Credit Guarantee Fund (KGF) revivification

- >355,000 firms used KGF since end-2016
- TRY197bn bonding (~ USD51bn) provided
- TRY220bn credit utilization (~ USD58bn)
- Euler Hermes expects probability of default on credits at 5 – 10% (open to moral hazard due to treasury support), adding at least TRY15bn on the government budget with lag effect

Other fiscal stimulus measures:

- **Turkish Wealth Fund (TVF)** formed in August 2016 to finance large-scale public infrastructure projects
- **KOSGEB**, a channel established to bail out and extend credit to SME.
- Various tax breaks and cuts

Loans to NFC growth (% y/y)



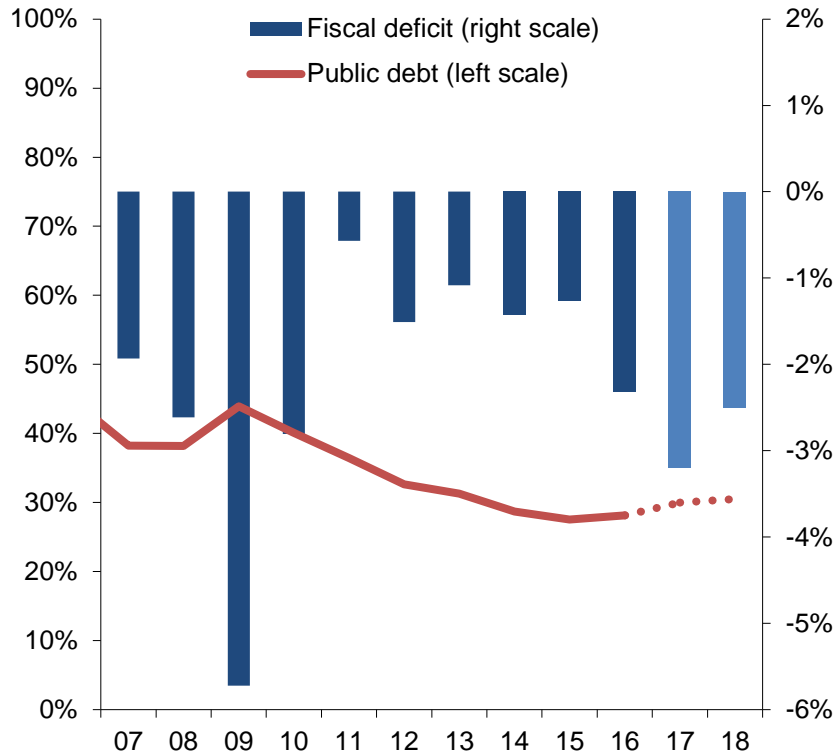
Source: Central Bank of Turkey, Euler Hermes

Is it sustainable? Public finances are still solid, but new debt gets more expensive

Stimulus expected to push fiscal deficit to -3.2% of GDP in 2017, though public debt is hovering around just 30% of GDP (good)

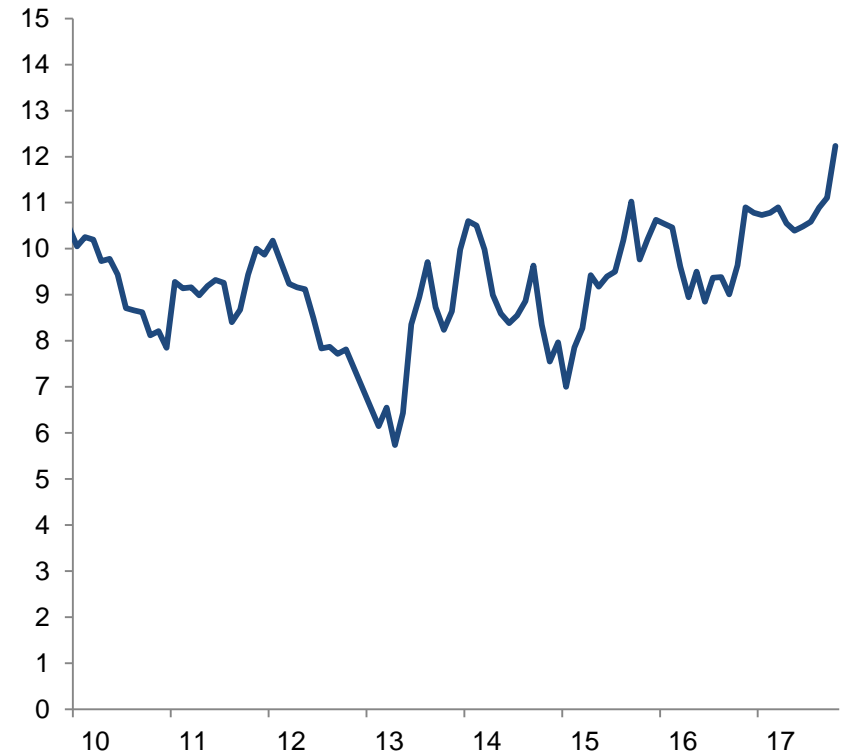
Turkey is not benefiting from the strong risk appetite from global investors in emerging market debt elsewhere

**Public finances
(% of GDP)**



Sources: IMF, Euler Hermes

Turkey 5-Year Bond Yield (%)



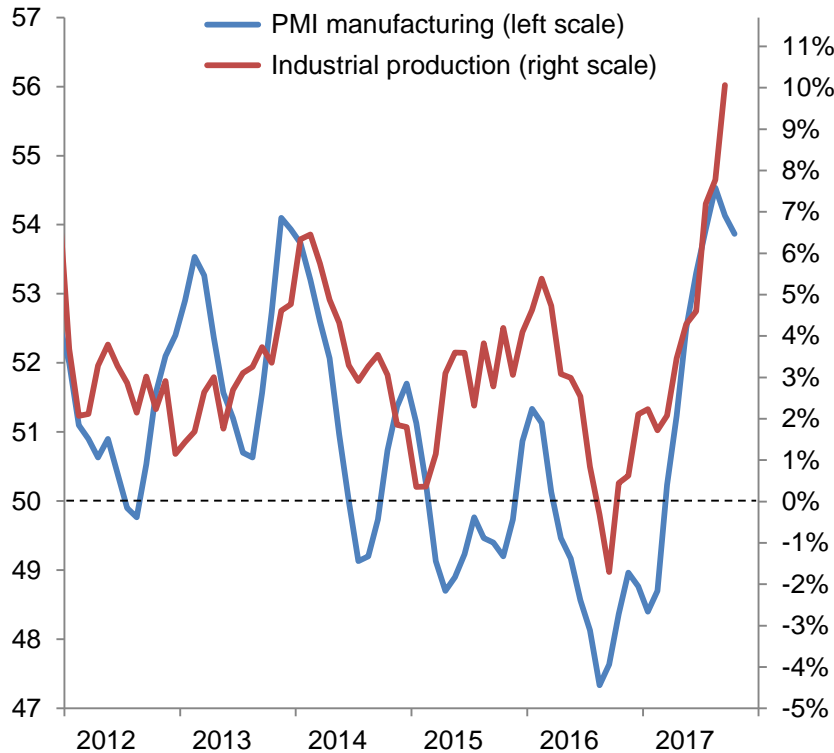
Source: Bloomberg, Euler Hermes

Advance indicators point to continued robust outlook in the near term but no further acceleration

Industrial production continues to surge but Manufacturing PMI has passed its peak

