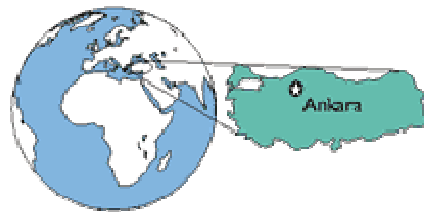


COUNTRY REVIEW

Turkey



26 August 2011

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EULER HERMES COUNTRY RISK GRADE: C
EULER HERMES COUNTRY RISK LEVEL: HIGH

Country Risk Grades are on a scale of AA, A, BB, B, C, D
Country Risk Levels are on a scale of LOW, MEDIUM, SENSITIVE, HIGH

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Strengths

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

Weaknesses

- History of political and economic instability; volatile international relations
- Lack of strong commitment to fiscal consolidation
- Surging short-term capital inflows have caused anew large macroeconomic imbalances:
 - continued rapid private sector credit growth
 - sharply widening current account balance
 - more generally a sharply rising gross external financing requirement
- Exchange rate vulnerability to political and external shocks
- The external debt-service ratio remains high in 2011-2012
- Foreign exchange reserves cover just two thirds of external debt payments falling due in 2012

KEY RISKS

- **Currency volatility and exchange rate risk**
- **High short-term capital inflows could be reversed suddenly in the event of a shock, resulting in considerable refinancing risks of companies and banks**
- **Overheating, followed by hard landing**

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Ankara
Population:	75.705 mn (2010)
GDP:	USD 736733 mn (2010)
Currency:	Turkish lira (TRY)
Form of state:	Republican parliamentary democracy
Head of government:	Prime Minister Recep Tayyip ERDOGAN (since March 2003)
Next elections:	Presidential: 2014 / Legislative: 2015

Major Industries (% of GDP at market prices, 2009)		Global Assumptions		2010	2011
Services	52.4%	Real GDP grth (% yr/yr)		3.3	2.9
Industry	35.5%	Inflation (% av) *		1.2	1.4
Construction	4.1%	Dated Brent (USD/b)		80	115
Agriculture	12.0%	* Major economies			

Main Exports (% of total, 2010)		Main Imports (% of total, 2010)	
Machinery & equipment	14.8%	Mineral fuels & oil	20.7%
Motor vehicles	12.1%	Machinery & equipment	19.3%
Iron & steel, articles thereof	12.0%	Iron & steel, articles thereof	9.7%
Textiles & clothing	9.7%	Motor vehicles	7.2%
Lead Export Markets (% of total exports, 2010)		Lead Import Markets (% of total imports, 2010)	
EU-27	46.2%	EU-27	38.9%
Germany	10.1%	Germany	9.5%
UK	6.3%	Russia	11.6%
Iraq	5.3%	China	9.3%
Russia	4.1%	USA	6.6%

Basic indicators

Selected economic indicators	2008	2009	2010	2011f	2012f
Nominal GDP (USD mn)	731,180	614,554	736,733	739,172	803,073
Population (mn)	73.91	74.82	75.71	76.60	77.51
GDP per capita (USD)	9,892	8,214	9,732	9,649	10,360
Real GDP growth (% yr/yr)	0.7	-4.8	8.9	6.5	4.0
Inflation (% eop)	10.1	6.5	6.4	6.0	5.9
Fiscal balance (% of GDP)	-2.5	-5.8	-3.6	-2.8	-3.0
Government debt (% of GDP)	39.5	45.4	42.3	42.0	40.0
Current account balance (% of GDP)	-5.7	-2.3	-6.5	-11.8	-8.1
External debt/GDP (%)	38.3	43.7	39.3	44.6	43.6
External debt/Exports of goods & services (%)	159.4	187.6	186.8	184.4	177.8
Debt-service ratio (%)	35.4	45.2	39.6	36.6	24.0
Foreign exchange reserves (USD mn)	70,231	69,178	79,046	80,000	85,000
Import cover (months)	4.0	5.5	4.8	3.7	4.0
Exchange rate assumption, TRY:USD (av)	1.30	1.55	1.50	1.68	1.70
Exchange rate assumption, TRY:EUR (av)	1.91	2.16	2.00	2.35	2.30
f: CRU central forecast					

