Country update **TURKEY**

Summary

Turkey´s economy appears to be headed for a soft-landing, after nearly overheating in 2011. While domestic demand growth came to a halt, exports took over as the main driver of growth. For 2012, we expect growth to come in at roughly 3%. After that, it is hoped that the central bank will be able to curtail domestic demand, which should result in more sustainable growth rates between 4% and 5%. This, combined with a focus on export-led growth should help bring down the current account deficit, although this goal will not be reached in the short-term. In the meantime, the Turkish economy will remain vulnerable to sudden shocks in investor sentiment, especially given that the current account deficit is largely financed out of short-term debt inflows.

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Turkey

National facts		
Type of government	Republic	
Capital	Ankara	
Surface area (thousand sq km)	781	
Population (millions)	73.3	
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		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	775	1.12
Nominal GDP at PPP	1075	1.35
Export value of goods and services	183	0.83
IMF quotum (in mln SDR)	1456	0.67
Economic structure	*2011*	*5-year av.*
Real GDP growth	8.6	3.3
Agriculture (% of GDP)	9	9
Industry (% of GDP)	28	28
Services (% of GDP)	63	63
Standards of living	*USD*	*% world av.*
Nominal GDP per head	10463	97
Nominal GDP per head at PPP	14519	117
Real GDP per head	8278	101

Social and governance indicators			rank / total
Human Development Index (rank)			92 / 187
Ease of doing business (rank)			71 / 185
Economic freedom index (rank)			73 / 179
Corruption perceptions index (rank)			61 / 183
Press freedom index (rank)			148 / 178
Gini index (income distribution)			38.95
Population below $1.25 per day (PPP)			0%
Foreign trade			**2011**
Main export partners (%)		*Main import partners (%)*	
Germany	10	Russia	12
UK	6	Germany	9
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
Machinery			12
Transport Equipment			9
Openness of the economy			
Export value of G&S (% of GDP)			24
Import value of G&S (% of GDP)			33
Inward FDI (% of GDP)			2.0

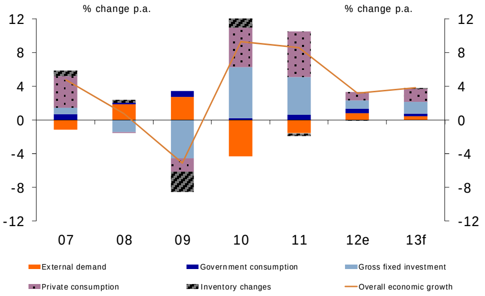
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

After the Turkish economy grew by a high 8.6% in 2011, growth has come down over the course of this year and the economy appears to be headed for a soft landing. In the first half of 2012, growth came down to 2.9% y/y. This is a comforting sign and we expect a growth rate of 3.5% for 2012 as a whole. Equally comforting is the fact that whereas the high growth rates in 2011 were primarily driven by domestic demand, fuelled by a massive inflow of portfolio investments, the positive contribution of domestic demand has since disappeared and exports are now driving growth. This is partly the result of the fact that Turkey increased its exports to the Middle East (and especially Iraq), thereby reducing its dependence on Europe. In light of the central bank's ability to orchestrate this soft landing, Fitch, one of the main rating agencies, decided to upgrade Turkey's sovereign rating to investment grade. This should help Turkey secure a more steady inflow of foreign capital.

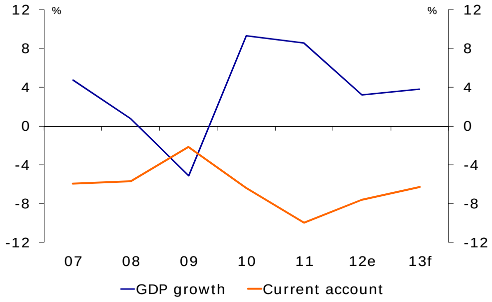
Still, the volatility of the past three years is a clear sign that the large and persistent deficits on the current account have left the country vulnerable to external shocks. In addition, since 2009, the current account deficit (CAD) is mostly financed out of short-term debt and portfolio investments, both of which are very volatile. The vulnerability created by this external imbalance became very apparent in 2009, when capital dried up, resulting in a 5% of GDP contraction. Subsequently, monetary easing in Europe and the US resulted in a large inflow of portfolio investments and short term debt, which caused the economy to overheat in 2011, when the current account deficit shot up to 10% of GDP. At the same time, FX reserves are relatively low, currently covering roughly 4 months of imports and only 60% of total debt service due.

