Euler Hermes Economic Research

Country Report

Turkey

Current account deficit remains the *Achilles' heel*

General Information

GDP	USD789 billion (World ranking 17, World Bank 2012)
Population	74 million (World ranking 18, World Bank 2012)
Form of state	Republican Parliamentary Democracy
Head of government	Recep Tayyip ERDOGAN (AKP)
Next elections	August 2014, presidential

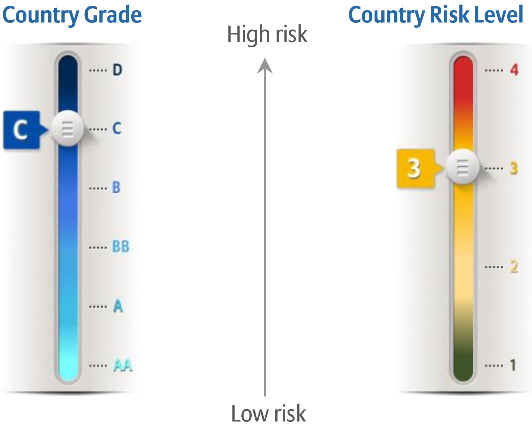
Strengths

- Important geostrategic position that has historically always ensured aid when needed
- Public finances
- Adequate business environment
- Well-educated workforce and competitive economy
- Mostly financially solid banking sector
- Increasingly important role as regional hub between Europe, MENA and Asia

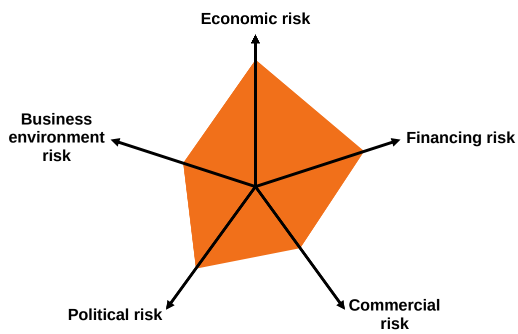
Weaknesses

- Continued rapid private sector credit growth
- Exchange rate vulnerability to domestic and external shocks
- Economic policy responsiveness
- Persistently large current account deficits, largely financed through short-term external debt which is consequently rapidly rising
- (External) debt refinancing risk of weaker companies and banks
- Deep-rooted division in society between secularists and religious conservatives

Country Rating C3



Risk Dimensions

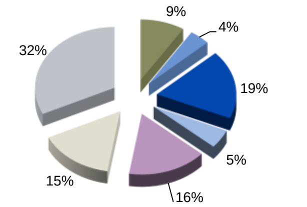


EULER HERMES
Our knowledge serving your success

A company of Allianz

Economic Structure

GDP breakdown (% of total, 2011)



Sources: UnctadStat, TurkStat, Euler Hermes

Trade structure (% of total, 2012)

By destination/origin

Exports		Rank		Imports
Germany	9%	1	11%	Russia
Iraq	7%	2	9%	Germany
Iran	7%	3	9%	China
United Kingdom	6%	4	6%	USA
UAE	5%	5	6%	Italy

By product

Exports		Rank		Imports
Machinery, appliances etc.	14%	1	25%	Mineral fuels and oils
Textiles and clothing	12%	2	18%	Machinery, appliances etc.
Iron and steel	11%	3	9%	Iron and steel
Precious stones and metals	11%	4	7%	Plastic and rubber products
Road vehicles and parts	10%	5	6%	Road vehicles and parts

Economic Forecast

	2010	2011	2012	2013	2014f	2015f
GDP growth (% change)	9.2	8.8	2.1	4.0	3.3	4.2
Inflation (%, end-year)	6.4	10.4	6.2	7.4	7.8	6.0
Fiscal balance (% of GDP)	-3.4	-0.7	-1.8	-1.5	-2.7	-2.4
Public debt (% of GDP)	42.3	39.1	36.2	35.8	36.0	35.5
Current account (% of GDP)	-6.2	-9.7	-6.1	-7.9	-6.3	-6.0
External debt (% of GDP)	39.9	39.3	42.7	53.1	54.0	55.0

