



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

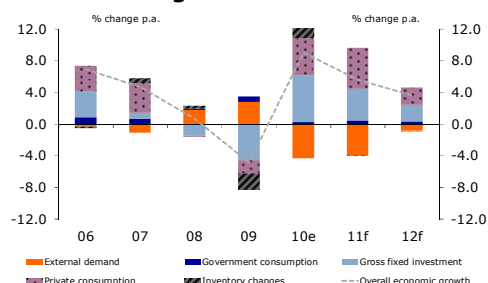
Turkey			
National facts		Social and governance indicators rank / total	
Type of government	Republic	Human Development Index (rank)	83 / 169
Capital	Ankara	Ease of doing business (rank)	71 / 183
Surface area (thousand sq km)	781	Economic freedom index (rank)	67 / 179
Population (millions)	72.6	Corruption perceptions index (rank)	56 / 178
Main languages	Turkish	Press freedom index (rank)	138 / 178
	Kurdish	Gini index (income distribution)	43.23
	other minority languages	Population below \$1.25 per day (PPP)	3%
Main religions	Muslim (99.8%)	Foreign trade 2010	
	other (0.2%)	<i>Main export partners (%)</i> <i>Main import partners (%)</i>	
Head of State (president)	Abdullah Gul	Germany	10
Head of Government (prime-minister)	Recep Tayyip Erdogan	UK	6
Monetary unit	Turkish lira (TRY)	Italy	6
		France	5
		US	7
Economy 2010		Main export products (%)	
<i>Economic size</i> bn USD % world total		<i>Main import products (%)</i>	
Nominal GDP	734 1.18	Textiles & Clothing	19
Nominal GDP at PPP	968 1.30	Iron & Steel	13
Export value of goods and services	155 0.83	Transport Equipment	13
IMF quatum (in mln SDR)	1191 0.55	Agro-industry	10
<i>Economic structure</i> 2010 5-year av.		<i>Main import products (%)</i>	
Real GDP growth	9.0 3.1	Chemicals	15
Agriculture (% of GDP)	10 9	Fuel	12
Industry (% of GDP)	27 28	Transport Equipment	9
Services (% of GDP)	64 63	Machinery	8
<i>Standards of living</i> USD % world av.		<i>Openness of the economy</i>	
Nominal GDP per head	10007 102	Export value of G&S (% of GDP)	21
Nominal GDP per head at PPP	13198 112	Import value of G&S (% of GDP)	27
Real GDP per head	7685 96	Inward FDI (% of GDP)	1.3

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

Introduction and update

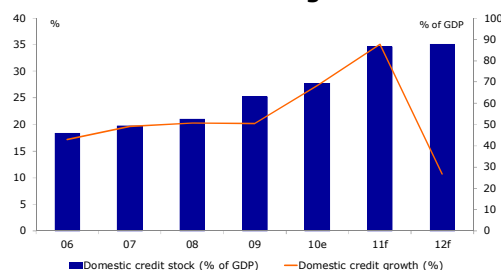
With a growth rate of 10.2% in the first half of 2011, Turkey’s economy was one of the fastest growing worldwide. On the one hand, Turkey’s economic expansion reflects the flexibility and the robustness of the economy, after it contracted by nearly 5% in 2009. On the other hand, there is a realistic 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.

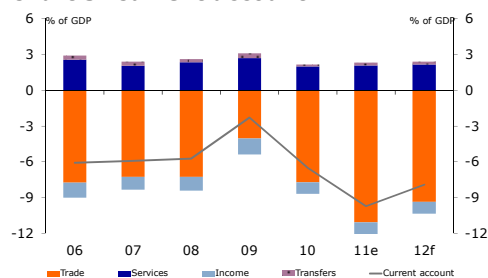
Vulnerability to the global economy

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's 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.

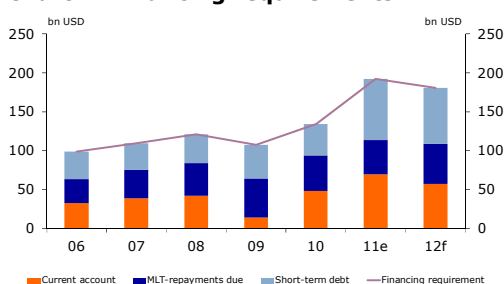
Secondly, CBRT policies (detailed below) were successful in slowing the increase in inward portfolio investments. Consequently, inflows are expected to come down to USD 16bn in 2012, which is still considered elevated.

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
<i>Key country risk indicators</i>							
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
<i>Economic growth</i>							
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
<i>Economic policy</i>							
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
<i>Balance of payments (mln USD)</i>							
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
<i>External position (mln USD)</i>							
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.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
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

Disclaimer

This document is issued by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. incorporated in the Netherlands, trading as Rabobank Nederland, and regulated by the FSA. The information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness. It is for information purposes only and should not be construed as an offer for sale or subscription of, or solicitation of an offer to buy or subscribe for any securities or derivatives. The information contained herein is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. All opinions expressed herein are subject to change without notice. Neither Rabobank Nederland, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith, and their directors, officers and/or employees may have had a long or short position and may have traded or acted as principal in the securities described within this report, or related securities. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities are described in this report, or any related investment. This document is for distribution in or from the Netherlands and the United Kingdom, and is directed only at authorised or exempted persons within the meaning of the Financial Services and Markets Act 2000 or to persons described in Part IV Article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001, or to persons categorised as a "market counterparty or intermediate customer" in accordance with COBS 3.2.5. The document is not intended to be distributed, or passed on, directly or indirectly, to those who may not have professional experience in matters relating to investments, nor should it be relied upon by such persons. The distribution of this document in other jurisdictions may be restricted by law and recipients into whose possession this document comes from should inform themselves about, and observe any such restrictions. Neither this document nor any copy of it may be taken or transmitted, or distributed directly or indirectly into the United States, Canada, and Japan or to any US-person. This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of Rabobank Nederland. By accepting this document you agree to be bound by the foregoing restrictions.