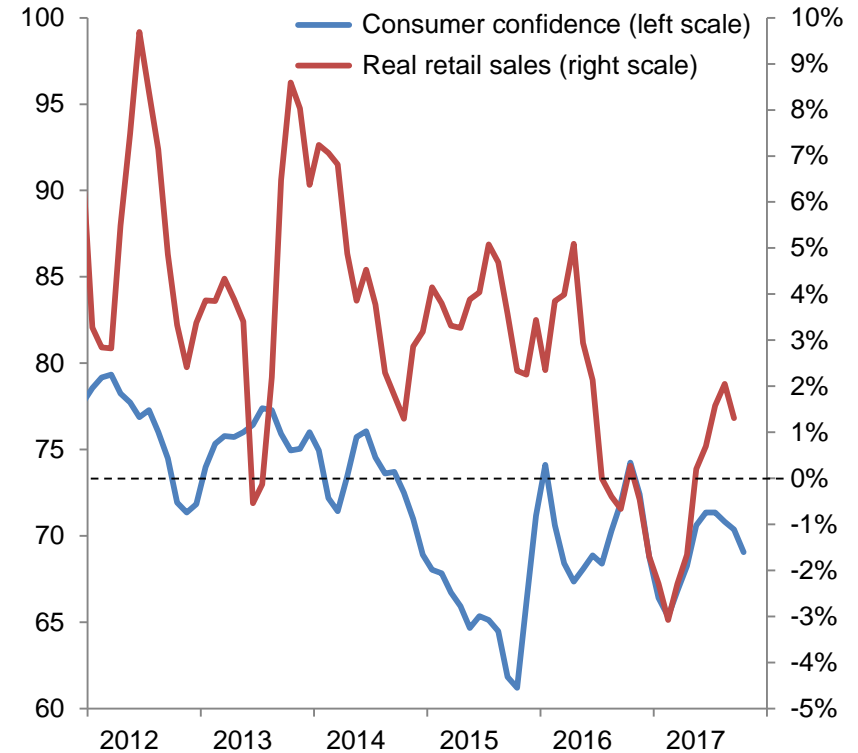
Retail sales growth has peaked, for now, while consumer confidence remains below the long-term average

Industrial production growth (% y/y) and Manufacturing PMI (3-month moving averages)



Source: Turkstat, IHS Markit, Euler Hermes

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

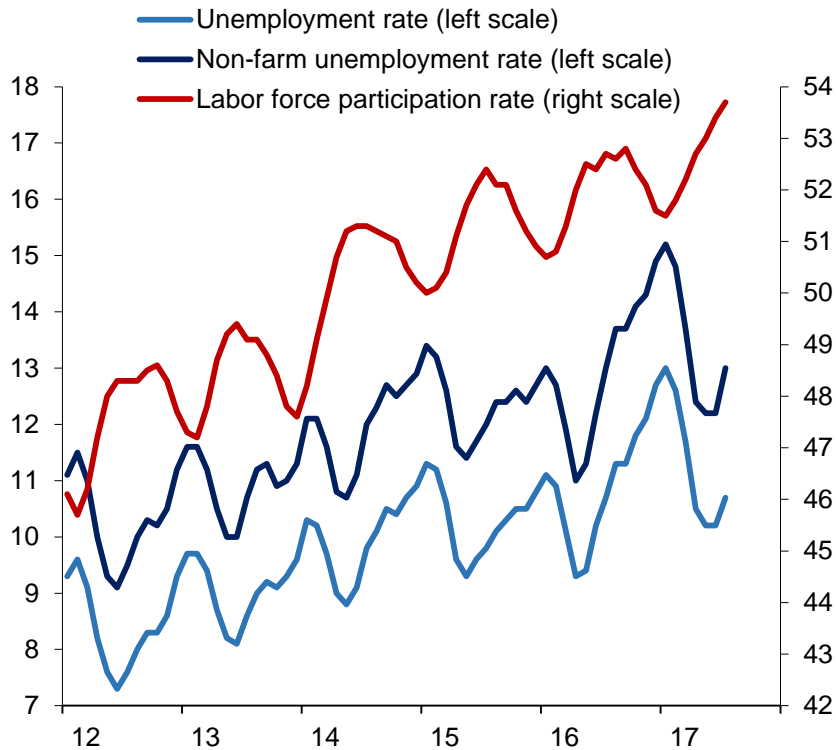


Source: Turkstat, Euler Hermes

Unemployment remains a problem, despite improving capacity utilization

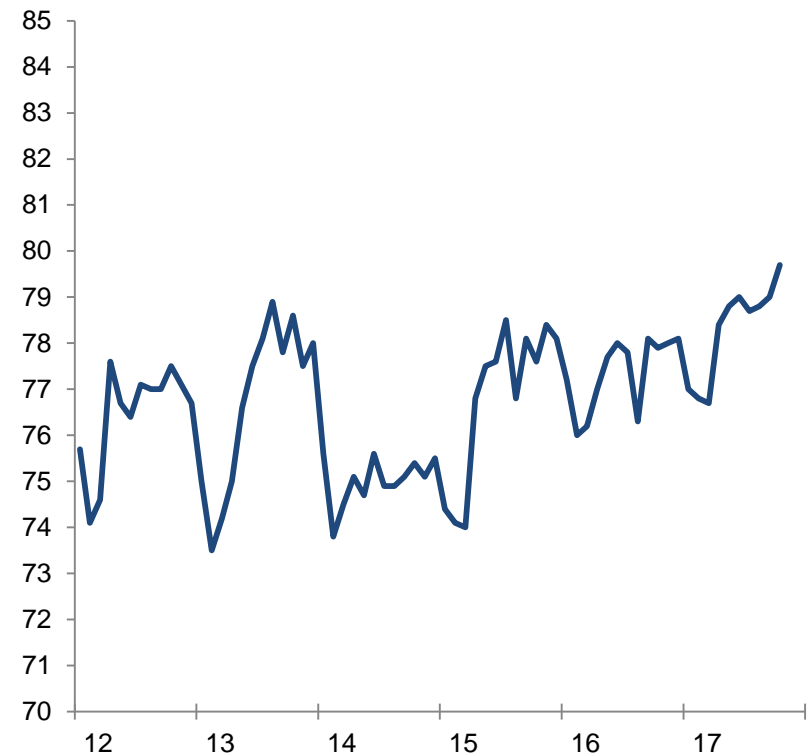
Despite the increase in the labor force, the unemployment rate remains high at above 10%. Strong GDP growth in 2017 (and before) has not created enough employment opportunities

Unemployment and labor force participation (%)



Source: Turkstat, IHS Markit, Euler Hermes

Capacity utilization ratio in the manufacturing industry (%)