Sources: National sources, IMF, World Bank, ECB, IHS Global Insight, 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 (34% of the vote) and its overwhelming re-election in July 2007 (47%). 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 June 2011 the AKP won a third term in office with another landslide victory, increasing its share of the votes to almost 50%. However, its number of seats in parliament declined to 326 out of 550, largely owing to an increased number of pro-Kurdish independents winning seats (36). Thus the AKP fell short of the 367 seats needed to unilaterally change the constitution as well as the 330 needed to take its proposals to a referendum. In a somewhat piecemeal manner, significant amendments to the 1982 military-drafted constitution have already been made during the AKP's rule, including curbing the political powers of the military and increasing the political oversight of the judiciary, thereby bringing the constitution closer to EU standards. But Prime Minister Erdogan has long sought to draft an entirely new civilian constitution. However, following the 2011 election result, the AKP cannot unilaterally press ahead with controversial reforms but will have to seek consensus for any reforms with a strengthened opposition. This should ensure political continuity and at the same time limit the risk of rising political tensions. However, this market-friendly outcome has been threatened by the parliamentary ban of one independent Kurdish deputy by the Supreme Election Board and his replacement with an AKP deputy which has resulted in a boycott of all of the other 35 independent Kurdish deputies to date. Should the AKP attempt to increase its number of parliamentary seats through by-elections, political tensions could rise anew.

More generally, the underlying problem of a deep-rooted division in society between secularists and religious conservatives remains in place. Fears among the secular establishment in Turkey, including the 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 occasional controversial actions. As a consequence, the political scene is likely to remain volatile and there remains a degree of risk of a future political crisis with the potential to disrupt policymaking, jeopardise financial market confidence and trigger economic crises.

Moreover, the unresolved Kurdish issue continues to pose a significant risk to political stability. Related terrorist attacks and military actions in the south-eastern provinces have again intensified in recent months. The above mentioned ban of a Kurdish deputy has not helped in this context.

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, but also to a lack of democratic freedoms, especially the authoritarian crackdown on critical journalists and media. 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.

Economic Stability

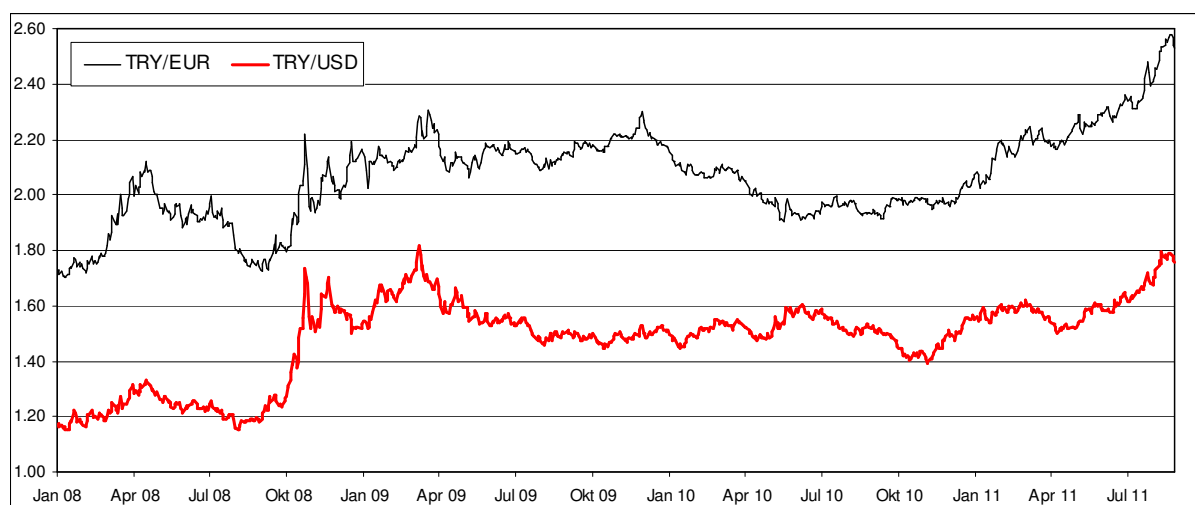
Following average annual real GDP growth of 6.6% in 2002-2007, the economy fell into a deep recession in 2008-2009. Calendar GDP grew by just 0.7% in 2008 and contracted by 4.7% in 2009, hit by both declining domestic and external demand. However, **the economy has strongly rebounded since Q4 2009**. Real GDP grew by 8.9% in 2010 and 11% yr/yr in Q1 2011, driven by domestic demand. Private investment surged by 33.5% in 2010 and 38.3% yr/yr in Q1 2011 while public investment was up by 15.1% and 4.9%, respectively. Private consumption expanded by 5.9% in 2010 and 11.6% yr/yr in Q1 2011 while government consumption increased by 2% and 6.7%, respectively. External demand recovered also, but net trade made a negative contribution to growth as import expansion (20.7% in 2010, 27% yr/yr in Q1 2011) clearly outperformed export expansion (3.4% in 2010, 7.7% in Q1). However, **the extraordinary strong recovery is clouded by overheating concerns**, especially since continued rapid private sector credit expansion has been the primary growth driver, largely financed through short-term foreign capital inflows, which have fuelled domestic demand and subsequently the surge in imports and have pushed the current account deficit to very high levels. Early indicators for Q2 2011 suggest that growth has moderated somewhat but external imbalances have continued to rise. Overall we forecast full-year growth of about 6.5% in 2011 and 4% in 2012, but **the risk of a hard landing has increased**.

