Country report

TURKEY

Summary

The sudden contraction of the economy in 2009 was followed by a rapid recovery in 2010. Although the economy of Turkey is known for its flexibility, the risk of overheating has moved to the forefront. Rising inflation and a widening current account deficit are telltales of this risk. Without tightening of monetary and fiscal policy, the risk of overheating and of a subsequent hard landing are present. If, on the other hand, the situation cools down, the economy is expected to grow 4-5% this year, which is a very manageable growth rate. The central bank has been reluctant to increase policy rates to prevent an even larger inflow of foreign capital. The government seems to keep its promise not to increase spending, but fiscal consolidation is not expected until after the June elections. The ruling AKP is expected to win these elections. The election campaign is marred by increased tension between (parts of) the Kurdish population and the government and an escalation of violence (mainly, but not exclusively in the south-east of Turkey).

Things to watch:

- Parliamentary elections in June 2011
- Risk of overheating economy (telltales: rising inflation, widening current account deficit, rising capacity utilization, strong credit growth)
- Inflow of foreign capital and credit growth

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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	735	1.18
Nominal GDP at PPP	966	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	8.9	3.2
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	10029	102
Nominal GDP per head at PPP	13171	112
Real GDP per head	7692	96

Social and governance indicators	rank / total
Human Development Index (rank)	83 / 169
Ease of doing business (rank)	65 / 183
Economic freedom index (rank)	67 / 179
Corruption perceptions index (rank)	56 / 178
Press freedom index (rank)	138 / 178
Gini index (income distribution)	41.2
Population below $1.25 per day (PPP)	3%

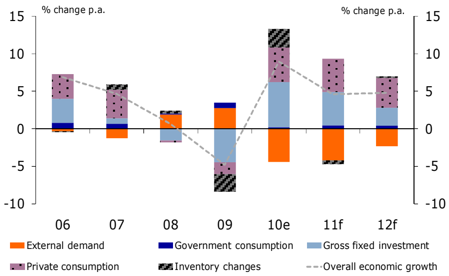
Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	10	Russia	12
UK	6	Germany	10
Italy	6	China	9
France	5	US	7
Main export products (%)			
Textiles & clothing			19
Iron & steel			13
Transport equipment			13
Agro-industry			10
Main import products (%)			
Chemicals			15
Fuel			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)			1.2

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

Economic structure and growth

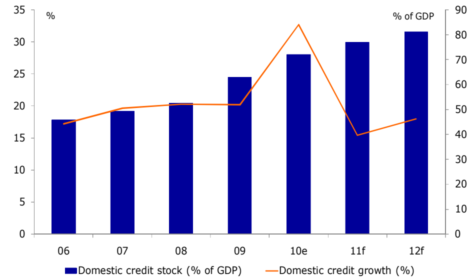
The sudden contraction of the economy in 2009 was followed by a rapid recovery in 2010. Economic growth increased from -4.8% in 2009 to 8.9% last year. In the third quarter of 2010, economic growth seemed to slow down somewhat, which was seen as a good sign considering the fact that the Turkish economy cannot sustain those Chinese-like figures. However, in the fourth quarter of 2010, economic growth accelerated again. Although the economy of Turkey is known for its flexibility, the risk of overheating has moved to the forefront. Rising inflation and a widening current account deficit are telltales of this risk. Moreover, capacity utilisation rate was 75.9% (seasonally adjusted) in April, which was somewhat down from the post-crisis peak in January but close to the level that is generally considered the optimum. A further increase would lead to pressure on prices. Without tightening of monetary and fiscal policy, the risk of overheating and of a subsequent hard landing are present. If, on the other hand, the situation cools down, the economy is expected to grow 4-5% this year, which is a very manageable growth rate. Important growth drivers in 2010 were private investment and consumption. Solid consumer confidence underlined domestic consumption, while ample credit growth and relatively low interest rates supported the private sector in general. The central bank has been struggling to rein in credit growth (see also section economic policy). Government spending was a limited growth driver, especially since the government decided to limit the increase in spending in 2010/11. The impact of external demand on economic growth was negative on the back of rapidly rising import demand.

