Turkey

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS December 19, 2014

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Recent quarters have seen Turkey's fortunes beginning to fade. Decelerating output has combined with rising concerns about the sustainability of the country's large current account deficit in view of potential threats to its financing. At the same time political stability is undermined by brazen actions of the government against media and a peaceful opposition.

Summary and conclusion

Following a buoyant recovery after the global financial crisis in 2009 growth has trailed and is set to underperform further in the current year with only 2,7% economic expansion. That is in part policy induced in order to reign in very rapid credit growth which last year led to a record current account deficit of 8% of GDP. The deficit should be reduced to around 5% in the current year as domestic demand moderates and the global oil price drops. The latter will also support the central bank in containing inflation pressure although still forecast to reach more than 9% before year-end as measured by the CPI, far above the central bank's 5%.target.

Despite improving, the external deficit still remains large and warnings are growing that it may no longer be sustainable in view of weaker growth. Moreover, short term and debt creating capital inflows continue to dominate its financing with foreign direct investments falling behind peers as share of GDP. This leaves the balance of payments hostage to international investor sentiment. So far the arrangement has worked well underpinned by cheap and ample global liquidity.

That, however, could be overturned should monetary tightening in the US soon turn off the liquidity tap. The fact that 80% of Turkey's borrowing abroad comes from European banks adds to the uncertainty. Europe also dominates 45% of the market for Turkish exports doubling the dependency of the external sector on one geographical area which could face intensifying economic travails in the near term. Low net reserves at the central bank – only 2 months import cover, may in a reasonably worst case scenario prove inadequate to maintain orderly conditions in the foreign exchange market

Turkey's underlying problem is a declining national savings rate reflecting in part a growing discouragement from long term investments in productive domestic sectors. That is puzzling for a country traditionally hailed as a place with a diversified and dynamic business culture. Political uncertainty is beginning to take its toll on investor sentiment. Recent brazen police actions against media and business people of the political opposition are poised to have long term effects on investor sentiment. While Pres. Erdogan could sit for another 10 years in office, political stability will be undermined from below should recent events become future norm.

The rating agencies were quick to upgrade the sovereign to investment grade two years ago based on strong fiscal policies, but have recently issued warnings of a downgrade despite further strengthening of fiscal metrics.

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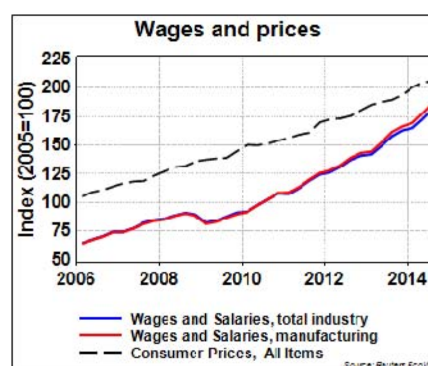
Recent developments

Growth trailing: Recently released GDP result for the July-September period (Q3) disappointed showing only 1,7% economic expansion against the same period of 2013, that is year-on-year (yoy). That came on the heels of worse than expected results also for the preceding quarters, and prompted warnings that the original projection of a 3% growth for the whole year was no longer within reach. Actually an early indicator like the Industrial Production index gained only 2,4% yoy growth in October pointing to weak performance of the economy in the last quarter of the year as well. Combined with slowly growing unemployment to 9,5% of the labour force by year end this points to only 2.7% growth for 2014 in our estimation, which means that for the last three years the country has barely been able to grow at an average of 3% a year. This makes the case for a secular downturn of growth capacity to less than half of what Turkey achieved in its heydays of 2002-2007, i.e. the year between its own financial crisis in 2001 and the global financial crisis in 2008.

Softer domestic demand: While public expenditures have continued to grow.at a more rapid clip reaching 6,6% in annualized term in Q3, the recent growth performance has been dented by softer demand from the more important private sector. That was in part a payback to the monetary tightening in Q1 as the central bank raised interest rates and restricted the use of credit cards to stem the excessive credit growth that had developed in 2013 and further heated up the housing market and regular consumer demand. Although, much of the tightening was rolled back in Q2, investor sentiment has been slow to recover. Recently, also exogenous factors joined in with a negative contribution as abnormal drought incurred heavy losses on agriculture. The external sector, by contrast has managed reasonably well due in large part to import compression as a result of reduced demand and more recently the drop in the oil price.

