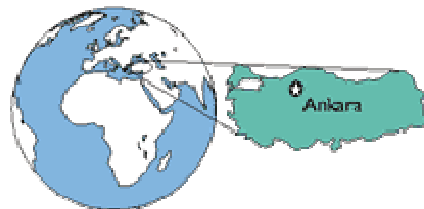


COUNTRY REVIEW

Turkey



21 April 2010

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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Important geostrategic position that has historically always ensured aid when needed.
- Adequate business environment and mostly financially solid banking sector.

Weaknesses

- History of political and economic instability.
- High and recently increased political uncertainty.
- Volatile international relations.
- Rapid deterioration of fiscal position, owing to deep 2009 recession and government spending.
- Exchange rate vulnerability to political and external shocks.
- Several years of large current account deficits, which were increasingly financed by short-term external borrowing, have caused a high external financing requirement.
- Hefty external debt servicing in 2010.
- Foreign exchange reserves just cover two thirds of external payments falling due in 2010.
- Vulnerability to potential risk aversion to emerging markets.
- Government's reluctance to agree an IMF Stand-By Arrangement.

KEY RISKS

- **Recession-driven sharp rise in bankruptcies.**
- **Difficulties to refinance large amounts of maturing external debt, potentially resulting in insolvencies or debt restructurings of companies and probably banks.**
- **Exchange rate risk (with respect to external debt repayments due as well as foreign trade credits).**
- **Banking sector illiquidity.**

Country Risk Assessment

Ratings	Turkey		Median Grade C	Hungary	Peers	
	Latest	Previous			Romania	Indonesia
Systemic Political Risk:	P3-	P3-	P2-	P2+	P2-	P3+
Systemic Economic Risk:	E5	E5	E5	E5	E5	E5
ME rating:	ME5	ME5	ME5	ME5	ME5	ME5
<i>Structure</i>	4.0	4.0	5.8	1.6	3.3	2.6
<i>Policy</i>	5.6	5.8	5.2	5.8	5.2	4.2
<i>Solvency</i>	4.3	4.3	3.3	4.6	4.8	4.2
<i>External Liquidity</i>	6.0	6.0	4.7	6.0	6.0	6.0
SBE rating:	SBE3	SBE3	SBE4	SBE2	SBE3	SBE5
COUNTRY GRADE:	C	C		C	C	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Ankara
Population:	73.91 mn (2008)
GDP:	USD 730844 mn (2008)
Currency:	Turkish lira (TRY)
Form of state:	Republican parliamentary democracy
Head of government:	Prime Minister Recep Tayyip ERDOGAN (since March 2003)
Next elections:	Legislative: 2011 / Presidential: 2014

Major Industries (% of GDP at market prices, 2008)	Global Assumptions	2009	2010	
Services	64.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	27.0%	Inflation (% av) *	-0.1	1.3
Agriculture	9.0%	Dated Brent (USD/b)	61	72
		* Major economies		

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Clothing & textiles	17.5%	Mineral fuels & oil	24.0%
Motor vehicles	16.0%	Chemicals	12.5%
Iron & steel	13.0%	Machinear & parts	10.5%
Agriculture	7.0%	Motor vehicles	7.5%
Lead Export Markets (% of total exports, 2008)		Lead Import Markets (% of total imports, 2008)	
EU-27	48.0%	EU-27	37.0%
Germany	9.9%	Germany	9.4%
UK	6.3%	Russia	15.5%
Italy	5.0%	China	7.7%
UAE	6.0%	USA	5.5%