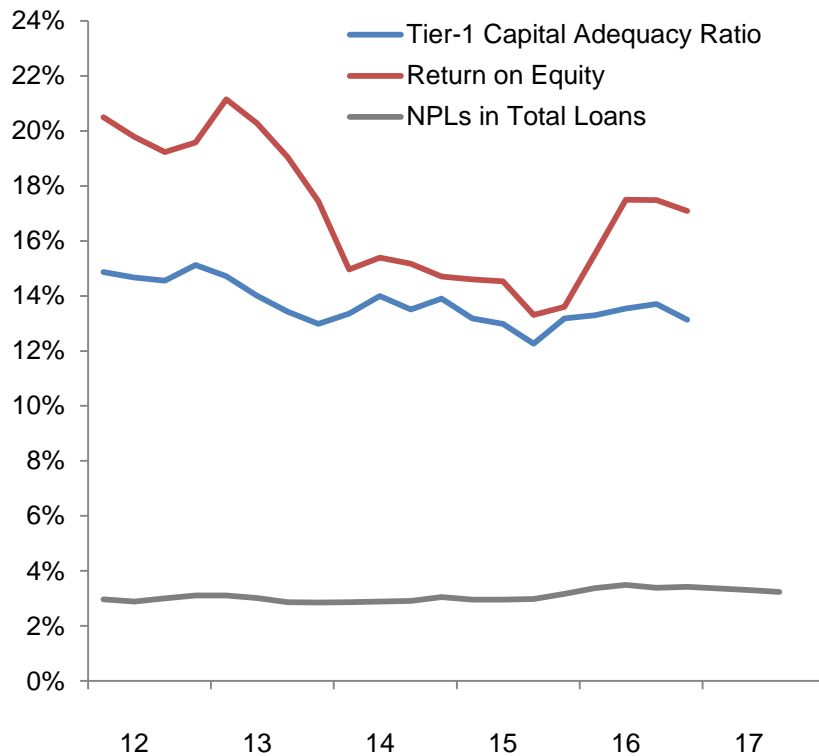


Source: Central Bank of Turkey, Euler Hermes

Banking sector still in fairly good shape overall

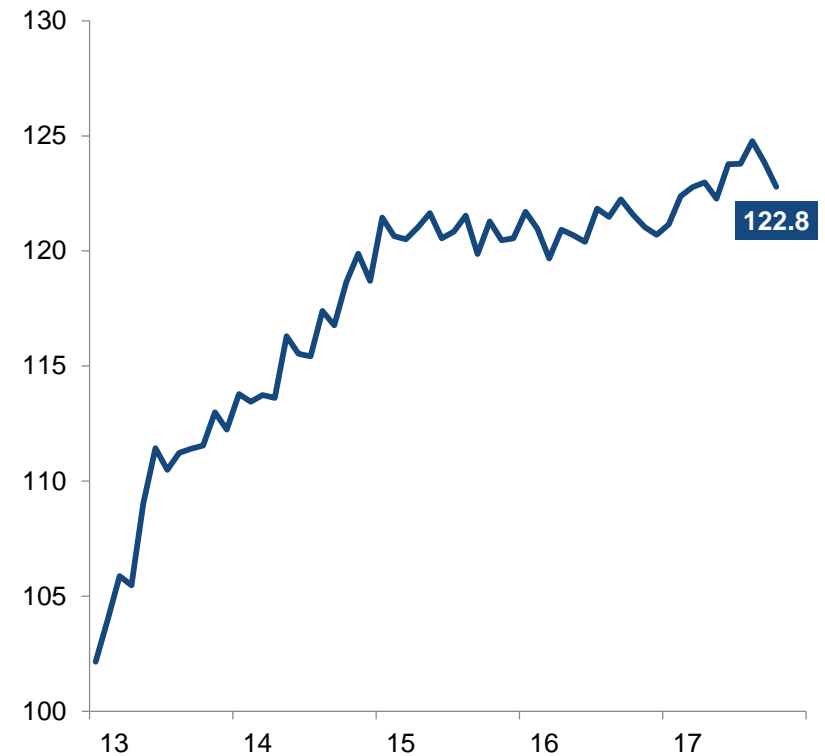
Capital adequacy and profitability are good and NPLs remain low, while the loan-to-deposit ratio has increased to a new high in 2017

Banking sector soundness indicators



Source: Central Bank of Turkey, IMF, Euler Hermes

Loan-deposit ratio



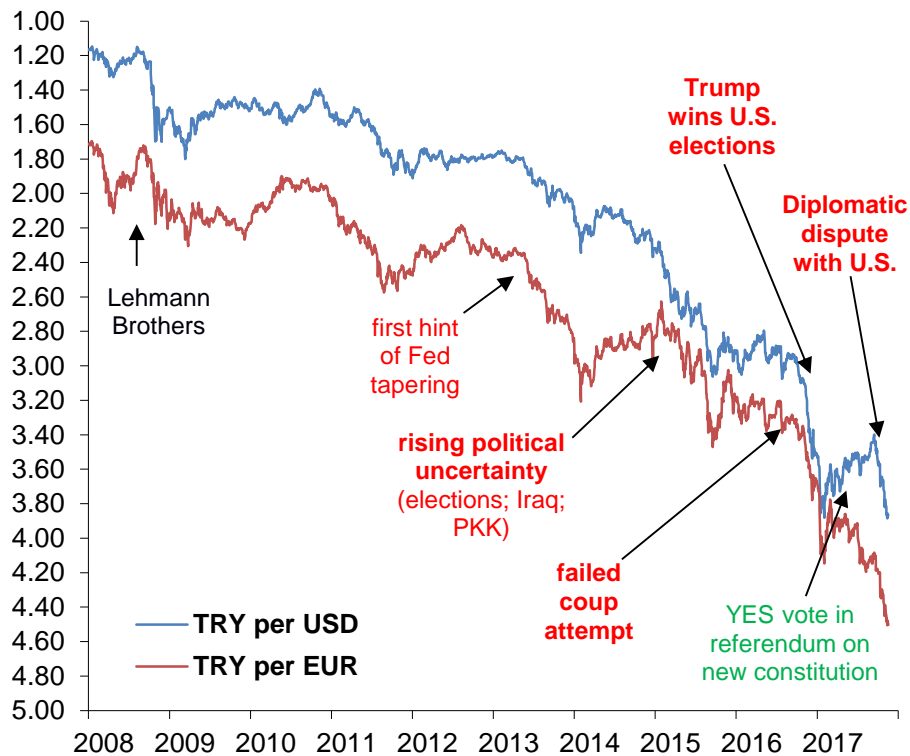
Source: Central Bank of Turkey, Euler Hermes

Full-blown currency crisis averted, for now

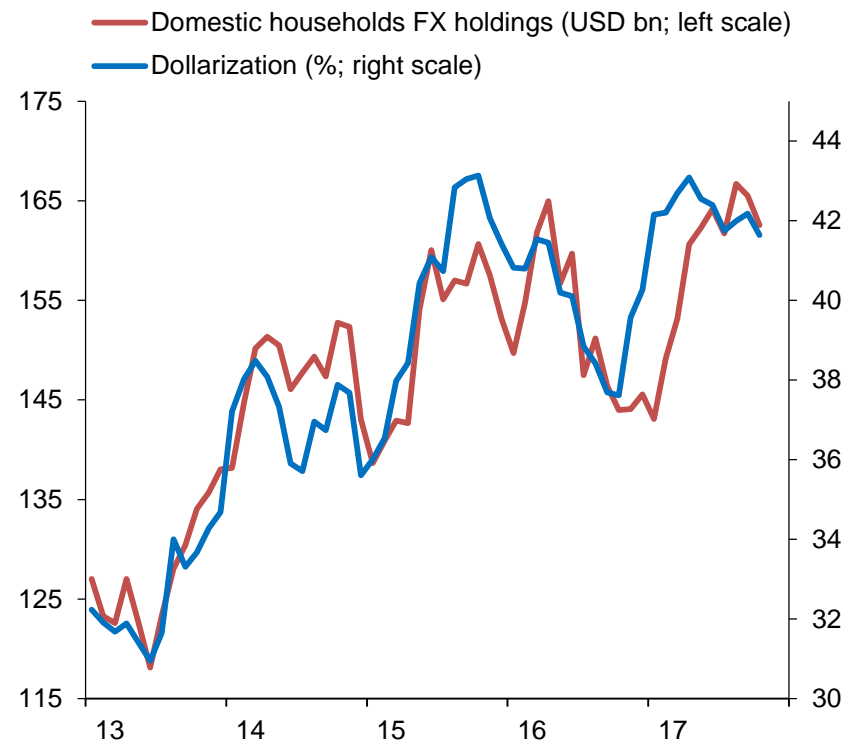
Sharp TRY depreciation since 2015 (-40% loss of value against the USD to date) has adversely affected corporates indebted in FX. We expect continued volatility and a -10% depreciation in 2018, due to growth slowdown, large current account deficit and ongoing dollarization