Easing inflation pressure: The recent steep decline in the global oil price, however, comes too late in the year to have any but a minor impact on price developments in 2014. Those are likely to end at around 9% yoy up from 7,5% rise in 2013 reflecting the impact of the 25% depreciation of the Lira and higher food prices, the latter caused by adverse climatic conditions for agriculture. For 2015 and subsequent years, a lower oil price at around the present level of $60-70/barrel for crude would make a material difference to the government's battle against rising prices. That is projected to calm down to 7,5% increase in the CPI and eventually trail down to 5% -- the government's present target, within a four-year period. Such a scenario also hinges on lower growth in house prices, estimated to reach 15%in the current year and more significant wage moderation than experienced in recent years.



Improving current account balance: Helped by reduced energy prices, domestic demand pullback and some support to exports from a more competitive exchange rate, the current account balance this year is estimated to improve by an impressive 2,5% of GDP but still end at a still too high $42bn, equivalent to 5% of GDP. From an all time high of $65bn.or almost 8% of GDP in 2013, the deficit was already down to $46bn. in the 12 months period up to last October. However, a part of that

improvement is due to volatile elements like gold trade where previous years soaring imports came to a halt with declining world prices since late 2013 suggesting much of that trade reflects speculative purchases rather than domestic consumption of the precious metal. Nevertheless, the overall current account development in 2014 presents a clear improvement on preceding years.

Deficit financing: Like in all years since the GFC the deficit has been overwhelmingly financed by loans, bonds issuance and other debt creating capital inflows. Before the GFC, in contrast, foreign direct investments (FDI), portfolio inflows into the stock exchange and other non-debt financing dominated. However, so far in the current year there have been marked shifts to a more healthy composition of the financing away from debt to non-debt financing although the latter still dominates. FDI inflows in the first half of the year stood at $4,5bn -- up 25% on a yoy basis, but that was in large part due to purchases of residential housing after the law was amended in 2013 to permit such sales to foreigners. Banks and large corporates stand for the lion share of the deficit financing as they continue to issue bonds and bills denominated in foreign currencies or contract loans from foreign financial institutions. In the January to June period, banks sold new securities to international investors for a total of $10 bn. while loans and credits to the entire economy added another $12bn.

Non-recorded capital inflows: The residual item for non-recorded capital or trade related flows – so-called "errors and omissions", added another 15% to the total financing of the current account deficit for the 10-month period ending last October. This item has seen a gradual decline over several years. That suggests exceptional financing from neighbouring and regional countries or when residents draw on retained earning held abroad, play a diminishing role in filling the financing gap.

Official reserves remain adequate according to "headline numbers": Official reserves in the hands of the central bank remain reasonably adequate at $135bn, equivalent to more than 6 months of import cover. That is according to "head-line" numbers, though. As pointed out by a recent IMF report, that number includes foreign exchange deposited by banks with the central bank in order to fulfil their reserve requirements for ordinary lira deposits from the banks' domestic customers.[1]

Unusual facility boosts official reserves: In most countries such reserve requirements can only be fulfilled by depositing local currency with the central bank. The unusual arrangement in Turkey was introduced in 2011 with the purpose to "mainly [to] smooth the impact of capital flow volatility on exchange rates and balance sheets of the Turkish banks"[2] At that time, the reserve level covered only 4 months of reserves and showed signs of volatility. As the new ROM facility kicked in banks took the opportunity to fulfil reserve requirements by borrowing abroad at much cheaper rates than in the local Lira market and placing the funds with the central bank, boosting the gross reserves of the latter in the process. Since then the central bank's foreign reserves have grown steadily to $135bn. of which the ROM facility represents around $60bn. Subtracting also banks' reserve requirements related to their deposit taking in foreign exchange, the IMF calculates that reserves freely at the disposal of the central bank – "net reserves" – now constitute only $45bn.or about two months' worth of imports. That is very low by any standard for a country with a wide-open capital account and a large current account deficit. The

[1] Article IV report on Turkey, IMF WasingtonDC, December 2014
[2] Reserve Options Mechanism and FX Volatility, Central Bank of Turkey, February. 2013

risk of relying on the ROM arrangement is that this may run out if Turkish commercial banks should experience reduced access to international capital markets.

