

External and domestic turbulences have sent TRY in free fall

General Information



GDP	USD800bn (World ranking 18, World Bank 2014)
Population	75.8mn (World ranking 18, World Bank 2014)
Form of state	Republican Parliamentary Democracy
Head of government	PM Ahmet DAVUTOGLU (AKP)
Next elections	November 2015, legislative



Strengths

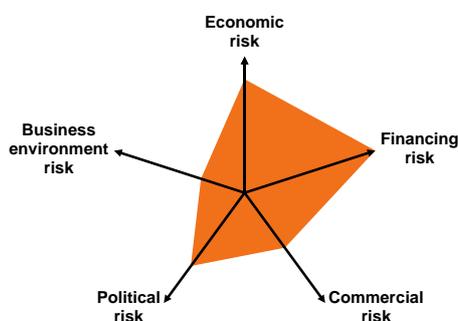
- Important geostrategic position that has historically always ensured aid when needed
- Public finances
- Adequate business environment
- Well-educated workforce and competitive economy
- Increasingly important role as regional hub between Europe, MENA and Asia

Weaknesses

- Continued rapid domestic 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 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	10% 1	10% Russia
Iraq	7% 2	10% China
United Kingdom	6% 3	9% Germany
Italy	5% 4	5% United States
France	4% 5	5% Italy

By product (% of total)

Exports	Rank	Imports
Road vehicles	11% 1	11% Machinery and equipment
Clothing	11% 2	8% Chemicals
Foodstuff	9% 3	8% Basic metals
Basic metals	9% 4	7% Petroleum and products thereof
Textiles	8% 5	6% Road vehicles

Source: Turkstat (2014)

Economic Overview

Free fall of TRY weighs down on growth...

Real GDP growth accelerated to +3.8% y/y in Q2 thanks to pre-election-related surging government consumption (+7.2% y/y) and fixed investment (+9.7% y/y). This took average growth in H1 2015 to +3.1% y/y which was entirely driven by domestic demand, with private consumption up by +5.1% y/y, government consumption by +4.9% and fixed investment by +5.2%. Net exports made a negative contribution to H1 growth. Real imports grew by +2.7% y/y while exports declined by -1.6% in H1 despite low oil prices, a weaker currency, modest interest rates, and some trade liberalisation. These potential export growth boosters were outweighed by rising political uncertainty and the accelerating TRY depreciation which have weighed down on economic sentiment. Early indicators for H2 suggest that business confidence (manufacturing PMI) has further deteriorated and economic activity (industrial production, retail sales) is slowing again. Euler Hermes expects that the recovery from just +2.9% real GDP growth in 2014 will remain modest and forecasts +3.2% for 2015 and +3.6% for 2016. However, the balance of risks to these forecasts is more on the downside.

...and challenges monetary policy

In January 2014, the Central Bank of Turkey (CBT) returned to orthodox monetary policy, hiking its key policy interest rate by 550bps to 10%. The decisive but belated move was a response to recurrent financial market turbulences over the previous year, which had exposed once again 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. However, upon some political pressure the CBT began to ease monetary policy again as early as May 2014, lowering the key policy rate in five steps by a cumulative 250bps to 7.5% in February 2015. This relatively loose monetary policy stance combined with the weak economic performance since 2014, ongoing large current account deficits and, in particular, political uncertainty that has been reinforced by the inconclusive general election in June 2015 and the new elections to be held in November have sent the TRY nose-diving this year. As of end-August 2015, the TRY had depreciated by -35% y/y against the USD and by -15% y/y against the EUR. Nonetheless, inflation held up well and even fell from 8.1% y/y in May 2015 to 6.8% in July, thanks to the drop in global oil prices. However, the rise of inflation to 7.1% in August indicates that the latest fall in the TRY has started to push up price pressures. EH expects inflation to pick up further in the next months, exceeding 8% in early 2016. Given this and the continued downside risk to the TRY, interest rate hikes look increasingly likely. Inflation is then forecast to fall back to about 6.5% at end-2016.

