Country update TURKEY

Summary

Slower growth in the second quarter helped calm the economy, thereby reducing the risk of overheating. Still, wide current account and trade deficits are a major source of concern. In 2011, we expect the trade deficit to reach 11% of GDP (from roughly 7% of GDP in 2010). Another concern is that, despite multiple efforts by the Central Bank to halt credit growth, the domestic credit growth rate is expected to reach roughly 35% in 2011 (from 27% in 2010). Finally, large inflows of hot money could have a potentially destabilizing effect. Still, an expected 9% growth rate in 2011 is impressive and underscores the flexibility of the Turkish economy, after it contracted by 4.8% in 2009. For 2012, we expect GDP growth to slow.

Things to watch:

- Turkey's large current and trade deficits
- Inflow of hot money
- Domestic credit growth

Author: **Anouk Ruhaak**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64860
A.N.Ruhaak@rn.rabobank.nl

Turkey

National facts		
Type of government	Republic	
Capital	Ankara	
Surface area (thousand sq km)	781	
Population (millions)	72.6	
Main languages	Turkish	
	Kurdish	
	other minority languages	
Main religions	Muslim (99.8%)	
	other (0.2%)	
Head of State (president)	Abdullah Gul	
Head of Government (prime-minister)	Recep Tayyip Erdogan	
Monetary unit	Turkish lira (TRY)	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	734	1.18
Nominal GDP at PPP	968	1.30
Export value of goods and services	155	0.83
IMF quotum (in mln SDR)	1191	0.55
Economic structure	*2010*	*5-year av.*
Real GDP growth	9.0	3.1
Agriculture (% of GDP)	10	9
Industry (% of GDP)	27	28
Services (% of GDP)	64	63
Standards of living	*USD*	*% world av.*
Nominal GDP per head	10007	102
Nominal GDP per head at PPP	13198	112
Real GDP per head	7685	96

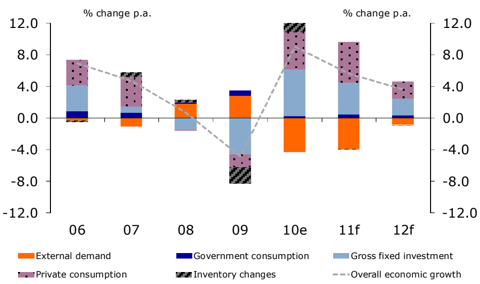
Social and governance indicators			rank / total
Human Development Index (rank)			83 / 169
Ease of doing business (rank)			71 / 183
Economic freedom index (rank)			67 / 179
Corruption perceptions index (rank)			56 / 178
Press freedom index (rank)			138 / 178
Gini index (income distribution)			43.23
Population below $1.25 per day (PPP)			3%
Foreign trade			**2010**
Main export partners (%)		*Main import partners (%)*	
Germany	10	Russia	12
UK	6	Germany	10
Italy	6	China	9
France	5	US	7
Main export products (%)			
Textiles & Clothing			19
Iron & Steel			13
Transport Equipment			13
Agro-industry			10
Main import products (%)			
Chemicals			15
Fuel			12
Transport Equipment			9
Machinery			8
Openness of the economy			
Export value of G&S (% of GDP)			21
Import value of G&S (% of GDP)			27
Inward FDI (% of GDP)			1.3

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

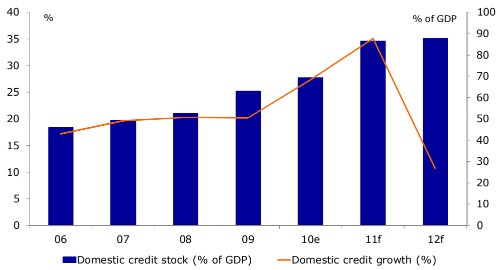
With a growth rate of 10.2% in the first half of 2011, Turkey's economy was one of the fastest growing worldwide. On the one hand, Turkey's economic expansion reflects the flexibility and the robustness of the economy, after it contracted by nearly 5% in 2009. On the other hand, there is a realistic fear that the economy is overheating, which may well result in a hard landing. For one, inflation is still on the rise and is expected to reach 6% in 2011, well above the central bank's (CBRT) 5% target.