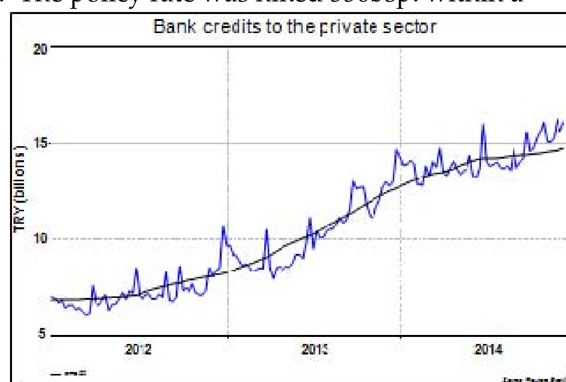
External debt and debt service represent a potentially mounting challenge: At 50% of GDP external debt is not alarmingly high for a relatively developed emerging market. However, due to overall short maturity, about half of it – 25% of GDP, needs to be rolled over every year. This could prove a mounting challenge under less helpful circumstances than at the present.

Policies

Since its financial crisis in 2001 Turkey has been much commended for its fiscal correction which has brought the sovereign back from the edge of the abyss. Monetary policies, in contrast, have often become the scapegoat. In recent years it has been blamed for being too lax and for introducing an excessively complicated policy framework that was seen as having little other purpose than to mask internal inconsistencies. Along with flagging growth of recent years, structural policies have gradually attracted focus.

Fiscal consolidation continues: In 2013 the fiscal deficit shrank to only 1% of GDP. This year the balance may deteriorate slightly leaving the end result closer to 2% of GDP due to higher than budgeted central government primary spending through the first half of the year. As a result the primary surplus may suffer but still remain well above zero, a marked drop, though, from the 5% surpluses that ruled for several years up to the GFC. Government indebtedness, measured by the ration to GDP, has come down to 37% from a peak of almost 100% in 2001 to 37%. The government may also be appraised for prudent debt management with a relatively long average maturity of 6 years of which 2/3 is denominated in lira and only a fifth held by foreign residents. – The hitch is that the government can be seen as encroaching on the private sector as expenditures to GDP reach 40% and continue to outgrow the productive sectors of the economy even though the budget balance may not suffer.

A stint of monetary policy tightening has yielded to premature loosening: In early 2014, after credit growth had peaked at 35% in 2013 prompting resurgent price pressure and a rapidly weakening exchange rate, the central bank slammed the breaks and tightened monetary policies. Prudential measures were introduced including limits on credit card loans. The policy rate was hiked 550bsp. within a new policy framework, replacing an opaque and complex old one that had much complicated the central bank's communication with markets. The new regime focused on creating a corridor for interbank market rates of about 3 percentage points where the floor was given by the repo rate and the ceiling by the rate at which banks could access the central banks overnight lending facility. However, as the turbulence in the exchange market calmed down, credit growth moderated to 16% and political pressure apparently rose, tightening was reversed already in the spring with cuts in the repo and lending rates of 50 and 75 bsp respectively. That was seen by many market participants as a premature easing in view of a still small output gap and high inflation expectations.



Banks gaining strength. Another stark contrast to Turkey's past is the strengthening of the banking system. Banks are now well capitalized with a CAR (capital adequacy ratio) at 16%, good profitability and a relatively low level of NPL (non-performing loans) at less than 3% of total loan books. It is also regarded as well regulated although the transfer of authority a few years ago over the regulatory agencies to respective ministries may have undermined the integrity of these agencies. Last October, Turkey was removed from FATF's list of countries lacking anti-money laundering and anti-terrorist financing compliance. However, at 114% Turkish banks' loan to deposit ratio much exceeds normal prudential ratios. Moreover this is mainly related to their lending in foreign currencies which has doubled over the last five years to $137bn. of which 2/3rds is on short terms as new tax regulations motivated companies to move their foreign currency borrowing on-shore.