Chart 1: Economic growth



Source: EIU

Chart 2: Domestic credit growth



Source: EIU

Regarding structural issues in Turkey, the stubbornly high unemployment rate, widespread tax evasion, relative low GDP per capita, unequal income distribution and widespread bureaucracy warrant attention. The unemployment rate has come down from the 2009 peak of 14%, but is unlikely to fall below 11% this year. The main issue is that job creation cannot keep up with the natural growth of the workforce (about 500,000 per year). With Turkey's young population, the need for new jobs will remain high in the medium to long term. Turkey has a GINI index of 43% (a measure of income equality with 0 being perfectly equal), the income distribution is therefore rather unequal, but not extreme. However, the inequality seems geographical in nature, with the south-eastern regions poorer than the western regions and large cities. The active promotion of the government and the increased border-trade with Iraq are having a positive effect on the south-east region, but there is still a long way to go.

The outlook for the Turkish financial sector is considered stable and the sector in general is expected to have the capacity to absorb shocks, on the back of solid capitalization, healthy profitability and sizeable reserves. The loan to deposit ratio was close to 80% end-2009, making it one of the lowest ratios in Europe. The profitability of banks was strongly supported by low policy rates during the crisis, but interest margins have fallen in the past year due to the competition in the Turkish financial sector. During the economic contraction in 2009, the ratio of non-performing loans (NPL) increased, but has since improved again. In September 2010, the NPL ratio was 4.3%. A risk to the stability of the financial sector is the current credit growth. The key challenge will be to sustain asset quality at current levels with many eager (new) consumers and intensifying competition. However, despite the increase in loans, the historical data do not yet indicate excessive loan growth. The average real rate of increase of loans in the banking sector during the 2003-2009 period was 23.9%. As of September 2010, the year-on- year real increase in loans was 15.8%, which is below average. The increased reserve requirement ration will hopefully dampen the credit growth in the coming months.

Political and social situation

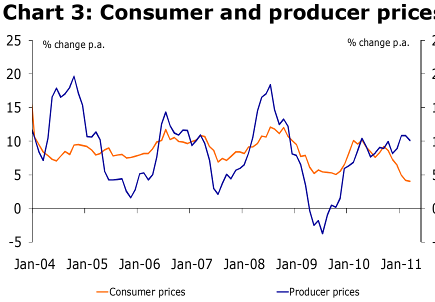
The parliamentary elections of 12 June 2011 are currently the focal point of Turkish politics. The ruling AKP is expected to win the elections, just as they did in 2002 and 2007. Due to the high 10% threshold, only two or three other parties and several independents (which are not subject to the 10% threshold) are expected to enter the parliament. However, the polls indicate that the AKP is expected to win by a smaller margin than in 2007. In an attempt to win more votes, the AKP refers –rightfully- to the macroeconomic performance of Turkey since they came to power in 2002 and their campaign promotes the intention to design a new constitution. The republican CHP party aims to draw voters by focusing attention on the AKP's increased power over other institutions, mainly the judiciary. The Kurdish oriented BDP focuses on the Kurdish dilemma.