The **current account deficit widened sharply** from USD14bn (2.3% of GDP) in 2009 to USD48bn (6.5% of GDP) in 2010. The external deficit has continued to soar in 2011 as it hit USD45bn in H1, up 122% yr/yr, suggesting that the full-year deficit will reach a worrisome level of more than 10% of GDP. Moreover, net foreign direct investment inflows have remained modest, covering just 12% of the current account deficit in H1 2011 after 19% in 2010 and 85% in 2009. As a result, the external deficit has been largely financed through short-term capital inflows, reflected in surging net portfolio investment inflows (USD16bn in 2010, +7004% yr/yr; USD17bn in H1 2011, +147% yr/yr) and net external borrowing by domestic banks (USD40bn in 2010, +485% yr/yr; USD7bn in H1 2011, -66% yr/yr). The short-term capital inflows have also fuelled private sector credit growth which accelerated from 12% at end-2009 to 40% a year later and has since remained around that level. Moreover, the capital inflows caused upward pressure on the Turkish lira (TRY) for most of 2010 and a real effective exchange rate appreciation.

Concerned about these rising macroeconomic imbalances, and encouraged by relatively low inflationary pressures, the central bank embarked on a **new monetary policy strategy in late 2010**: lower interest rates to curb short-term foreign capital inflows and ease upward pressure on the TRY but higher bank reserve requirements to tighten monetary policy at home (reduce credit growth) in spite of lower interest rates. From September 2010 to January 2011, the central bank cut its key policy one-week repo rate by a total 75bps to 6.25% and the overnight borrowing rate by a total 500bps to 1.5%, while the overnight lending rate was raised by 25bps to 9%. In several steps since December 2010, the central bank has further raised minimum reserve requirements on TRY deposits substantially, especially those on short-term liabilities. So far, the impact of the unorthodox monetary policy mix has been limited. Short-term foreign capital inflows have remained high in H1 2011 though there has been a shift from bank external borrowing to portfolio investment inflows. Consequently, private sector credit growth has remained high as well (41% yr/yr in July 2011). At least, the policy mix was successful in easing upward pressure on the TRY and re-balancing the real effective exchange rate.

In July 2011, however, exchange rate volatility increased suddenly and the TRY weakened more than probably intended. The central bank responded by foreign exchange (FX) market interventions and, at an interim meeting on 4 August, it cut the one-week repo rate by 50bps to 5.75%, intending to reduce the risk of a domestic recession potentially caused by global economic problems. In order to offset the negative impact of the policy rate cut on inflation and the exchange rate, the overnight borrowing rate was raised by 350bps to 5%, while the overnight lending rate was kept at 9%. The repo rate cut surprised markets which have been concerned about the overheating of the economy and the soaring current account deficit. Meanwhile, currency volatility and weakening has continued in August. Year-to-date the TRY has fallen by about 22% against the EUR and 13% against the USD. **We expect the macroeconomic imbalances to remain relatively large** in the near future such that **exchange rate risk continues to be high**. Moreover, **external (re-)financing risks for banks and companies remains high** because the short-term capital inflows could be unwound relatively quickly which could produce a systemic crisis if investor sentiment changed suddenly for some reason (e.g. external shock or renewed political turmoil).