Chart 1: GDP growth



Source: EIU

Chart 2: Domestic credit growth



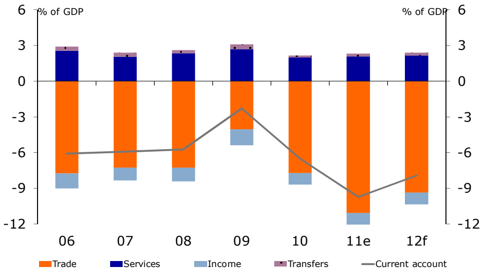
Source: EcoWin

In addition, Turkey's credit growth rate is expected to increase from 27% in 2010, to 35% in 2011. Although the level of credit growth also reflects the fact that Turkey's banking system is catching up, as the country is still relatively underbanked, the rapid increase is worrisome. Thirdly, the high

GDP growth rate is partly funded by large inflows of hot money that could easily be reversed. Finally, strong domestic demand has resulted in a large trade deficit that is expected to reach 11% of GDP in 2011.
In light of these red flags, slowing growth at the beginning of the third quarter is comforting. Overall, we expect the Turkish economy to grow by 7.5% in 2011. For 2012, growth should be slower at 3.5%, as domestic demand contracts and the euro zone crisis reduces demand for Turkish exports. Moreover, we expect the slowdown in credit growth, which started in Q311, to continue in 2012, as the various monetary policies implemented by the CBRT start to sort effect.

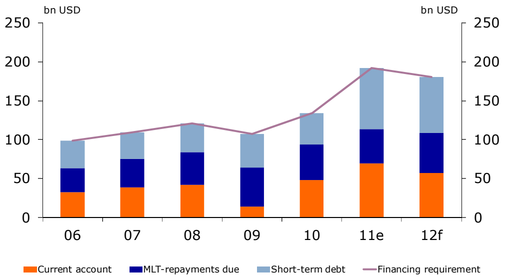
Vulnerability to the global economy
The liberalization of the Turkish economy has opened it up to the world at large. However, in times of crisis a strong connection with, and, in many aspects, a dependency on the world can create vulnerabilities. For one, the Turkish inability to raise sufficient FX reserves through exports has made the country especially dependent on hot money inflows and short-term debt flows. This dependency has only increased. With a current account deficit expecting to peak at roughly 9% of GDP in 2011, Turkey's financing requirement has increased as well. At the same time, portfolio investment inflows are soaring, on account of loose monetary policies in China, the US and EU. Between 2009 and 2011, net portfolio investments increased from an outflow of USD 0.9bn to an inflow of USD 19bn. Although these investments could help deepen the financial sector, they could also be easily reversed, once investor sentiment turns against Turkey. Given the global turbulence, Turkey's large current account deficit and its high inflation rate, this is not unimaginable. A shift in investor' sentiment would also be dangerous in light of Turkey's increasing negative investment position. Moreover, with FX reserves only covering 4.5 months of exports and a liquidity ratio at 82 in 2011 (from 94 in 2010), Turkey is ill-prepared for an episode of capital flight.
Another vulnerability stems from Turkey's dependence on the euro zone as its main export market. Fiscal consolidation in the euro zone is expected to further slow demand for Turkish exports. This effect will be especially pronounced in Italy, which is the destination of 6% of all Turkish exports.
Despite these vulnerabilities, there are some comforting factors as well. For one, the Turkish economy is known for its flexibility. Past experiences show that when growth contracts, demand for foreign (luxury) goods rapidly contracts as well, which helps to reduce the trade and current account deficits and quickly reduces short term debt levels. Indeed, we do expect slowing growth in 2012 to result in a somewhat lower, but still high, current account deficit of roughly 8% of GDP. However, even if the current account deficit were to fall further, we are still worried by the fact that Turkey did not report a surplus on the current account since 2002.
Secondly, CBRT policies (detailed below) were successful in slowing the increase in inward portfolio investments. Consequently, inflows are expected to come down to USD 16bn in 2012, which is still considered elevated.

Chart 3: Current account



Source: EIU

Chart 4: Financing requirements



Source: EIU

Economic policy

The CBRT has been confronted with a challenging global economic environment. On the one hand, it saw itself forced to stem the large inflows of hot money, while, on the other hand, it has had to tackle high domestic credit growth and a weakening currency (the lira fell by 20% vis-à-vis the dollar since the start of 2011) that has been driving up the cost of imports and thereby inflation. In response, the CBRT has chosen to maintain a low policy rate (repo rate), currently at 5.75%, while increasing reserve requirements for foreign currency deposits and short-term deposits. As mentioned above, this policy has been successful in slowing inward portfolio investments. However, it has done little to slow inflation, which has occasioned critics to push for an increase in the policy rate. The CBRT, however, is convinced slowing demand in 2012 will help reduce inflation. It further hopes to halt inflation by strengthening the lira through exchange rate interventions. So far, this policy has yielded little success.