The AKP also aims to win more votes among the large Kurdish minority. But in the past months the relationship between the government and the Kurdish population seems to have gotten worse, rather than better. Violence has escalated, Kurds have been called to engage in acts of civil disobedience, and the pro-Kurdish BDP has threatened to boycott the elections – which could be more negative for them than the AKP, but the signal is important. We give a few examples of why the relations have soured, but reality is much more complicated than can be depicted here.
First, in August 2010, the AKP initiated new talks with Kurdish representatives, promising more rights for Kurds. Now, Kurdish organisations, led by the BDP, claim that the renewed dialogue was merely meant to increase AKP's popularity. The progress on Kurdish rights has indeed been rather slow. Second, the decision of the election board to prevent several Kurdish candidates from running, did not go down well with the Kurdish population. The politicians were banned due to their terrorism-related convictions. However, speaking in Kurdish in public was already seen as terrorism-related in the past. Many believe that the AKP is behind this decision to prevent popular Kurdish politicians from running. Although the decision was largely overturned later, the damage had been done. Third, the BDP and other organizations speak out against the increased violence against Kurdish separatists. On the other hand, the government claims that the PKK, the outlawed Kurdistan Workers' Party, is responsible for several attacks on government and army targets – including a convoy with AKP officials in a Black Sea coast province (initially it was thought that Prime Minister Erdogan, who was also in that region, was the target, but later reports contradicted this). It was the first time in two decades that campaigning politicians were the target of violence.
If the AKP wins the elections, but fails to secure a majority in parliament, Turkey can be faced with a minority cabinet or a coalition government. As AKP is expected to remain the dominant party in parliament, there is an expectation that policies will be continued. Major challenges for the new government will be macroeconomic stability, the structural challenges mentioned above (e.g. unemployment), human rights, press freedom and democratization, and clearly the relation with the Kurdish population. A new constitution will also be on the agenda.
The unrest in the Middle East has tested Turkey's foreign politics. Besides having ties with the EU and the US, Turkey has been working on their position as a regional power and mediator in the past years. But the so-called "zero problem with neighbours" policy becomes quite difficult if the neighbours run into problems themselves. For example Libya, where a large Turkish community lives, posed the dilemma whether Turkey should continue to support Kaddafi or support the rebels. Eventually, Turkey sided with the west and backed the alliance against Kaddafi. If the situation in Syria escalates further, this would create new, difficult choices for the government. Another area of foreign politics that draws attention is the relationship with Israel. Last year, diplomatic tensions rose after several incidents, of which the Israeli entering of a Turkish ship heading for Gaza was the most prominent.
Progress towards EU accession has pretty much stalled. Only 13 of the 35 negotiation chapters have been opened, only one is closed. The situation in Cyprus along with the general sentiment in the EU, mostly in France, are the main obstacles. The EU chapters could be an important anchor for progress in the area of human rights, democracy and economic reforms.

Economic policy
Full-year inflation rose from 6.3% in 2009, which was the lowest level in years, to 8.6% in 2010. This was mainly due to a rapid increase early 2010, as in the second half inflation fell in several consecutive months due to the lagged effect of lira appreciation and lower food prices. With strong domestic demand, elevated fuel prices, the delayed effect of higher food prices and depreciation of the lira, price pressure is increasing. Inflation is therefore expected to increase in the coming months, thereby making the Turkish central bank's (CBRT) inflation expectation of 6.9% not

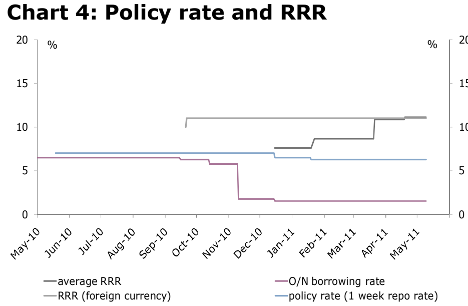
unrealistic. However, when the economy cools and commodity prices stabilize this year's inflation could be around 5%, which is below the CBRT's target.
Whether the economy will cool depends to a great extent on whether monetary and fiscal policy will be tightened. The latter will surely not be tightened until after the elections. The CBRT has been hesitant to increase policy rates as it does not want to attract more short-term foreign investment. The quick economic recovery and relative high interest rates have attracted a part of the global excess liquidity. Instead the CBRT took a rather experimental approach in the second half of 2010. It has lowered its policy rate several times while increasing reserve requirement ratios (RRR) substantially; starting with RRR on foreign currency deposits and a strong increase on the short-term deposits. The jury is still out on the effectiveness of this experiment. Initially the inflow of foreign capital eased, but the measures seems to have increased government bond yields and interbank rates, which might new foreign capital inflows. Moreover, considering the strong economic growth, rising inflation and widening current account deficit, the monetary policy seems too loose. Perhaps that the CBRT, on its own initiative, is waiting until after the elections before taking a more stringent approach.
The new central bank governor, mr. Basci, was well received by the markets. Mr. Basci started in the spring of 2011 and is considered to be at friendly terms with prime minister Erdogan. Considering the necessity to tighten both monetary and fiscal policy, this could be a good sign.
The Turkish lira appreciated from 2.24 TRY/EUR to 1.93 TRY/EUR in the first half of 2010, but has since returned to the 2.24 TRY/EUR region. The inflow of foreign capital and recovering export demand pushed the currency up initially, while the strong import demand and the central bank actions created downward pressure. Also the general emerging market sentiment influenced the lira. The recent developments in Greece and other European countries could also have a considerable effect on the lira in the near future.