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

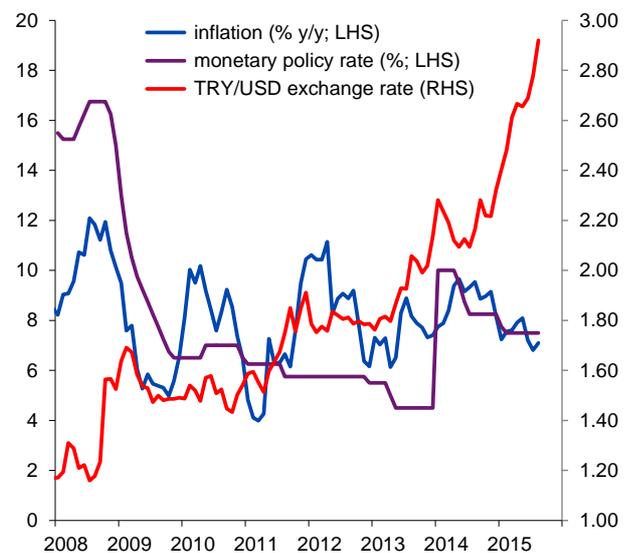
The fiscal position has markedly improved since the domestic economic crisis in 2001. The annual fiscal deficit has been below -2% of GDP since 2011 and should remain so in 2015-2016. The public debt-to-GDP ratio has more than halved from almost 80% in 2001 to around 34% in 2014. Although this ratio is expected to rise to 37% in 2015 due to the TRY depreciation, it will remain moderate as compared to the Eurozone average (94% of GDP), for example.

Key economic forecasts

	2013	2014	2015f	2016f
GDP growth (% change)	4.1	2.9	3.2	3.6
Inflation (% end-year)	7.4	8.2	7.5	6.5
Fiscal balance (% of GDP)	-1.3	-1.5	-2.0	-1.8
Public debt (% of GDP)	36.2	33.5	37.0	36.0
Current account (% of GDP)	-7.9	-5.7	-5.6	-5.8
External debt (% of GDP)	53.0	53.4	59.0	61.0

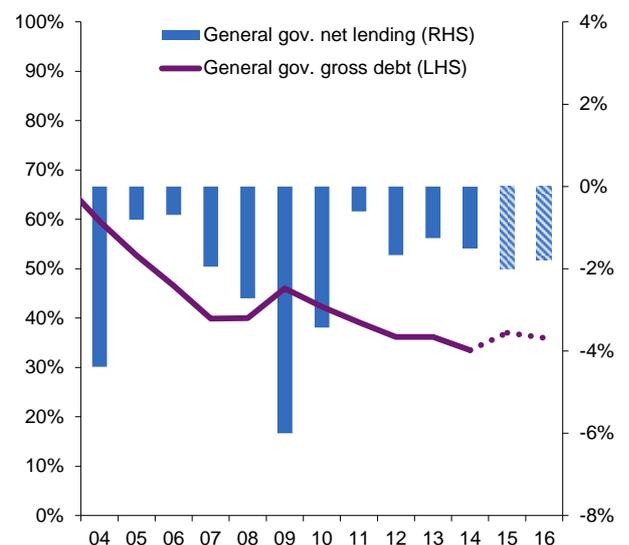
Sources: National sources, IHS, Euler Hermes

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



Sources: National sources, IHS, Euler Hermes

Public finances (% of GDP)



Sources: IMF, Euler Hermes

Current account deficit has narrowed somewhat but remains worrisome...

The current account deficit decreased from USD64.7 bn (-7.9% of GDP) in 2013 to USD46.5 bn (-5.7% of GDP) in 2014 as the weaker TRY ensued import moderation. In H1 2015, the shortfall was USD22.7 bn, down -7.5% y/y. Nonetheless, Euler Hermes forecasts the annual current account deficit to remain at a worrisome ratio of just under -6% of GDP in 2015-2016, because Turkish GDP will decline this year in USD terms owing to the sharp TRY depreciation.