Figure 1: Growth performance



Source: EIU

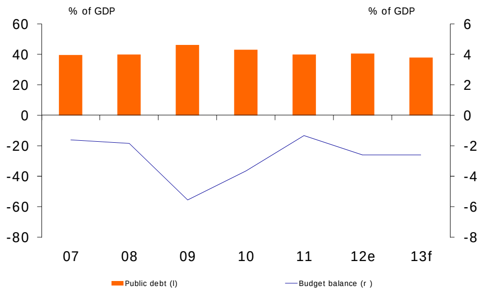
Figure 2: Overheating



Source: EIU

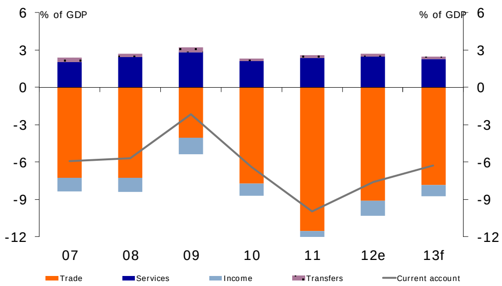
In order to reduce the vulnerability created by this external imbalance, the Central Bank's governor announced that it would not allow domestic demand to grow in the way it did in 2011. Instead, the Central Bank will aim for export-led growth. However, although exports have driven growth in the past two quarters, we do not believe this a sustainable trend. Most importantly, despite the fact that Turkey has made great strides in growing its export base and diversifying its export partners (away from Europe), the added value of its exports is currently insufficient for exports to become the main driver of growth. Especially the country's dependence on energy and intermediary goods imports, needed to produce its exports, is considered a weakness. Reducing this dependency, while simultaneously investing in the export sectors would go a long way, but will not yield substantial results overnight.

Figure 3: Public finances



Source: EIU

Figure 4: Current account balance

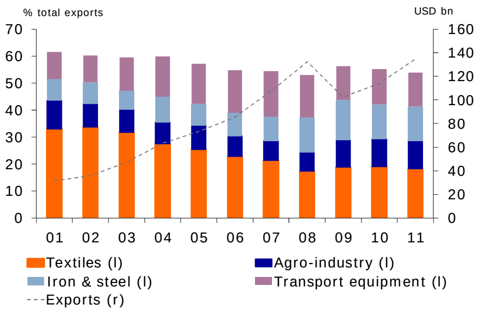


Source: EIU

In the meantime, we derive comfort from the fact that Turkey's financial sector is in excellent shape. Over the course of the past decade, Turkey's financial system, perceived as one of the country's main weaknesses only 11 years ago, has been transformed into one of the most stable systems in Europe. This was underscored by the sector's robust performance throughout the recent global crisis. Banks remained well capitalized, with an average capital ratio of 16%, while NPLs stand at a low 2.5% of all outstanding loans (relative to over 30% in 2001). In addition, even though banks are the largest holders of external debt (both in domestic and foreign currencies), improved regulation forces them to hedge their positions, while it has become more common for banks to obtain external debt denominated in domestic currency, thereby removing exchange rate risks. Plus, during the last episode of massive hot money inflows, the Central Bank of Turkey (CBRT) increased the bank's reserve requirements in general, and FX reserves in particular, while also curtailing the amount of short-term loans banks were allowed to extend. In addition to a strong banking sector, low public debt holdings provide further comfort. In addition, the government appears well aware of the risks of running high deficits. Although slowing growth will reduce public revenues, the government already announced that it would not introduce any stimulus measures. For 2013, we expect the budget deficit to remain at 2.6% of GDP.

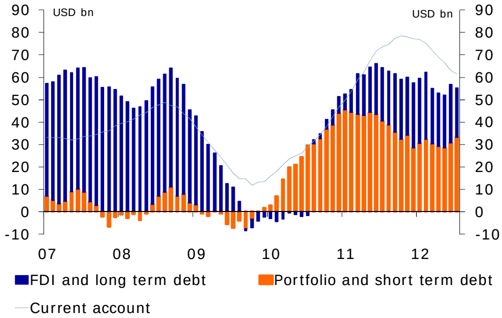
Given Turkey's vulnerability to global shocks and the high risk of external shocks, growth forecasts are more often wrong than right. Assuming that the crisis in the eurozone does not deteriorate significantly and further assuming that the ECB and the FED will continue to support liquidity we expect the Turkish economy to grow by 3.5% in 2013. Growth will be partly driven by export growth. In addition, we expect domestic demand to pick up. Still, large downside risks remain, including a sudden outflow of capital, or a eurozone break-up. Another risk is the ongoing war in Syria, which threatens to spill into Turkey (see below). Although we do not expect a full-blown war between the two neighbors, tensions are likely to reduce security along the Turkish-Syrian border. Negative headlines as a result of this political crisis could deter investors, as well as tourists.

Figure 5: Exports



Source: EIU

Figure 6: Financing CAD



Source: CBRT and Yapi Kredi

Syria

The ongoing civil war in Syria is affecting neighboring countries, including Turkey. Over the last months, violence along the Syrian-Turkish border worsened, as Syrian fighters are increasingly active in Turkish border towns. This, in turn, has forced the Turkish government to break with its zero-problems-with-neighbors policy and attack Syrian military posts. In addition, the line of communication between Damascus and Ankara has been severed. Although the Turkish government declared that it does not seek a full-blown war with Syria, the risk of war did increase when Turkey stated it would defend its citizens and would not hesitate to attack if need be.