Basic indicators

Selected economic indicators	2006	2007	2008	2009	2010f
Nominal GDP (USD mn)	530,343	648,598	730,845	622,366	723,570
Population (mn)	72.09	73.00	73.91	74.81	75.71
GDP per capita (USD)	7,357	8,885	9,888	8,319	9,557
Real GDP growth (% yr/yr)	6.9	4.7	0.7	-4.7	3.5
Inflation (% eop)	9.7	8.4	10.1	6.5	8.0
Fiscal balance (% of GDP)	-0.2	-1.6	-2.2	-6.0	-5.0
Current account balance (% of GDP)	-6.1	-5.9	-5.8	-2.2	-3.9
External debt/GDP (%)	39.1	38.4	38.0	43.6	40.9
External debt/Exports of goods & services (%)	174.2	172.8	158.1	190.2	188.6
Debt-service ratio (%)	38.6	38.6	34.9	48.6	33.1
Foreign exchange reserves (USD mn)	60,710	73,156	70,231	69,178	70,000
Import cover (months)	5.0	4.9	4.0	5.5	4.7
Exchange rate assumption, TRY:USD (av)	1.43	1.30	1.30	1.55	1.50
Exchange rate assumption, TRY:EUR (av)	1.81	1.79	1.91	2.16	2.10
f: CRU central forecast					

Sources: Turkstat, Turkish Treasury, Central Bank, Ministry of Finance, IMF, ECB, Euler Hermes Economic Studies

Political Stability

Turkey's political landscape has changed considerably since the religious conservative Justice and Development Party's (AKP) landslide election victory in November 2002. With a commanding majority in parliament, the AKP government under Prime Minister Erdogan focused on a relatively successful economic and political reform path, driven by IMF programmes and EU prerequisites for the start of accession negotiations, which eventually began in October 2005. This policy course ushered in a period of relative political and economic stability after years of volatility. In July 2007, the AKP won overwhelmingly an early parliamentary election with 47% of the vote (up from 34% in 2002).

However, fears among the secular establishment in Turkey, including the still powerful military and the judiciary, that the AKP—a party with roots in political Islam—might steer the country away from pro-Western and secular policies have never really waned. Moreover, since 2007 the government has fed these fears of a hidden Islamist agenda by several controversial actions, such as the nomination and eventual election of former foreign minister Gul as President—which triggered a serious political crisis in April-July 2007—and the lifting of a ban on wearing the Islamic headscarf in particular public buildings (e.g. in universities), a law that was later overturned by the Constitutional Court. Tensions between the AKP and the military, which considers itself as the guardian of the secularist state, have again increased recently as many high-ranking military officers were temporarily detained in February-April 2010 and questioned about their role in an alleged 2003 coup plot. Further, the AKP proposed 29 constitutional amendments in April, many of which are directed at the military and the judiciary.

More generally, the underlying problem is the deep-rooted division in society between secularists and religious conservatives. As a consequence, the political scene will remain volatile and on the brink of crisis from time to time and the resulting political instability has the potential to disrupt policymaking, jeopardise financial market confidence and trigger economic crises.

The Kurdish issue also remains a cause of concern. An upsurge in Kurdish separatist violence in the south-eastern provinces and terrorist actions by Kurdish PKK rebels was observed from 2006-2008, to which the government responded with military action, including incursions into northern Iraq in order to combat suspected rebels, sheltering in that region. More recently, the government has announced plans aimed at a peaceful solution to the issue, but the Constitutional Court's decision to close the pro-Kurdish Democratic Society Party and renewed PKK violence, both in December 2009, may have thwarted the AKP's Kurdish initiative.

International relations have remained complicated, often damaged by Turkey's domestic political turbulences. EU accession talks are largely on hold owing to Turkey's failure to fulfil its obligation to open its ports and airports to (Greek) Cyprus. Relations with the US were strained in recent years, but have improved under Barack Obama's presidency. Moreover, Turkey is a member of NATO and has an important geo-strategic position that has historically always ensured aid when needed. This is not expected to change in the medium term.

Turkey's track record of IMF-backed economic stabilisation programmes has been mixed, reflected in frequent reform slippages and delays of IMF disbursements. Overall, however, recent IMF programmes have been an important tool for the achieved economic progress under the AKP government. In May 2008—following the successful completion of the latest IMF programme—the government decided not to enter into a new arrangement with the Fund. In the wake of the intensification of the global financial and economic crisis in autumn 2008, Turkey entered discussions on a new IMF Stand-By Arrangement (SBA) in November 2008, but an agreement was not reached, mainly owing to unresolved differences over fiscal policy. In early 2010, as the economic outlook was improving, the government decided not to sign a new IMF SBA for the time being.