But their clients could be another matter: Recent years' rapid increase in credit extension has left banks with loans that could turn sour as they season in a less favourable economic scenario of weaker than previously expected growth. Moreover, banks funded much of this credit growth with loans from abroad with cheap but often short maturities resulting in possible maturity miss-matches in the balance sheets. A mitigating feature of this development, however, was that a part of banks' lending did not represent new borrowing, as noted above, but rather a shift from off-shore to on-shore sources where the off-shore sources were often subsidiaries of domestic banks. As such, total leverage of Turkish companies did not necessarily increase. -- As regards currency miss-matches banks should in principle be protected. Most of the on-lending to clients has been in the same currency as the funding currency. But they could be exposed indirectly. Regulations limits foreign currency denominated loans to companies with either proven access to international capital markets of with natural hedging. But the latter leaves a grey area when export revenues are poorly synchronized with debt repayments. This is an issue that could come to a head should Turkish banks' supply of foreign funding dry up. Also, about TL60bn. ($27bn.) of foreign currency indexed TL-loans are not subject to these regulations. Observers also suspect many companies to sit on additional unhedged foreign currency borrowing from others than domestic banks.

Exchange rate developments: In late 2013 and early 2014 the Turkish Lira depreciated by about a quarter but recovered a third of the losses shortly after the central bank had acted against the rout. The CDS spreads on the sovereign followed suit but have recently shot up, also that in parallel with the new weakening of the TL in recent weeks. The IMF still view the TL as somewhat overvalued to the tune of 10-20% against a backdrop of continued large current account deficits on current policies.

Structural policies gaining importance: In view of fiscal consolidation and a new workable framework for monetary policies under a managed to free-floating exchange rate regime, structural problems have become the main issue for solving Turkey's over-arching macro-economic stabilization problem: ***a too low savings rate that creates a persistent current account deficit***. Such problems include an overregulated labour market that creates incentives for business to operate outside the perimeters of existing laws and regulations. High minimum wages, restrictions on part time employment and unduly high severance pay as stipulated by law, work to deter companies in the formal sector to take in new workers. Last May, the government announced a new National Employment Strategy but lack of details failed to convince many business people that it truly represented new winds.

Eroding investor sentiment: Over the last year Turkey has slid 11 renks on the "corruption index" of Transparency International. That was probably prompted by the widening perceptions of an inefficient and inconsistent judiciary after a major corruption scandal in 2013 which involved top echelons of the ruling AKP party. In the World Bank's Doing business Survey, Turkey recently dropped 14 levels to number 55 among 189 countries. Incidents such as recent attacks on opposition media have come to overshadow the progress on rationalizing and privatizing the energy sector. In return, many investors continue to see Turkey as a diversified and dynamic place to do business:

Politics

Political stability becoming "skin deep": Probably the worst omen for Turkey's attempt to safeguards its former reputation among investors is the perception of fading political stability. Before the present police clamp down on media, politicians and business people not favoured by the government, under AKP, the ruling Islamist party since 2002, Turkey was still seen as a huge improvement on the political circus that had existed before. Even though such actions can be rationalized as the reactions of a regime that sees itself cornered by foreign -- in particular western -- forces, they still heighten the sense of unpredictability. The European Convention of Human Rights in the Hague recently ruled that Turkey was discriminating against its Alevite minority which represents a more liberal interpretation of Islam that the mainstream Sunni. Denying this ruling has set the government on course for "war" with some 30-40% of its population, including also the Kurdish minorities. The country's EU aspirations, a long standing issue for more than half a century, is hardly talked about anymore. Negotiations have stalled as long as Turkey is unwilling to open its harbours and airports to the Greek-Cypriote part of Cyprus.

Up-coming elections: Parliamentary elections are scheduled for next May. They will follow presidential elections of last August which secured a five-year term for Mr. Erdogan. He was otherwise barred from running for another term as PM. A proposal to lower the 10% threshold for any party to enter Parliament is now under debate and the Constitutional Court has also undertaken to rule on the legality of the high entry barrier. The exact election outcome of any change to this rule is uncertain. Under the existing election law many observers believe AKP should have a good chance of winning the campaign. That is at least according to polls by the AKP while other polls predict a more uncertain fallout. Some observers set that uncertainty in the context of the attacks on the opposition.