Sources: IHS, national sources, Euler Hermes

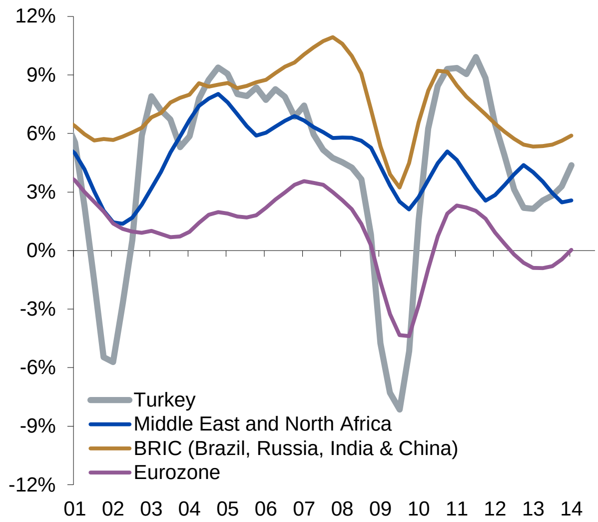
Economic Growth

Growth resilient in 2013 but forecast to moderate in 2014

Economic activity proved resilient to political and global financial market turbulences in 2013. Real GDP grew by +4%, up from +2.1% in 2012. Domestic demand was the sole growth driver, with private consumption expanding by +4.6%, public consumption +5.9% and investment +4.3%. Exports were almost flat at +0.1% while imports increased by +8.5% such that net exports made a large negative contribution to full-year 2013 growth.

In Q1 2014, real GDP grew by a strong +4.3% y/y and +1.7% q/q, however, thanks to a one-off boost by soaring gold exports (+53% y/y; mainly to Switzerland) – in an apparent move to cut back earlier accumulated gold reserves before gold prices may drop – lifting overall export growth to +11.4% y/y while imports edged up by just +0.8% y/y, so that net exports made a large positive contribution to Q1 growth. Meanwhile, currency depreciation, rising inflation and monetary tightening sharply reduced private domestic demand, with household consumption growth slowing to +2.9% y/y and private investment declining by -1.3% y/y. In contrast, increased government spending supported growth, with public consumption expanding by +8.6% y/y and public investment by +4.1% y/y. While the export surge is unlikely to continue for the remainder of the year (exports would have grown just +3.4% y/y in Q1 without the gold boost), domestic demand may gain some momentum if the central bank relaxes monetary policy against the background of the recent currency stabilisation. EH expects full-year real GDP to grow by +3.3% in 2014 and +4.2% in 2015.

GDP growth (% y/y, 4 qtrs cumulated)



Sources: IHS, national sources, Euler Hermes

Unorthodox monetary policy ...

To tackle excessive credit growth and large speculative foreign capital inflows – seen as main sources of rising macroeconomic imbalances and economic overheating – the central bank embarked on an unorthodox monetary policy strategy in late 2010: lower interest rates to curb short-term foreign capital inflows and ease upward pressure on the TRY and sharply higher bank reserve requirements to tighten monetary policy at home in order to reduce credit growth in spite of lower interest rates. The strategy eventually appeared to be successful in facilitating a soft landing, including a reduction of private sector credit growth to a more reasonable level of around 18% y/y at end-2012.

... finally replaced by conventional measures

However, credit growth and external imbalances increased again in 2013. Moreover, the vulnerabilities associated with large current account deficits predominantly financed through short-term capital inflows, especially when combined with political turmoil and sluggish policy responsiveness, were exposed by recurrent financial market turbulences over the past year. After stabilising in 2012, the Turkish lira (TRY) depreciated by over 30% against a USD-EUR basket from mid-May 2013 to end-January 2014. At the same time, inflation accelerated. Then, the central bank finally returned to orthodox monetary policy, hiking its key policy interest rate by 550bps to 10%. The decisive but belated move has reversed the earlier depreciation, and the TRY has re-gained about 10% since then. This encouraged prime minister Erdogan to call for monetary easing as early as March – and the central bank did so in May when it cut the key policy rate again by 50bps to 9.5%, even though inflation has continued to rise, reaching 9.7% y/y in May 2014. EH expects inflation to moderate only slightly to about 7.8% at end-2014, still well above the central bank's 5% inflation target.