Economic Stability

Following average annual real GDP growth of 6.6% in 2002-2007, the economy fell into a deep recession in 2008-2009. Quarterly GDP contracted by 7% yr/yr in Q4 2008, 14.5% in Q1 2009, 7.7% in Q2 and 2.9% in Q3. Calendar GDP grew just 0.7% in 2008 and contracted by 4.7% in 2009, hit by both declining domestic and external demand. The 2009 recession would have been even deeper if public consumption had not grown strongly by 7.8%. Private consumption shrank by 2% and private investment plummeted by 22%. Exports shrank by 5.4% while the drop in domestic demand caused a 14.4% decline in imports (both in TRY terms). However, the economy improved in the course of 2009 and rebounded to 6% yr/yr growth in Q4, driven by private and public consumption—though base effects also mattered—while investment continued to contract and the contribution of net exports shifted back to negative. Early indicators for 2010 show a somewhat mixed picture. Industrial output grew by about 15% yr/yr in the first two months and the manufacturing capacity utilisation ratio

increased by 12.5% yr/yr to 67.8% in the first three months, though this level was still well below the average of 2005-2008 which was above 75%. However, net trade is likely to constrain GDP growth in Q1 as exports shrank 1% yr/yr while imports expanded by 24%. Overall we forecast about 3.5% growth in 2010, with H1 being stronger than H2 owing to base effects.

Inflation fell to historically low levels in 2009, as a result of lower global food and energy prices, demand-side pressures stemming from the sharp economic downturn and relative exchange rate stability since mid-2009. Twelve-month consumer price inflation eased from 12% in October 2008 to a record low of 5.1% in October 2009. Thereafter, inflation has accelerated again to 10.1% yr/yr in February and 9.6% in March 2010 as a result of the recovery in aggregate demand and base effects. These impacts as well as higher global commodity prices and indirect tax increases are likely to maintain average inflation at around 9% in 2010. An upside risk to this forecast is renewed currency weakness.

The central bank took the chance of low inflation to reduce interest rates considerably, in order to spur the shrinking economy. The Overnight Borrowing Rate was lowered 13 times in a row, by a total of 1,025 bps from 16.75% in November 2008 to 6.5% in November 2009. Since then the central bank has kept its key policy interest rate unchanged, thus leaving the real interest rate deeply negative. Should inflationary pressures persist in the near term, however, it is likely to switch to monetary tightening in H2.

Despite one year of relative currency stability, exchange rate risk remains significant. The gradual appreciation of the local currency, the lira (TRY), against the USD and the EUR during the boom period 2004-2007 was occasionally sharply interrupted owing to domestic political tensions or global financial market turbulences (e.g. 29% down in May-June 2006). In 2008, the TRY was already highly volatile before September owing to continued political turmoil. Then the sell-off in Turkish assets in the wake of the intensification of the global financial crisis was accompanied by a 14% (32%) depreciation of the TRY against the EUR (USD) in September-October 2008. The currency nosedived again in February-March 2009, reaching record lows in mid-March. Since then the TRY has recovered overall, having regained about 8% against both the EUR and USD in the year to end-March 2010. However, the exchange rate has remained volatile, reflecting vulnerability to domestic political turbulences, and as of mid-April 2010, the TRY was still down about 15% against the EUR and 25% against the USD from end-August 2008. These figures reflect the increased cost of servicing external debt. We expect the currency to remain highly vulnerable to domestic or external shocks as well as to potentially deteriorating economic fundamentals.