Exchange rate development

(reflecting high vulnerability to regional and external shocks)



Turkish households FX holdings and dollarization of bank deposits

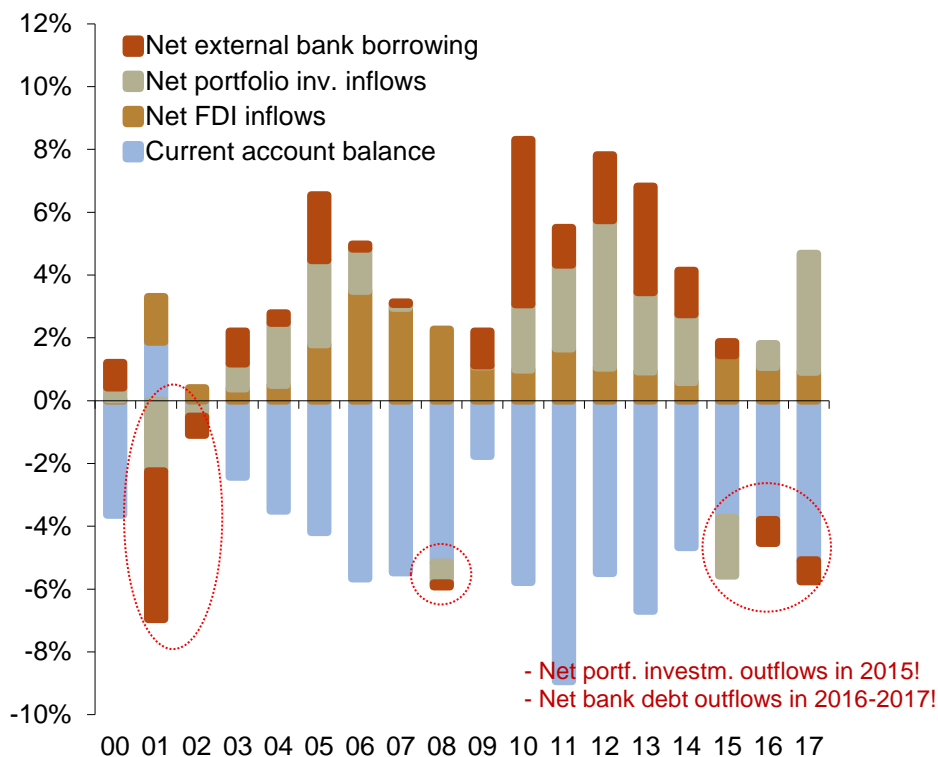


Current account deficit, and its financing, remain Turkey's *Achilles' heel*

High current account deficits largely financed through new short-term external debt has been a looming risk for a long time

Strong rebound in external trade activity in 2017. Weaker TRY benefits exports but, along with rising oil prices, also raises import costs

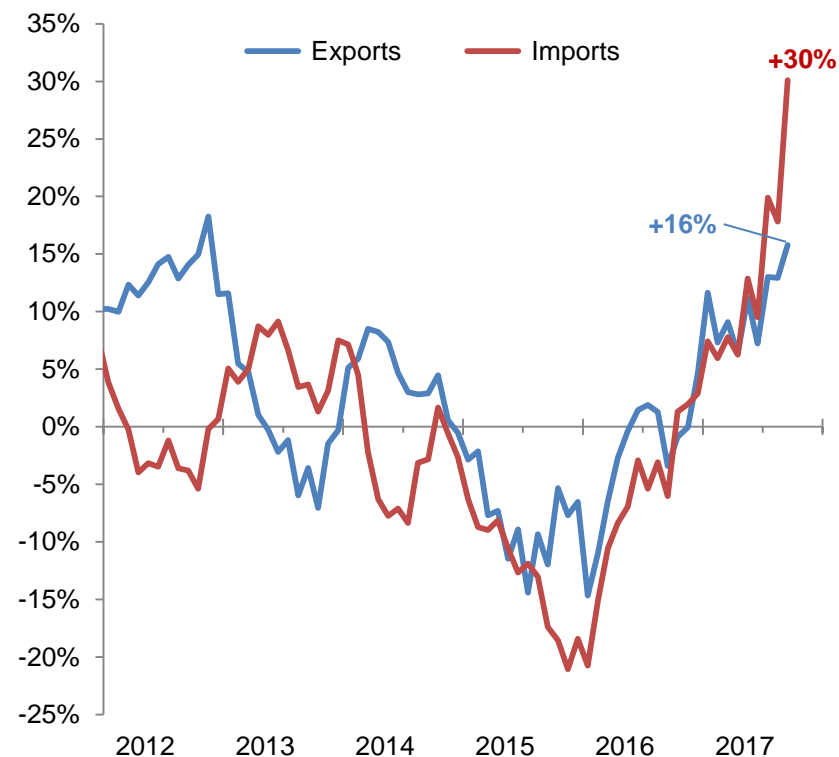
Current account deficit and financing (% of GDP)



Note: 2017 data refer to January-August 2017.

Sources: National statistics, Euler Hermes

Growth of nominal exports and imports of goods (USD; 3-month moving averages; % y/y)



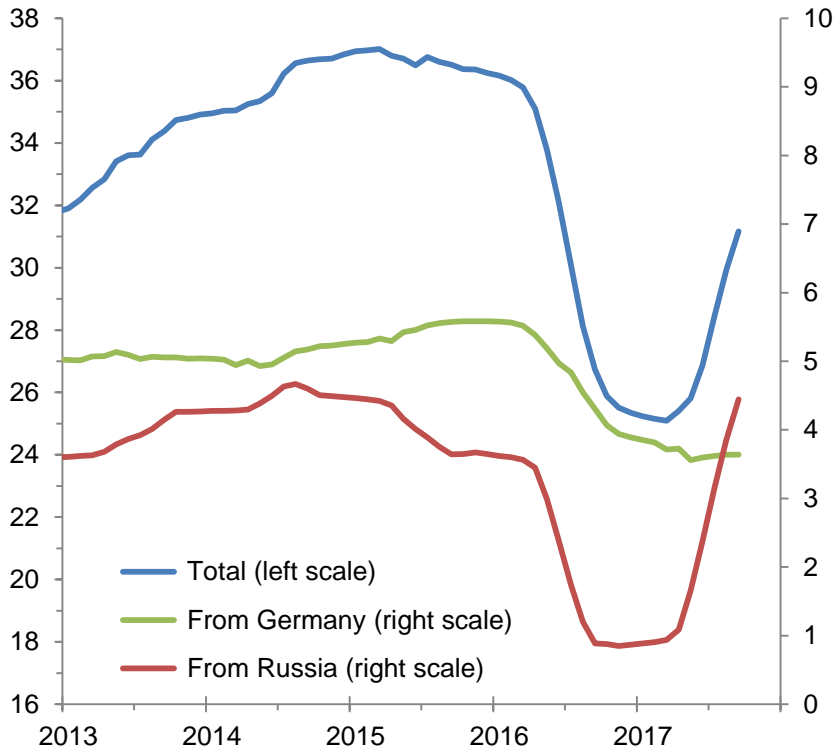
Sources: Turkstat, Euler Hermes

Tourism is recovering but FDI inflows remain weak

Sharp drop in tourist arrivals has bottomed out, mainly thanks to Russians coming back, but return to the record high will take a long time