Chart 3: Consumer and producer prices



Source: EIU

Chart 4: Policy rate and RRR



Source: Ecowin

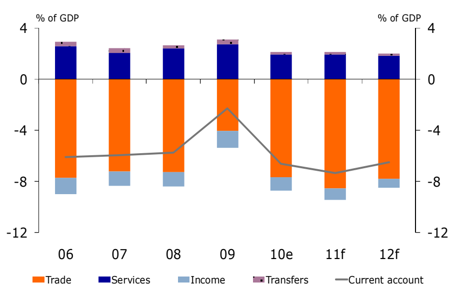
The fiscal situation of Turkey improved last year, as the fiscal deficit shrunk from 5.5% of GDP in 2009 to 3.6% of GDP in 2010 – helped by the high GDP growth. Being an election year, one would expect a widening fiscal deficit this year, as has been seen with previous elections. However, the government has committed itself to limit additional spending. Indeed, the pace of government spending has remained under control since January. The fiscal deficit is therefore expected to improve slightly in 2011 to around 3.5% of GDP. Despite this positive direction, more fiscal austerity is needed after the elections to prevent the country from overheating. The level of public debt is moderate at slightly above 40% of GDP. The maturity structure of Turkish government debt could be lengthened, but this is a common notion for Emerging Markets.

Balance of Payments

The widening current account deficit is currently a hot topic in the macroeconomic risk profile of Turkey. On the back of a rapid economic recovery, import demand boomed in 2010 (+32% yoy), outpacing export growth (+10% yoy) by far. This caused the trade deficit to widen from 4% of GDP in 2009 to 7.7% of GDP in 2010. As the trade balance is the main determinant of the current account balance, the current account deficit deteriorated from 2.3% of GDP in 2009 to 6.6% of GDP in 2010. Provided that the economy cools this year, import growth is expected to slow to a little over 10% in 2011. Although exports are expected to grow at a similar pace, the trade deficit - and therefore the current account deficit- is forecast to widen again this year. The current account deficit is expected to be more than 7% of GDP in 2011, before starting to shrink again to around 6.5% of GDP in 2012.

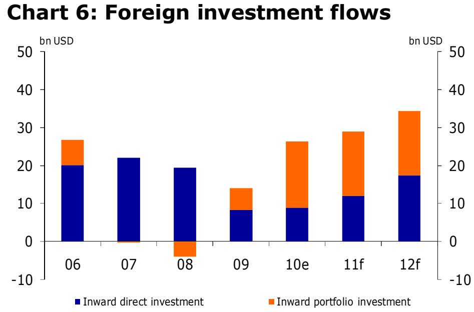
Turkey is known for its flexible current account balance. When the economy grows, so does the deficit on the current account, and when the economy slows, so does the current account deficit. This flexibility means that in less prosperous times, Turkey needs less foreign capital to cover the current account deficit. So why is this widening current account deficit such a hot topic? First, it is one of the signs to suggest that the economy might be overheating. Second, the current account deficit is mostly financed with short-term debt (see also next section). This makes Turkey more sensitive to changes in investor sentiment.