Regional security getting worse: The war against the terrorist regime – ISIS -- that quickly established itself in Northern Iraq at the beginning of the current year has come close to Turkeys southern borders. So far, the risk of the war spilling over onto Turkish soil seems limited.

Outlook

Moderate growth likely to continue: While this year is likely to provide another slight disappointment when the final numbers tick in for the fourth quarter, a number of observers expect 2015 and 2016 to produce better results. While the first quarter result may still be weak due to base year effects, GDP is likely to accelerate through the year and easily pass the 3% growth mark. Monetary tightening should

no longer be needed as credit growth has come down and lower energy prices help the central bank steer inflation into calmer waters. Pressure for fiscal contraction should also not be too loud as the fiscal deficit appears to remain well within normal standards of prudent policies.

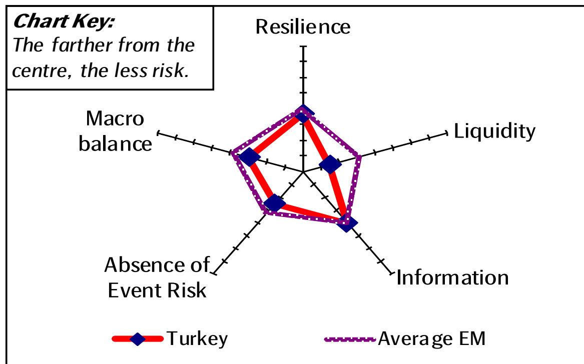
The problem lies primarily with domestic investor sentiment and the external economic environment. It may still be early to say if domestic investor sentiment have been materially hurt by recent political events, but, if anything, it is likely to be negative for investment demand. As regards the external environment, Turkey is likely to be favoured at this stage of the business cycle by accelerating world trade, raising its share of world imports by almost 1 pp. to 5,4%. In our base scenario of continued growth in the world economy, Turkey should be able to continue gradually accelerating expansion toward the end of the decade.

Risk to the base scenario is first of all connected to the continuing problems in Europe. With a share of 45%, the continent is by far the largest destination of Turkish exports. At the same time, Turkish banks have become addicted to foreign funding primarily from European banks. A new euro-crisis might come to strike from two sides: First; on the real economy as exports to Europe is hit by reduced imports demand from the continent. That may force the central bank to sell foreign exchange to offset reduced net inflows under the current account. Second; as European banks panic and become less willing to take risks in general, including on countries outside the continent, Turkish banks may have to withdraw their foreign exchange deposits with the central bank under the ROM facility. In the not unlikely situation that this would occur at about the same time, the central bank could lose reserves too quickly to maintain market confidence in its ability to manage the situation.

Other risks are related to the security situation in the Middle East. This is the second largest destination of Turkish exports with a share of some 30%. Last august Turkish exports to Iraq had declined by 50% yoy to this country alone. A third risk could be investor running away from emerging markets as the US begins to tighten monetary policies in 2015. Countries with high external deficits like Turkey are regarded as the most vulnerable to such investor panic.

Turkey: Risk Profile

Key ratios	2014
Population (mil)	75.9
GDP/capita (US$)	10 586
Real GDP (% chg)	2.7%
Inflation (%)	8.9%
Current Account (% of GDP)	-5.2%
Gross reserves/imports (months	5.6
Budget balance (% of GDP)	-1.6%
Government debt (% of GDP)	37%



External ratings:
Fitch: BBB- / Stable
Moody's: Baa3 / Neg.
S&P: BB+ / Neg.

Peers:
Indonesia
Russia
Morocco

Graph: The pentagon shows Turkey's risk profile as average strong on resilience, but weak on macro balance and liquidity. It is weaker than average on eventrisk.