Turkey's fiscal position has sharply deteriorated in the wake of the deep recession and is a cause of concern. We forecast that a combination of the usual automatic stabilisers in a recession and fiscal stimulus measures taken by the government have pushed the fiscal deficit to about 6% of GDP in 2009. Total public debt rose from 40% of GDP in 2008 to around 47% in 2009. The government has been able to finance its deficit through increased debt issuance which has met strong demand, primarily from local banks. Therefore it has been under little immediate pressure to sign an IMF SBA and we do not expect it to do so as long as it has access to market funding. However, this poses a medium-term risk of ballooning public debt. In September 2009, the government announced a Medium-Term Programme (MTP) for 2010-2012 which envisages some, though relatively modest fiscal tightening. But thanks to the better than expected economic performance in Q4 2009 and Q1 2010, this year's fiscal targets under the MTP—fiscal deficit 5.7% of GDP; public debt 49% of GDP—are likely to be overachieved. Sticking to the MTP may help avert a fiscal crisis but requires close monitoring as the risk that the government will not adhere to the Programme will increase ahead of the general election scheduled for mid-2011.

The current account deficit narrowed considerably from average annual 5.9% of GDP in 2006-2008 to 2.2% in 2009 as imports shrank faster than exports amid the economic downturn. However, the trade pattern has reversed in the first two months of 2010 (see above) and the external deficit grew to USD5.6bn from just USD0.8bn in the same period of 2009. Hence we forecast the deficit to widen to about 4% of GDP this year. The coverage of the current account deficit through net foreign direct investment (FDI) improved from 37% in 2008 to 44% in 2009, but fell to just 12% in January-February 2010.

The large proportion of the high current account deficits in recent years financed through new external indebtedness boosted total external debt to a peak of USD291bn in Q3 2008, equivalent to relatively high levels of about 40% of GDP or 165% of export earnings. While the total debt declined somewhat to USD271bn at end-2009 owing to reduced external financing needs and possibilities, it still increased in relation to GDP (about 44%) and exports (190%). We expect similar ratios at end-2010.

Short-term external debt accounts for one fifth of total debt. The debt-service ratio surged to a very hefty 49% in 2009 and is forecast to remain heavy at about 33% in 2010.

Foreign exchange reserves had continuously fallen from a peak of USD77.3bn at end-September 2008 to a low of USD62.4bn as of 24 April 2009 (i.e. by almost 20%), partly owing to central bank measures to boost foreign exchange liquidity and probably also to stabilise the TRY. Thereafter reserves recovered gradually to USD69.2bn at end-2009. They have remained quite volatile, though, and fallen slightly to USD67bn as of 9 April 2010, which is probably a result of the currency composition (as the EUR share has declined in USD terms so far in 2010). Nonetheless, the current level is sufficient to cover about 4.5 months of forecast imports in 2010. However, reserves cover less than 25% of money supply M2 and, critically, just about two thirds of short-term external debt and principal repayments due in 2010. This problem has been obvious over the past years as large current account deficits were largely financed through short-term external debt which has been difficult to be rolled over amid the global financial crisis. Although overall tight global liquidity conditions are currently easing, the high short-term external debt burden remains a serious risk.

Structural Business Environment

The structural business environment is adequate. Turkey is ranked 88th—slightly above average—in our assessment of 210 countries. Still, some significant impediments to strong, stable, sustainable economic growth remain in place. Areas of particular weakness are administrative inefficiency, perceptions of corruption, the overburdened court system (bankruptcy proceedings take about 40 months), labour market restrictions and barriers to capital flows.

On a positive note, the banking sector is today stronger than in 2000-2001 when its weaknesses contributed significantly to the home-grown financial and economic crisis. Substantial banking reform under IMF and World Bank guidance has resulted in a large restructuring, better regulation and supervision of the sector which is now more transparent and financially stable. Although the banking sector has not remained unaffected by the global financial crisis and worsening economic conditions, it has so far shown remarkable resilience thanks to a lower degree of dependence on external financing. However, the share of non-performing in total loans has increased from 3.5% at end-2007 to 5.3% in September 2009 and a further rise is expected.

The 25% depreciation of the TRY against the USD over the past 20 months has had a significant impact at the corporate level and any renewed potential sharp lira weakening would add to that. Importing firms have suffered from higher import prices and the financial burden and insolvency risk of companies with foreign-currency denominated debt has increased. Yet exporting firms have benefitted from the lira depreciation unless they are highly dependent on imported inputs.

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Charts