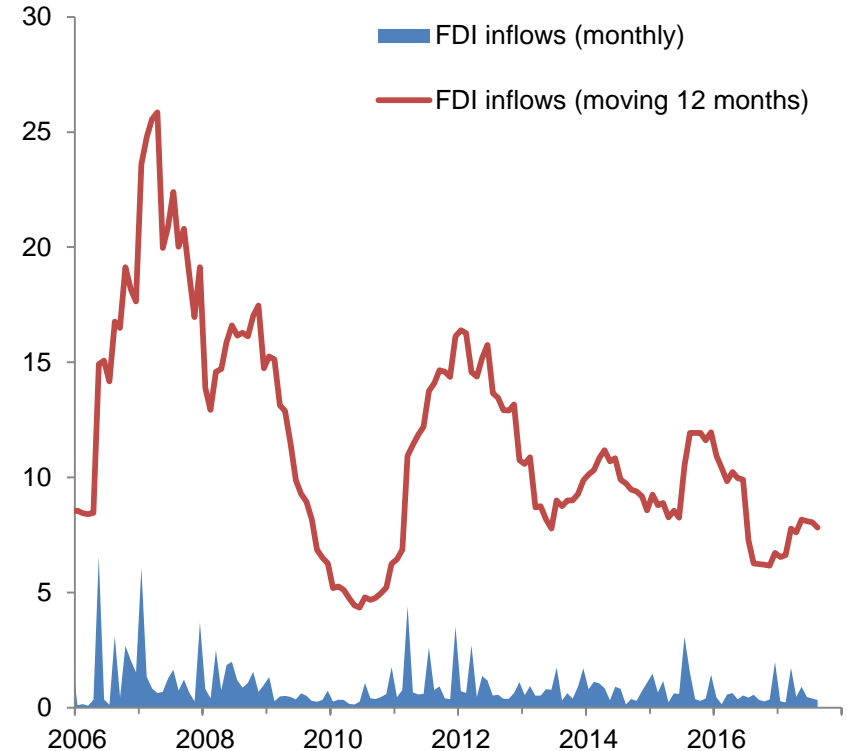
FDI inflows, never really strong in relation to GDP (1.6% in 2010-2016) remain below the levels in 2011-2014

**Foreign visitors arrivals in Turkey
(million; moving 12 months)**



Sources: National sources, Euler Hermes

FDI in Turkey (USD bn)



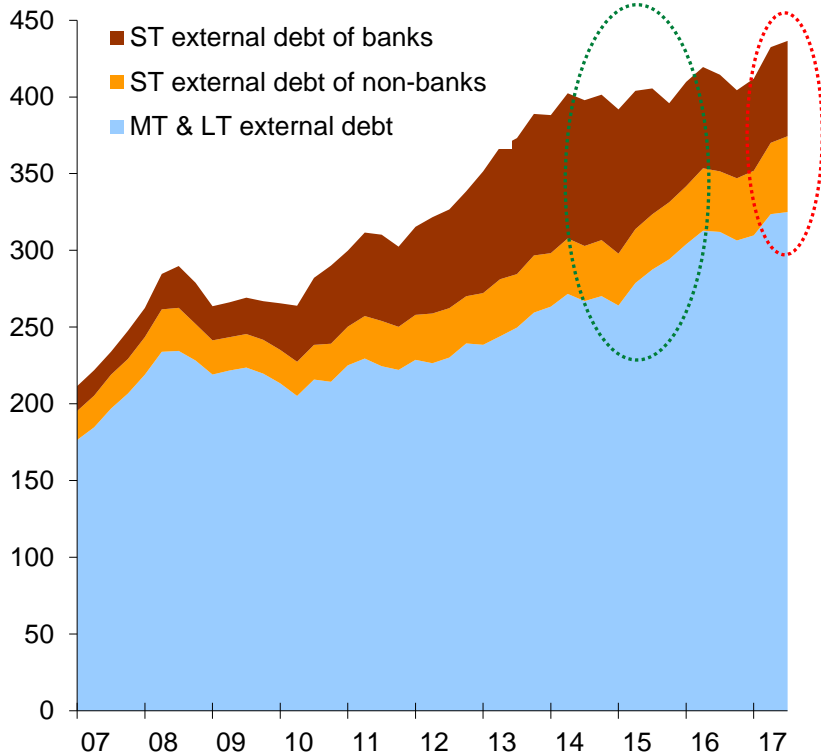
Sources: Central Bank of Turkey, IHS, Euler Hermes

Short-term external debt rises again in 2017, after some deleveraging in 2015-2016

Capital outflows led to a reduction of ST external debt of banks by USD30bn in 2015 and 7bn in 2016. As a result...

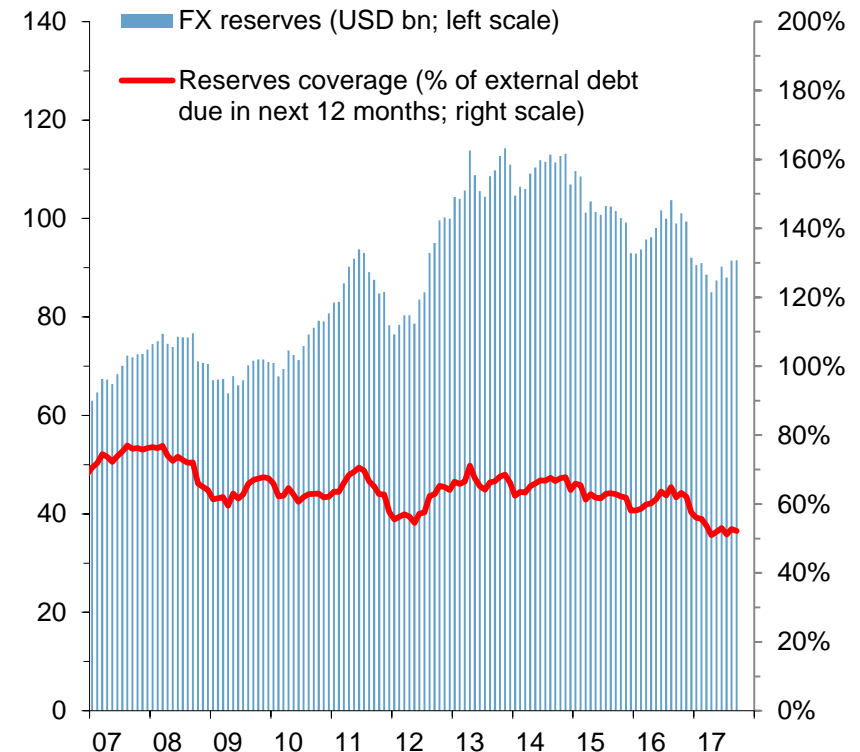
...FX reserves dropped by USD30bn from end-2014 to April 2017, now covering only 50% of short-term debt (>120% is good)

External debt (USD billion)



Sources: National sources, Euler Hermes

FX reserves (USD bn) and coverage of external debt payments falling due within 1 year (%)