Chart: TRY against EUR and USD since 31 December 2007



Source: ECB

Inflation has been fairly moderate since 2009. It eased from 6.4% at end-2010 to a record low of 4% yr/yr in March 2011 before it picked up again to 6.3% in July. We expect average annual inflation of around 6% in 2011-2012. Upside risks to this forecast include further currency weakening.

Turkey's **fiscal position appears adequate but remains a cause of some concern**. Cyclically strong tax revenues thanks to the sound economic performance since Q4 2009 and markedly lower interest payments have narrowed the fiscal deficit from 5.8% of GDP in 2009 to 3.6% in 2010 and reduced public debt from 45.4% of GDP in 2009 to 42.3% in 2010, thus overachieving the 2010 fiscal targets under the government's Medium-Term Programme (MTP) for 2010-2012—fiscal deficit 5.7% and public debt 49% of GDP. Nonetheless, higher-than-targeted public spending as well as continued postponement of the implementation of a fiscal rule—planned for June 2010, setting a long-term fiscal deficit target of 1% of GDP—to date indicate reluctance to tighten fiscal policy. This could undermine market confidence in the events of lower future growth, domestic or external shocks. Our central forecast assumes that the government's revised fiscal deficit target of 2.8% of GDP is about to be met in 2011. Public debt should remain at about 42% of GDP. International credit rating agencies currently rate long-term, foreign currency government bonds one or two notches below investment grade (Fitch: BB+, S&P: BB, Moody's: Ba2, all with a positive outlook).

The predominant financing of the large current account deficit since 2010 through new external indebtedness has **boosted total external debt to a record USD299bn in Q1 2011**, equivalent to relatively high levels of about 40% of GDP or 170% of export earnings. Moreover, short-term external debt is rising faster than the total, hitting a new record high of USD85bn in Q2 2011 and increasing to 27% of the total from 19% in 2008. The **debt-service ratio remains heavy** at about 37% in 2011 and 24% in 2012.

FX reserves surged from USD70bn in June 2010 to USD92bn in June 2011, largely as a result from the increased short-term capital inflows (see above). From early July to mid-August 2011, however, FX reserves have declined by about USD5bn, presumably owing to the already mentioned central bank intervention to stabilise the TRY and/or a reversal in capital inflows. A further decline until end-2011 is likely. The current level of FX reserves is sufficient to cover about four months of imports, down from five months in 2010. Critically, they cover less than 25% of money supply M2 and only about two thirds of short-term external debt plus amortisation on medium- and long-term debt due in 2012. This problem has been persistent over the past years as large current account deficits were largely financed through short-term external debt. However, thanks to solid economic policies and an overall resilient banking sector, corporate refinancing problems were limited during the 2008-2009 global financial crisis. Nonetheless, as global liquidity conditions are currently tightening again, **Turkey's large gross external financing needs leave it highly vulnerable in times of global risk aversion, a risk that should not be disregarded**. Gross external financing needs—commonly defined as current account deficit plus amortisation on M/LT debt plus ST debt at the end of previous period—are estimated at about 30% of GDP in 2011, up from 20% in 2010.

The banking sector is today stronger than in 2000-2001 when its weaknesses contributed significantly to the home-grown financial and economic crisis. Banks have shown remarkable resilience during the global financial crisis in 2008-2009. However, some developments require monitoring: Firstly, domestic banks have financed the rapid private sector credit growth since 2010 through sharply increased net external borrowing. Crucially, while banks' external liabilities were largely balanced by external assets in 2006-2008, assets have been liquidated significantly in 2009-2011. Secondly, the share of government securities in total assets of the banking system increased from 26.5% in 2008 to 32% in Q1 2010 (latest available data); for state-owned banks the share increased from 38.2% to 40.7%, respectively.

Structural Business Environment

The structural business environment is adequate. Turkey is ranked in the third out of six categories in our assessment of 181 countries. There is a perception of moderate corruption, though it appears to be declining. According to the World Bank's *Doing Business 2011* survey, the court system is overburdened—bankruptcy proceedings take about 40 months.

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Charts