Chart 5: Current account balance



Source: EIU

Chart 6: Foreign investment flows



Source: EIU

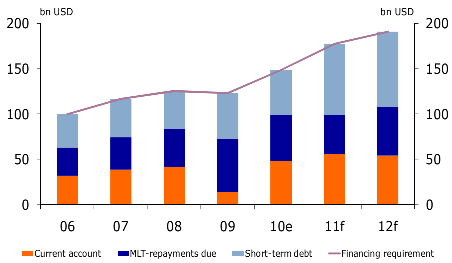
Foreign investment flows towards Turkey decreased over 2009 as a result of the financial crisis. During 2010, foreign direct investment (FDI) recovered moderately, but foreign portfolio investment boomed. Portfolio investment increased from USD 5.6bn in 2009 to USD 17.5bn in 2010. The quick economic recovery of Turkey and relative high interest rates have attracted part of the global excess liquidity that has been created by the loose monetary policies in Europe, China and the US. While inward portfolio investment can deepen the local capital markets, it is also a reason for concern. By nature, portfolio investment can be quickly reversed and a rapid inflow can lead to the creation of asset bubbles as there is a run on assets. For these reasons, the CBRT has been trying to stem the inflow of portfolio flows by cutting policy rates and increasing the reserve requirement ratios for foreign currency deposits. These measures seem to sort effect to the extent that no rapid growth is expected in 2011/12, but levels are expected to remain elevated. A change in investor sentiment, potentially caused by many reasons ranging from the Greece debt crisis to loss of confidence in Turkey, can lead to a quick reversal of portfolio flows. This would have a negative effect on Turkish assets and thereby on the economy.

External position

The external financing requirements of Turkey in 2010 were approximately evenly related to the current account deficit, short-term debt repayments and medium/long-term debt repayments due.

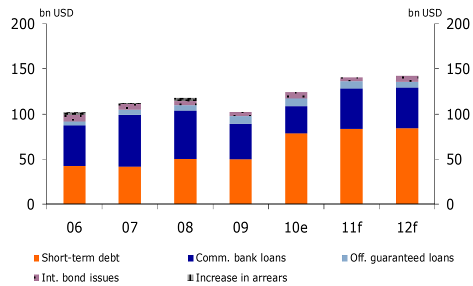
For 2011/12, the short-term debt repayments are expected to increase to almost half of the external financing needs. This is related to Turkey's external financing sources. Only about 10% to 15% of the financing sources comes from foreign investment, either direct or portfolio. The bulk is covered by debt financing. When looking at the decomposition of debt financing sources, short-term debt stands out. Short-term debt is expected to grow from USD 50bn in 2009, via USD 78bn in 2010 to USD 84bn in 2011/12. This rapid increase is partially related to the widening current account balance, as trade finance tends to be short-term.

Chart 7: Financing requirement



Source: EIU

Chart 8: Decomposition of debt financing



Source: EIU

In line with debt financing sources, Turkey's external debt is expected to grow from USD 290bn in 2010 to USD 312bn in 2011/12. Helped by the strong economic growth, the level of external debt to GDP is expected to stay around 40% of GDP. About a quarter of this is short-term debt. Foreign exchange reserves are expected to rise by USD 4bn this year to USD 84bn. In terms of import cover, this amounts to 4.5 months, which is above the generally accepted minimum of 3 months, but not very comfortably. The liquidity ratio seems to be on a downward trend. In 2007, the ratio was 100%, but has since declined and is expected to be 85% in 2011.
Overall, the external position of Turkey is considered manageable, but does not seem to be heading in the right direction. On the one hand, the level of external debt is moderate, short-term debt is only a quarter of total debt and Turkey has good access to the international markets. On the other hand, short-term debt is rising, the import cover is just above minimum and the liquidity ratio is declining.