Sources: Central Bank of Turkey, IHS, Euler Hermes

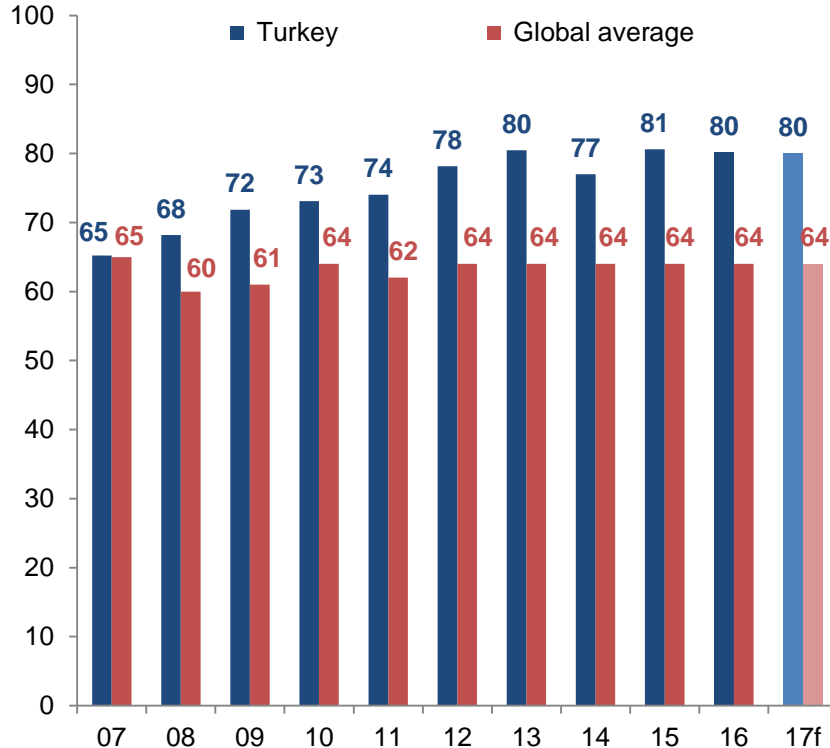
Steadily deteriorated payment behavior since 2007

– DSO now among the longest worldwide

In 2016 companies paid on average 15 days later than in 2007 and 16 days later than the global average (64 days in 2016)

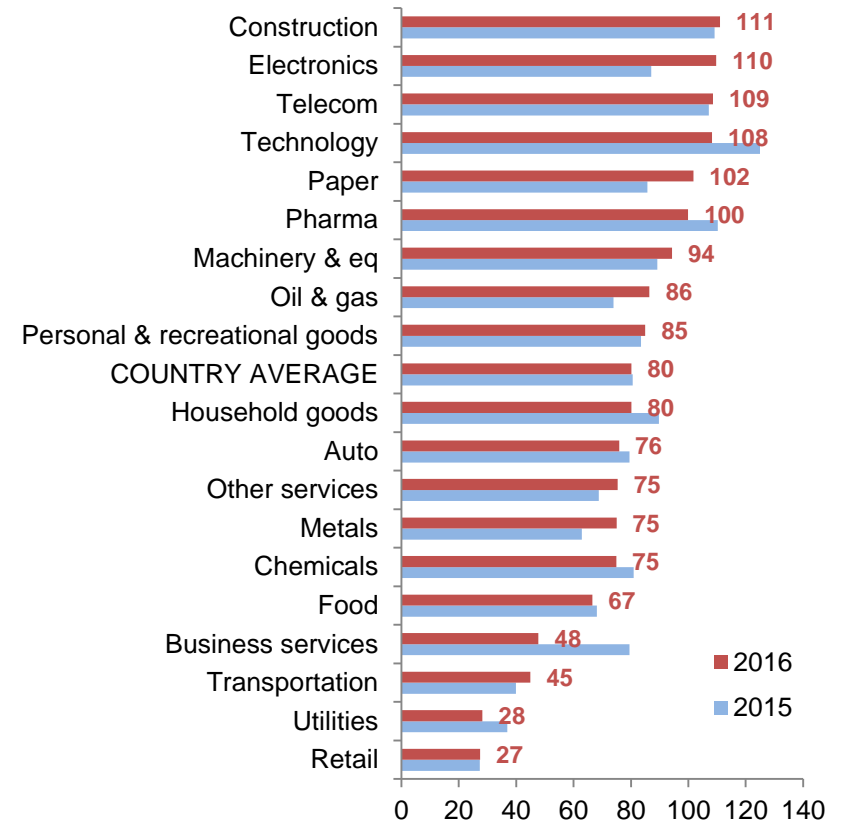
Construction, high-tech, paper, pharma and machinery wait ≥3 months to be paid

Average Days Sales Outstanding (DSO) of listed companies (number of days)



Sources: Bloomberg, Euler Hermes

Average DSO by sector in Turkey (number of days)



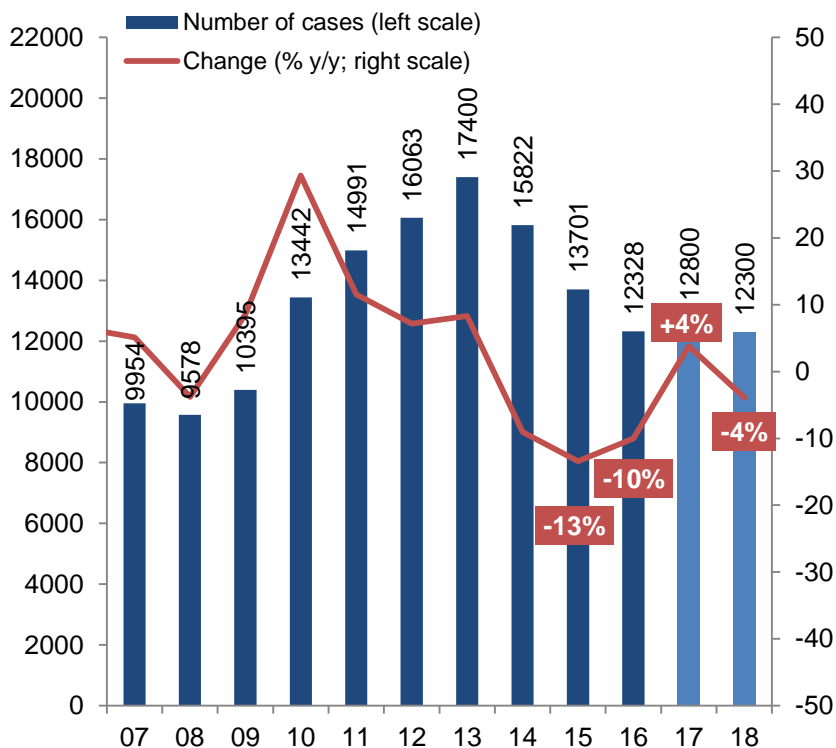
Sources: Bloomberg, Euler Hermes

Insolvencies forecast to decline in 2018, but the devil is in the detail (sector risk)

Insolvencies to rise by +4% in 2017, as TRY depreciation take its toll on firms with FX-denominated debt. U-turn in 2018