...and the financing of the deficit remains a particular cause of concern

Net foreign direct investment inflows have been modest in recent years (USD4.2 bn or 1.2% of GDP in H1 2015), covering just 16% of the cumulative current account deficit from 2010 to mid-2015. The large remainder of the shortfall was financed through new short-term external debt: In 2014, net portfolio investment inflows, which have a more speculative nature, amounted to USD20.1 bn (2.8% of GDP) and net external bank borrowing reached USD14 bn (2% of GDP). Particularly worrisome, H1 2015 saw net portfolio investment outflows of USD4 bn (-1.2% of GDP), leaving a large financing gap of about USD15 bn for the current account deficit.

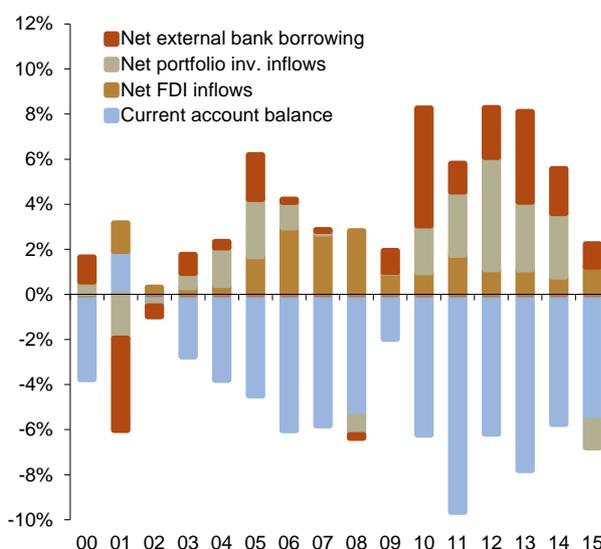
Large short-term external debt poses risks and requires close monitoring

As a result of the current account deficit financing over the past years, total external debt rose to a record USD402 bn at end-2014, up from USD339 bn at end-2012, before slightly falling back to USD393 bn in Q1 2015. Moreover, owing to the ongoing TRY depreciation since 2013, the ratio of external debt to GDP (forecast at 53% in 2015) or export earnings (201%) has sharply increased since end-2012 (43% and 165%, respectively). Furthermore, short-term external debt has risen faster than the total, hitting a worrisome, new record high of USD133 bn in Q4 2014 and increasing to about 33% of the total from 17% at end-2007.

Foreign exchange (FX) reserves still adequate?

Owing to central bank intervention to stabilise the TRY and partial reversals of earlier capital inflows, FX reserves fell from a record USD114 bn in November 2013 to a 30-month low of USD101 bn in June 2015 – reflecting Turkey's ongoing vulnerability to external and political events. While the current level of FX reserves still appears comfortable with regard to import cover (around five months), they cover just about half of the estimated external debt payments falling due in the next 12 months, which is well below an adequate level of at least 100%.

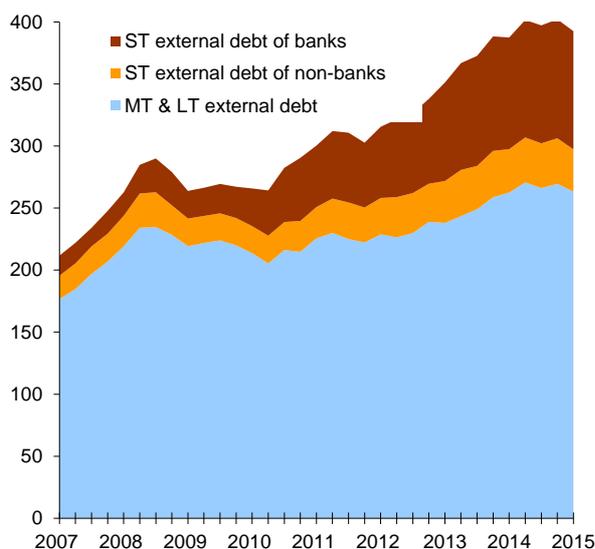
Current account and financing of deficits (% of GDP)



Note: 2015 data refer to Q1-Q2 2015.

Sources: National sources, IHS, Euler Hermes

External debt (USD bn)



Sources: Central Bank of Turkey, Euler Hermes

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