Turkey

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	6.9	4.7	0.7	-4.8	8.9	4.6	4.8
Consumer prices (average % change pa)	9.6	8.8	10.4	6.3	8.6	5.6	7.5
Current account balance (% of GDP)	-6.1	-5.9	-5.7	-2.3	-6.6	-7.3	-6.5
Total foreign exchange reserves (mln USD)	60892	73384	70428	70874	80713	84130	84480
Economic growth							
GDP (% real change pa)	6.9	4.7	0.7	-4.8	8.9	4.6	4.8
Gross fixed investment (% real change pa)	13.3	3.1	-6.2	-19.0	29.9	18.5	9.0
Private consumption (real % change pa)	4.6	5.5	-0.3	-2.3	6.6	6.3	5.8
Government consumption (% real change pa)	8.4	6.5	1.7	7.8	2.0	5.0	4.0
Exports of G&S (% real change pa)	6.6	7.3	2.7	-5.0	3.4	3.8	3.8
Imports of G&S (% real change pa)	6.9	10.7	-4.1	-14.3	20.7	18.1	10.1
Economic policy							
Budget balance (% of GDP)	-0.6	-1.6	-1.8	-5.5	-3.6	-3.3	-2.5
Public debt (% of GDP)	45	40	40	46	43	43	41
Money market interest rate (%)	15.6	17.2	16.0	9.2	5.8	2.0	3.5
M2 growth (% change pa)	21	22	27	11	24	14	17
Consumer prices (average % change pa)	9.6	8.8	10.4	6.3	8.6	5.6	7.5
Exchange rate LCU to USD (average)	1.4	1.3	1.3	1.5	1.5	1.6	1.6
Recorded unemployment (%)	10.3	10.3	11.0	14.1	12.0	11.8	8.7
Balance of payments (mln USD)							
Current account balance	-32249	-38434	-41959	-13991	-48561	-55970	-54470
Trade balance	-41056	-46852	-53021	-24850	-56354	-65240	-65010
Export value of goods	93613	115361	140800	109647	120923	135630	140470
Import value of goods	134669	162213	193821	134497	177277	200870	205490
Services balance	13555	13283	17311	16749	14245	14840	15260
Income balance	-6656	-7108	-8362	-8189	-7816	-6990	-6270
Transfer balance	1908	2243	2113	2299	1364	1420	1550
Net direct investment flows	19261	19941	16955	6856	7154	10250	15500
Net portfolio investment flows	2642	-2332	-5262	2884	14146	15510	15330
Net debt flows	34491	33835	34774	-6732	24738	19760	6250
Other capital flows (negative is flight)	-13371	232	-7358	12322	13608	13850	17380
Change in international reserves	10774	13242	-2850	1338	11085	3400	0
External position (mln USD)							
Total foreign debt	206833	249181	277277	268308	290366	312470	315440
Short-term debt	42315	41803	50714	49681	78623	83600	84310
Total debt service due, incl. short-term debt	77270	90163	96225	117938	107989	130640	147400
Total foreign exchange reserves	60892	73384	70428	70874	80713	84130	84480
International investment position	-206845	-314866	-201539	-279042	n.a.	n.a.	n.a.
Total assets	142429	167366	184168	178319	n.a.	n.a.	n.a.
Total liabilities	349274	482232	385707	457361	n.a.	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	-8.5	-7.8
Current account balance (% of GDP)	-6.1	-5.9	-5.7	-2.3	-6.6	-7.3	-6.5
Inward FDI (% of GDP)	3.8	3.4	2.7	1.4	1.2	1.6	2.1
Foreign debt (% of GDP)	39	39	38	44	39	41	38
Foreign debt (% of XGSIT)	164	162	149	177	181	175	170
International investment position (% of GDP)	-39.0	-48.7	-27.6	-45.4	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	61	59	52	78	67	73	80
Interest service ratio incl. arrears (% of XGSIT)	8	8	7	6	5	5	6
FX-reserves import cover (months)	5.0	4.9	4.0	5.6	4.9	4.5	4.4
FX-reserves debt service cover (%)	79	81	73	60	75	64	57
Liquidity ratio	99	100	99	98	91	85	83

Source: EIU