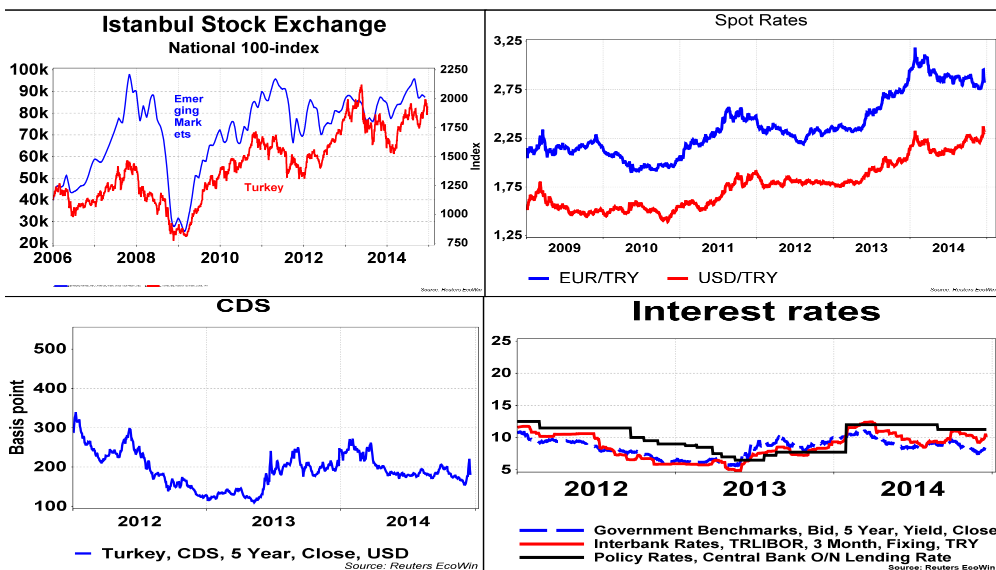
Key data:	2010	2011	2012	2013	2014	2015	2016
GDP (mill. US$)	734	777	790	823	804	856	934
GDP/capita (US$)	10159	10622	10666	10963	10586	11146	12044
GDP (change)	9.2%	8.8%	2.1%	4.1%	2.7%	3.2%	3.4%
Investments/GDP	24%	26%	25%	25%	23%	24%	25%
Budget balance/GDP	-4%	-1%	-2%	-1%	-2%	-1%	-1%
Govt debt/GDP	45%	41%	40%	38%	37%	35%	32%
CPI inflation (%)	8.6%	6.5%	8.9%	7.5%	8.9%	7.3%	6.4%
Money demand (%)	16.2%	19.5%	9.7%	17.4%	15.0%	11.8%	12.1%
Stock prices	72252	73171	74111	75044	75946		
Interest rates	7.4%	8.6%	8.7%	6.8%	10.0%	8.9%	7.6%
Exch. Rate ($)	1.50	1.67	1.79	1.90	2.18	2.28	2.35
Trade/GDP (%)	41%	48%	49%	49%	50%	50%	51%
Oil price (Brent)	$80	$111	$112	$109	$100	$70	$81
Millions US $							
Export of goods	120 992	142 392	161 948	161 789	171 287	186 668	209 071
Imports of goods	177 317	231 495	227 246	241 696	231 285	242 336	266 924
Other:	11 012	14 053	16 804	14 873	18 400	19 592	21 344
Current account	**-45 313**	**-75 050**	**-48 494**	**-65 034**	**-41 598**	**-36 077**	**-36 510**
Current account (%/GI	-6.2%	-9.7%	-6.1%	-7.9%	-5.2%	-4.2%	-3.9%
FDI	7 626	13 784	9 180	9 196	7 809	10 379	11 625
Loan repayments	-47 660	-41 472	-43 209	-69 829	-88 581	-97 482	-102 639
Net other capital flows	90 551	117 646	82 523	143 967	124 844	128 716	132 657
Balance of payments	**5 204**	**14 908**	**0**	**18 300**	**2 473**	**5 536**	**5 133**
Reserves	73 132	88 040	88 040	106 340	108 813	114 349	119 482
Total debt	290 966	303 119	325 488	374 693	406 799	437 986	466 601
o/w short term debt	66 701	80 206	93 745	119 522	130 318	137 431	143 154

Sources: Oxford Economics and SEB estimates

Rating history				
Moodys	Ba2	Ba2	Ba1	Baa3
Fitch (eoy)	BB+	BB+	BBB-	BBB-

Type of government: Parliamentary Democracy
Next elections Legislative: 2015; Presidential: 2019

Other:
Latest PC deal 1980/fully repaid
Latest IMF arrangement 2005 (SBA), Completed



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