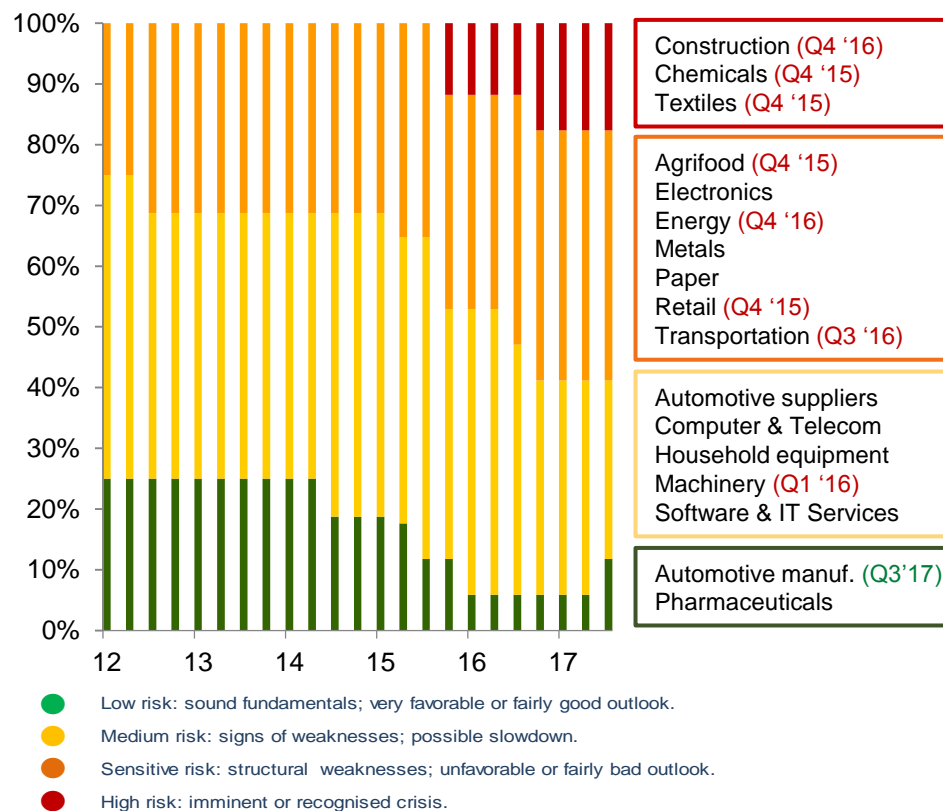
8 sector downgrades in the last 8 quarters, and only 1 upgrade

Corporate insolvencies in Turkey (number of cases and growth rate)



Sources: TOBB, Euler Hermes

Evolution of the sector risk levels in Turkey

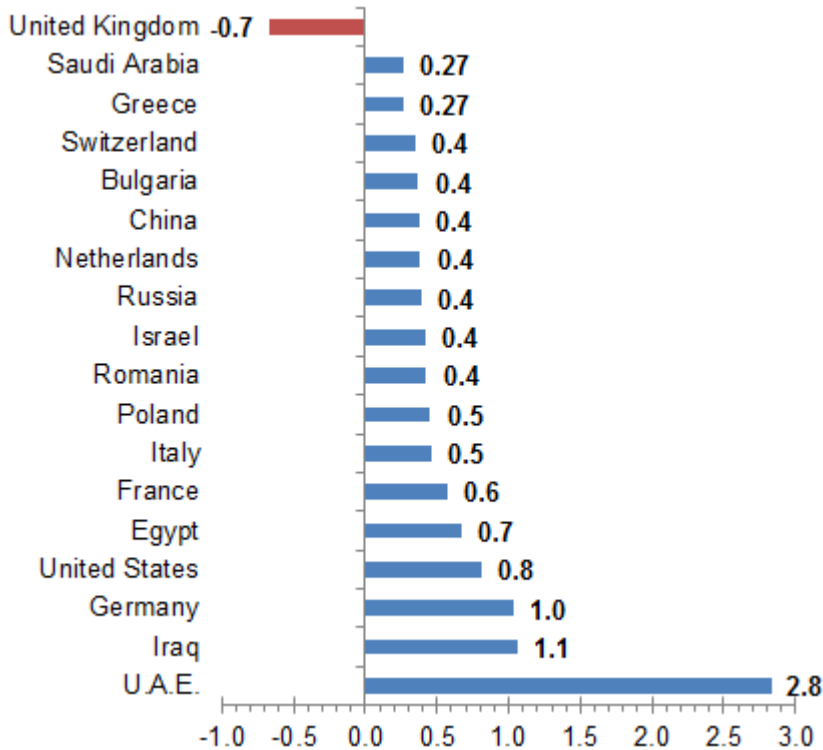


Source: Euler Hermes

Export recovery to continue in 2018: +USD16bn (the same as in 2017)

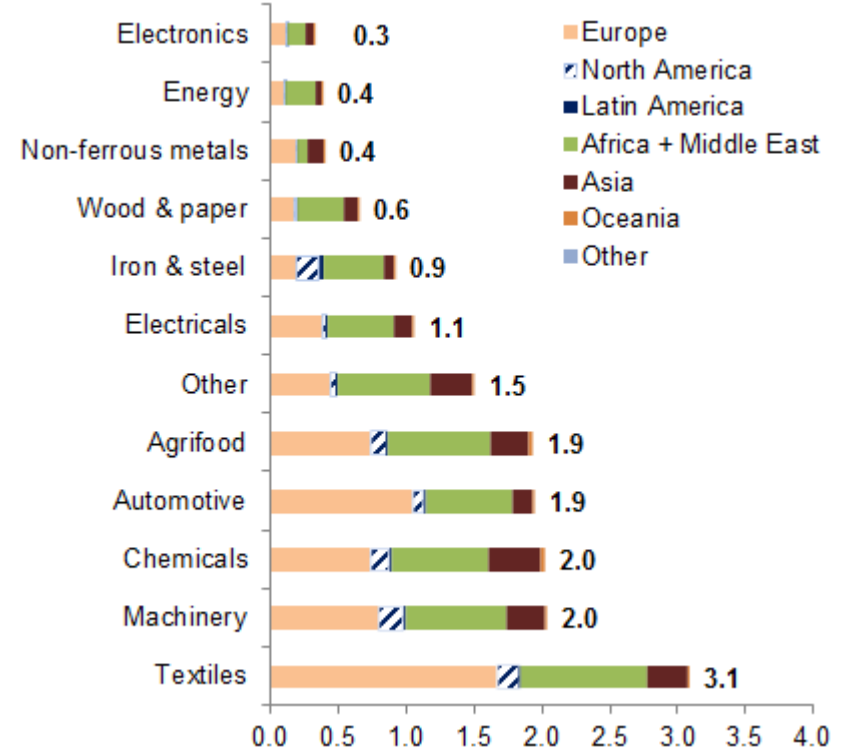
Turkey's exports benefit from recoveries in MENA and Europe, though the UK will be the main drag. MENA has caught up with Europe as a key region with regard to export gains

Potential 2018 export gains for 18 key trading partners (forecast by EH trade model)



Sources: IMF, Chelem, Turkstat, Euler Hermes

Potential 2018 export gains by sector (forecast by EH trade model)



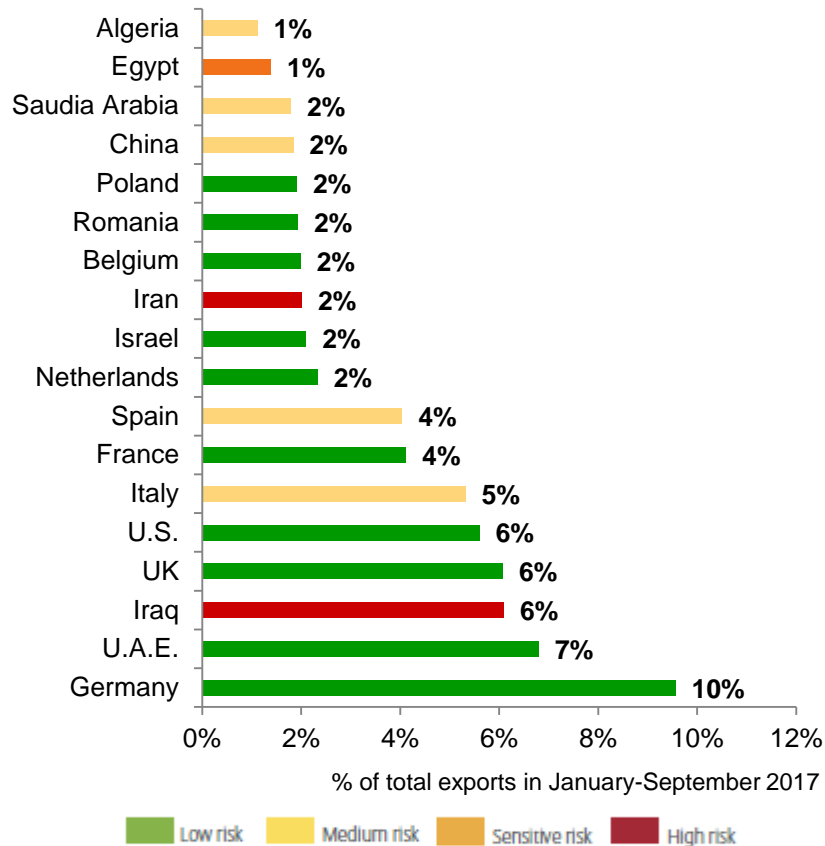
Sources: IMF, Chelem, Euler Hermes

Exporting companies face overall moderate country and insolvency risk – yet several hot spots