Fiscal policy is also geared towards slowing domestic demand, while simultaneously consolidating the fiscal balance. Last October, the government announced its economic policy goals for the coming two years, which include a reduction of public debt to 32% of GDP in 2014 (from roughly 40% of GDP now). Although this goal is considered overly ambitious, we welcome the general policy direction, as reduced public spending will further reduce the risk of an overheating economy.

Turkey

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	6.9	4.7	0.7	-4.8	9.0	7.5	3.5
Consumer prices (average % change pa)	9.6	8.8	10.4	6.3	8.6	5.9	7.4
Current account balance (% of GDP)	-6.1	-5.9	-5.7	-2.3	-6.5	-10.0	-8.7
Total foreign exchange reserves (mln USD)	60892	73384	70428	70874	80713	86390	87590
Economic growth							
GDP (% real change pa)	6.9	4.7	0.7	-4.8	9.0	7.5	3.5
Gross fixed investment (real % change pa)	13.4	3.0	-5.8	-19.4	29.5	20.0	8.0
Private consumption (real % change pa)	4.7	5.4	-0.3	-2.4	6.7	9.5	3.0
Government consumption (real % change pa)	8.8	6.7	1.7	7.0	1.9	4.0	3.5
Exports of G&S (real % change pa)	6.7	7.4	2.8	-5.5	3.5	4.5	4.9
Imports of G&S (real % change pa)	7.1	10.5	-3.6	-14.9	20.7	20.0	6.2
Economic policy							
Budget balance (% of GDP)	-0.6	-1.6	-1.8	-5.5	-3.6	-1.7	-1.8
Public debt (% of GDP)	46	40	40	46	43	42	40
Money market interest rate (%)	15.6	17.2	16.0	9.2	5.8	1.6	2.7
M2 growth (% change pa)	21	22	27	11	24	17	17
Consumer prices (average % change pa)	9.6	8.8	10.4	6.3	8.6	5.9	7.4
Exchange rate LCU to USD (average)	1.4	1.3	1.3	1.5	1.5	1.7	1.8
Recorded unemployment (%)	10.3	10.3	11.0	14.1	12.0	10.2	10.1
Balance of payments (mln USD)							
Current account balance	-32249	-38434	-41959	-13991	-47739	-72900	-62450
Trade balance	-41056	-46852	-53021	-24850	-56445	-84100	-79180
Export value of goods	93613	115361	140800	109647	120902	140360	149110
Import value of goods	134669	162213	193821	134497	177347	224460	228280
Services balance	13555	13283	17311	16749	14699	17970	21890
Income balance	-6656	-7108	-8362	-8189	-7322	-8460	-6820
Transfer balance	1908	2243	2113	2299	1329	1680	1660
Net direct investment flows	19261	19941	16955	6856	7814	11500	13000
Net portfolio investment flows	2642	-2332	-5262	-926	14511	19060	16660
Net debt flows	23010	34064	33153	-12064	40352	22950	4890
Other capital flows (negative is flight)	-1890	3	-5737	21463	-3852	25510	28790
Change in international reserves	10774	13242	-2850	1338	11085	6110	900
External position (mln USD)							
Total foreign debt	195537	235984	263532	251372	289205	316010	318120
Short-term debt	34333	36903	43497	39725	77269	84810	84720
Total debt service due, incl. short-term debt	76863	83366	91508	104864	93719	130120	142900
Total foreign exchange reserves	60892	73384	70428	70874	80713	86390	87590
International investment position	-206820	-314920	-201460	-274333	-357142	n.a.	n.a.
Total assets	142429	167366	184168	178048	179974	n.a.	n.a.
Total liabilities	349249	482286	385628	452381	537116	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-7.7	-7.2	-7.3	-4.0	-7.7	-11.6	-11.0
Current account balance (% of GDP)	-6.1	-5.9	-5.7	-2.3	-6.5	-10.0	-8.7
Inward FDI (% of GDP)	3.8	3.4	2.7	1.4	1.3	1.9	2.1
Foreign debt (% of GDP)	37	36	36	41	39	43	44
Foreign debt (% of XGSIT)	155	154	142	166	179	170	162
International investment position (% of GDP)	-39.0	-48.7	-27.6	-44.7	-48.7	n.a.	n.a.
Debt service ratio (% of XGSIT)	61	54	49	69	58	70	73
Interest service ratio incl. arrears (% of XGSIT)	8	8	7	8	5	5	5
FX-reserves import cover (months)	5.0	4.9	4.0	5.6	4.9	4.2	4.2
FX-reserves debt service cover (%)	79	88	77	68	86	66	61
Liquidity ratio	100	103	101	104	94	81	82

Source: EIU