Another risk is that of increased fighting between the Turkish army and the PKK. When the Syrian army abandoned the Kurdish areas in Syria (near Turkey's south-east border), the consequent vacuum has been filled by the PKK, which has reportedly started to employ the area as a military base. It is still uncertain how this situation will play out, but the risk of Turkish attacks on the PKK has increased, as has the risk of counterattacks by the PKK.

Despite the political implications of the Syrian war, the economic implications have thus far been minimal. Although bilateral trade between Turkey and Syria came to a halt, trade to other partners was not affected, as most exports were rerouted through others countries. There is, however, a concern that the negative publicity due to enduring cross-border violence could deter investors and tourists.

Rabobank

Turkey

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	4.7	0.8	-5.1	9.3	8.6	3.2	3.8
Consumer prices (average % change pa)	8.8	10.4	6.3	8.6	6.5	9.1	8.0
Current account balance (% of GDP)	-5.9	-5.7	-2.2	-6.4	-10.0	-7.6	-6.3
Total foreign exchange reserves (mln USD)	73384	70428	70874	80713	78322	83880	82120
Economic growth							
GDP (% real change pa)	4.7	0.8	-5.1	9.3	8.6	3.2	3.8
Gross fixed investment (real % change pa)	3.0	-5.7	-19.4	30.1	19.0	4.0	5.5
Private consumption (real % change pa)	5.5	-0.2	-2.3	6.7	7.8	1.4	2.3
Government consumption (real % change pa)	6.7	1.7	6.9	1.8	5.4	4.5	3.0
Exports of G&S (real % change pa)	7.5	2.8	-5.5	3.5	6.4	5.6	5.5
Imports of G&S (real % change pa)	10.6	-3.9	-14.6	20.7	11.2	1.8	3.4
Economic policy							
Budget balance (% of GDP)	-1.6	-1.8	-5.5	-3.7	-1.3	-2.6	-2.6
Public debt (% of GDP)	40	40	46	43	40	40	38
Money market interest rate (%)	17.2	16.0	9.2	5.8	3.0	5.0	5.3
M2 growth (% change pa)	15	27	13	19	12	6	7
Consumer prices (average % change pa)	8.8	10.4	6.3	8.6	6.5	9.1	8.0
Exchange rate LCU to USD (average)	1.3	1.3	1.5	1.5	1.7	1.8	1.8
Recorded unemployment (%)	10.3	11.0	14.1	12.0	9.8	9.0	9.3
Balance of payments (mln USD)							
Current account balance	-38434	-41524	-13370	-46643	-77238	-59740	-56400
Trade balance	-46852	-53021	-24850	-56445	-89471	-71390	-70490
Export value of goods	115361	140800	109647	120902	143406	154240	164090
Import value of goods	162213	193821	134497	177347	232877	225630	234580
Services balance	13283	17748	17316	15493	18273	19450	20220
Income balance	-7108	-8364	-8191	-7139	-7774	-9550	-8140
Transfer balance	2243	2113	2355	1448	1734	1760	2010
Net direct investment flows	19941	16955	6858	7574	13410	13000	16750
Net portfolio investment flows	-4582	-5262	-926	10133	22403	12330	15260
Net debt flows	36646	36464	-13589	27712	8976	29990	8620
Other capital flows (negative is flight)	-329	-9483	22365	12200	34688	9590	14010
Change in international reserves	13242	-2850	1338	10976	2239	5170	-1760
External position (mln USD)							
Total foreign debt	252950	284080	271225	293872	306747	331410	338930
Short-term debt	43135	53104	49711	78123	82921	99140	96890
Total debt service due, incl. short-term debt	91433	98662	115131	108411	133494	140830	160740
Total foreign exchange reserves	73384	70428	70874	80713	78322	83880	82120
International investment position	-313087	-200236	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	170140	186427	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	483227	386663	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-7.2	-7.3	-4.0	-7.7	-11.6	-9.1	-7.9
Current account balance (% of GDP)	-5.9	-5.7	-2.2	-6.4	-10.0	-7.6	-6.3
Inward FDI (% of GDP)	3.4	2.7	1.4	1.2	2.0	1.9	2.1
Foreign debt (% of GDP)	39	39	44	40	40	42	38
Foreign debt (% of XGSIT)	165	153	179	181	162	165	158
International investment position (% of GDP)	-48.4	-27.4	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	60	53	76	67	71	70	75
Interest service ratio incl. arrears (% of XGSIT)	8	7	8	7	6	6	6
FX-reserves import cover (months)	4.9	4.0	5.6	4.9	3.7	4.1	3.8
FX-reserves debt service cover (%)	80	71	62	74	59	60	51
Liquidity ratio	100	99	100	91	79	83	81

Source: EIU