Low to moderate country risk in most key export destinations. But beware of higher risk in MENA region

Our Export Insolvency Index (IDEX) for Turkey is expected to slow down to -1% but remains favorable – caution in hot spots

Country risk in top 20 export markets, Q3 2017



Sources: Turkstat, Euler Hermes

Weighted average of insolvency variations for Turkey's main export partners (in %)

| Turkey | | 2016 | 2017f | 2018f |
|----------------|----------------------|------------------------|------------|------------|
| IDEX | | -6% | -2% | -1% |
| Trade partners | Export share | Change in insolvencies | | |
| 1 | Germany 9.4% | -7% | -5% | -3% |
| 2 | United Kingdom 6.7% | -1% | 5% | 6% |
| 3 | France 4.9% | -7% | -7% | -4% |
| 4 | U.S. 4.5% | -2% | 0% | 5% |
| 5 | Italy 4.3% | -9% | -11% | -6% |
| 6 | Switzerland 4.2% | 3% | 1% | 0% |
| 7 | Spain 3.3% | -18% | -3% | 0% |
| 8 | Russia 2.5% | 4% | 8% | -5% |
| 9 | Belgium 2.0% | -6% | 4% | -5% |
| 10 | Romania 2.0% | -18% | 5% | 5% |
| 11 | The Netherlands 1.7% | -17% | -20% | -5% |
| 12 | China 1.7% | 9% | 19% | 8% |
| 13 | Poland 1.6% | 8% | 12% | 0% |
| 14 | Bulgaria 1.2% | -16% | -10% | -5% |
| 15 | Greece 0.9% | -3% | -3% | -5% |
| 16 | Morocco 0.9% | 25% | 12% | 8% |
| 17 | Austria 0.9% | 1% | -2% | 1% |
| 18 | Sweden 0.7% | -6% | 0% | 1% |
| 19 | Canada 0.6% | -7% | -3% | 0% |
| 20 | Czech Republic 0.5% | -10% | -9% | -7% |

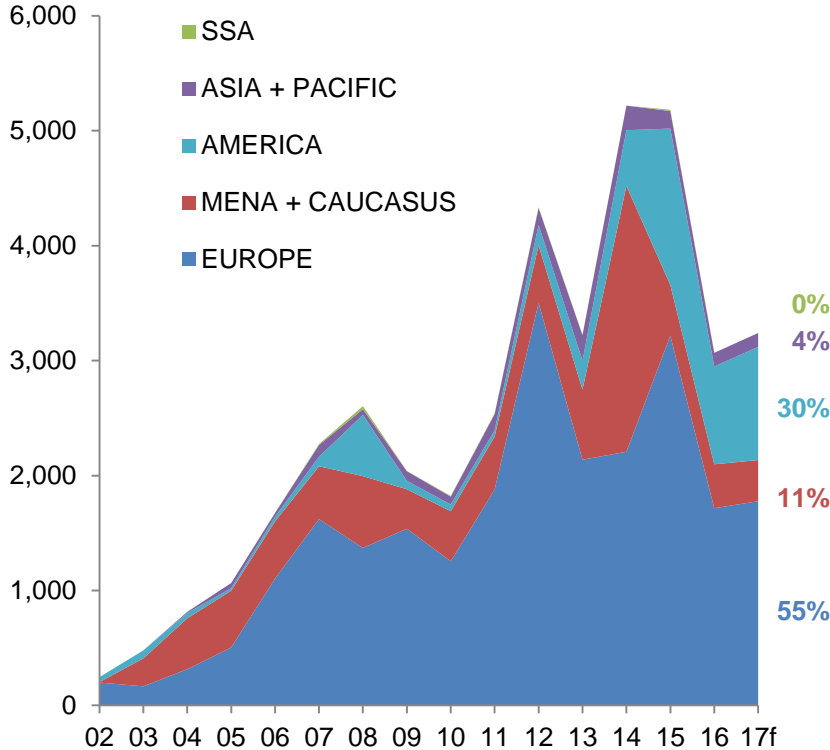
Sources: Chelem, National sources, Euler Hermes

Total FDI outflows have weakened since 2015 but those to the U.S. have increased

Turkish companies invested less in Europe and MENA & Caucasus in recent years. SSA and also Asia not targeted as yet

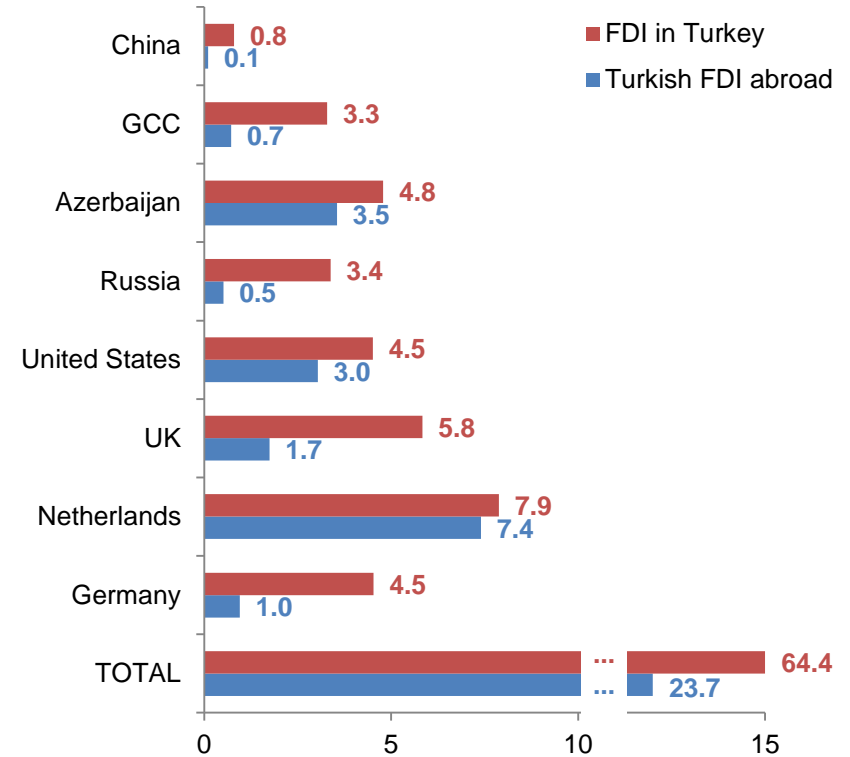
Netherlands and Azerbaijan are top partners for FDI in both directions. China is a minor FDI partner so far – One Belt One Road has yet to arrive

Turkish FDI abroad by main regions (USD mn)



Sources: Central Bank of Turkey, Euler Hermes

Turkish FDI inflows and outflows in 2011-2016 (USD bn)



Sources: Central Bank of Turkey, Euler Hermes

Thank you for your attention!

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