Exchange rate risk remains a concern

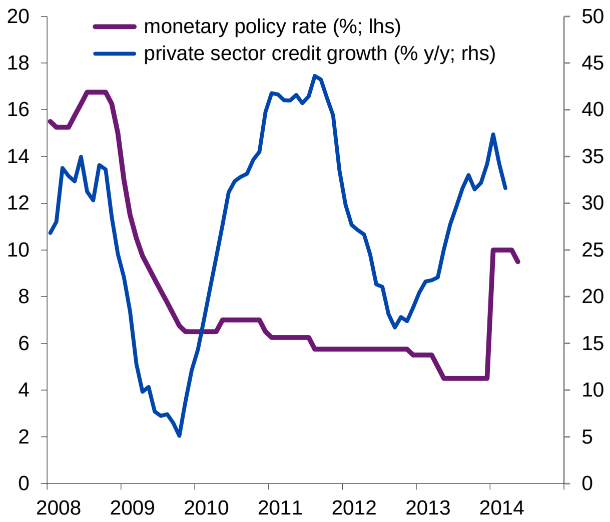
Early policy loosening could once again increase the TRY's vulnerability to a fresh sell-off, especially against the background of the forthcoming presidential election in August 2014 and ongoing large current account shortfalls. After all, the exchange rate of the TRY has shown considerable volatility and vulnerability to external and domestic shocks in recent years. Currency risk remains a concern in the medium term, especially since short-term foreign capital inflows have remained substantial to date.

Adequate fiscal position

Turkey's fiscal position has markedly improved since the domestic economic crisis in 2001. The fiscal deficit has been below 3% of GDP since 2011 and should remain so in 2014-2015. Total public debt in relation to GDP has halved from almost 80% in 2001 to around 36% in 2013. Fitch Ratings agency upgraded Turkey to investment grade in November 2012, followed by Moody's in May 2013. S&P has kept the country one notch below that level, for now.

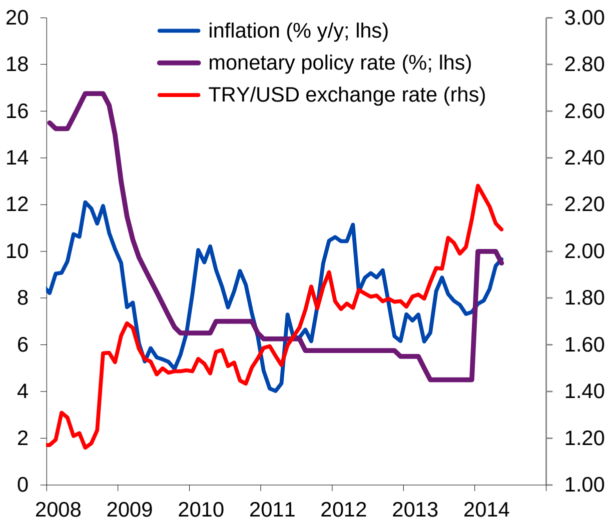
It should be noted, however, that much of the improvement of Turkey's fiscal position in recent years is owed to strong tax revenues thanks to the sound economic performance and markedly lower interest payments rather than spending restraint. Indeed, public spending has often been higher-than-targeted, indicating a reluctance to fiscal consolidation. This could undermine market confidence in the event of lower future growth, domestic or external shocks.

Monetary policy and private sector credit growth



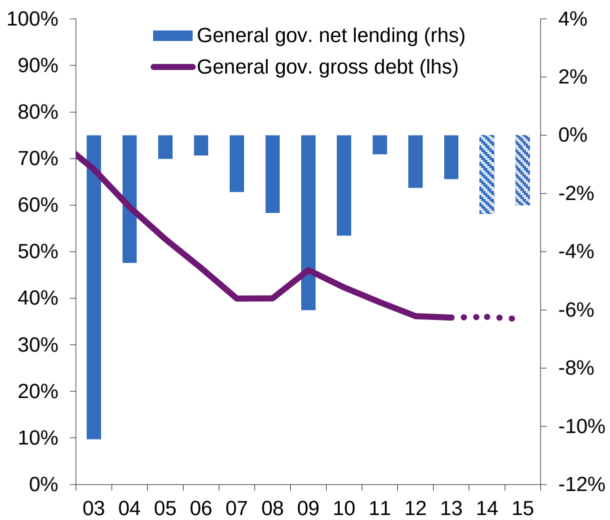
Sources: IHS, national sources, Euler Hermes

Monetary policy, inflation and exchange rate



Sources: IHS, national sources, Euler Hermes

Public finances (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

External Sector

Current account deficit is narrowing slightly...

The current account deficit increased from USD48.5bn (6.1% of GDP) in 2012 to USD65.1bn (7.9% of GDP) in 2013, as the terms of trade deteriorated. Meanwhile, as a result of the TRY depreciation until early 2014 and the ensuing import moderation, the current account deficit has declined somewhat, amounting to USD16.4bn in the first four months of 2014, down 34% y/y. EH forecasts the annual shortfall to narrow to a still large 6.0-6.5% of GDP in 2014-2015.

...but the financing of the deficit remains a cause of concern

Net foreign direct investment (FDI) inflows have been modest in recent years (USD9.8bn or 1.2% of GDP in 2013), covering just 17% of the annual current account deficits in 2010-2013. The large remainder of the shortfalls was financed through new short-term external debt: In 2013, net portfolio investment inflows, which have a more speculative nature, amounted to USD23.8bn (2.9% of GDP) and net external bank borrowing increased to USD30.5bn (3.7% of GDP).

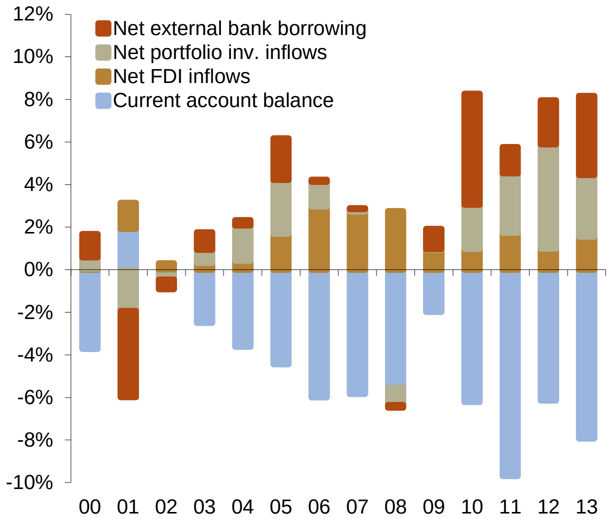
Rapidly rising short-term external debt poses risks and requires close monitoring

As a result, total external debt has risen to a record USD388bn in 2013, up from USD338 at end-2012. Owing to the TRY depreciation, the ratio of external debt to GDP (53%) or export earnings (185%) has sharply increased in 2013 (up from 43% and 164%, respectively). Moreover, short-term external debt has risen faster than the total, hitting a worrisome, new record high of USD131bn in 2013 and increasing to about 33% of the total from 17% at end-2007. The debt-service ratio has fallen but will remain large at about 25% in 2014.

Foreign exchange reserves appear adequate

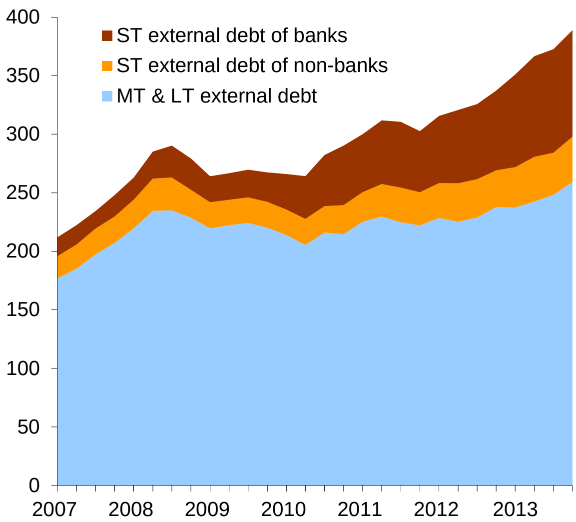
Largely as a result of the above mentioned substantial short-term capital inflows in previous years, foreign exchange reserves rose to a record USD114bn in April 2013. Owing to central bank intervention to stabilise the TRY and partial reversals of earlier capital inflows, reserves fell to a temporary low of USD105bn in July 2013 and again in January 2014 – reflecting Turkey's ongoing vulnerability to external and political events – before recovering to USD109bn in April 2014. Positively, the current level of foreign exchange reserves is comfortable with regard to import cover (around five months). In other terms, however, reserves cover just about 65% of the estimated external debt payments falling due in the next 12 months, which is well below a comfortable level of at least 100%.

Current account balance and financing of deficits (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

External debt (USD billion)



Sources: Central Bank of Turkey, Euler Hermes

Contact Euler Hermes Economic Research Team
research@eulerhermes.com

Last review: 2014-06-16
Country Risk Analyst:
Manfred Stamer
manfred.stamer@eulerhermes.com