Turkey

SEB COUNTRY RISK ANALYSIS **November 27, 2016**

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A growing sense of unease over political developments is going hand in hand with an economic slowdown. External and public sector balances are deteriorating although the latter still remains a relative strength for Turkey.

Country Risk Analysis

Summary and conclusions

Steps taken in the direction of trimming the democratic freedoms and checks and balances in Turkey are creating a growing sense of unease and making the business environment more uncertain. Although economic activity is cooling, there is limited proof in data so far that these steps have had a marked effect on economic performance. It appears unlikely, however, that the process towards a more authoritarian society can continue without finally taking its toll on economic incentives, sentiment and thus activity.

Slow investment growth and a poor performance of the tourism industry should produce real GDP growth of less than 3% in 2016 despite expansionary economic policies. Going forward, a collapse in economic activity is unlikely but there are several indications of a secular downturn in growth capacity to less than half of that seen in the years running up to the global financial crisis in 2008. Trailing growth has relieved some inflationary pressures but structural factors are keeping the rate of inflation significantly above the central bank's target.

Turkey's underlying economic problem is largely a low national savings rate reflecting in part a general discouragement from long term productive investments. Moreover, short-term and debt creating capital inflows have long been the main financing source for the external deficit which is edging up faster than expected. Meanwhile, as a response to slower growth, monetary and fiscal policy has turned more expansionary.

Since the failed coup this summer, two of the major external sovereign credit rating agencies cut their ratings one notch while a third settled for introducing a negative outlook. The agencies generally referred to increases in risks related to the country's sizeable external funding requirements, and a weakening in credit fundamentals such as economic growth and institutional strength. More recently, Standard&Poor's reaffirmed their sovereign rating and revised the outlook from negative to stable.

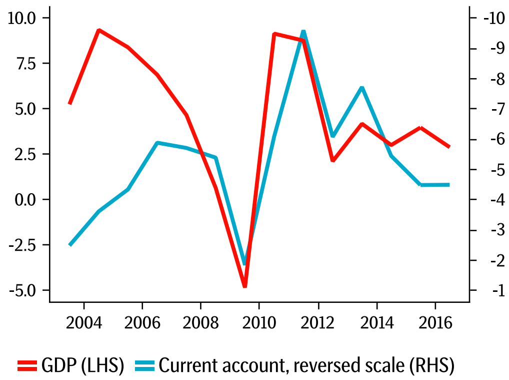
Recent developments

Growth trailing: Despite a series of shocks over the past three years, the economy has proved fairly resilient, although growth at 3.7% on average has been slower than normal. Household and government spending have largely been driving economic activity. The domestic spending has been boosted by rising wages and low fuel price and is taking place in an environment of loose monetary conditions. Following a 4% GDP expansion in 2015 growth started cooling largely due to a deepening slump in tourism. Slow investment growth and little recovery in tourism should produce real GDP growth of 2.8% in 2016 despite expansionary economic policies. This forecast is broadly in line with that of the IMF which recently cut their forecast to 2.9%.

Market sentiment towards Turkey has soured. Financial market sentiment was largely favourable during the first half of 2016. Following a temporary dip in connection with the failed coup in July sentiment has been on a gradual deteriorating path that accelerated following Trump's election as US President. Since the start of the year, the lira has lost about 17% of its value versus the USD and a little less against the euro. Bond rate spreads versus Germany have crept up to long-term highs and the CDS premiums are up about 10%. At the same time the main equity index is still in positive territory for the year.

GDP growth and current account deficit

Percent



Source: IMF

Inflation fluctuating at relatively high levels. Following the cooling in economic activity, consumer price inflation has moderated slightly in 2016. This follows average inflation of nearly 8% in 2015 which was significantly higher than the central bank's 5% target. Slower growth has overshadowed the inflationary effect coming from more expensive imports following the depreciated exchange rate. The central bank expects consumer price inflation at 7.5% by end-2016. This is roughly in line with our forecast and also fairly high given (i) the meagre economic growth and (ii) compared to other emerging markets. Furthermore, inflation expectations are cemented around these levels.

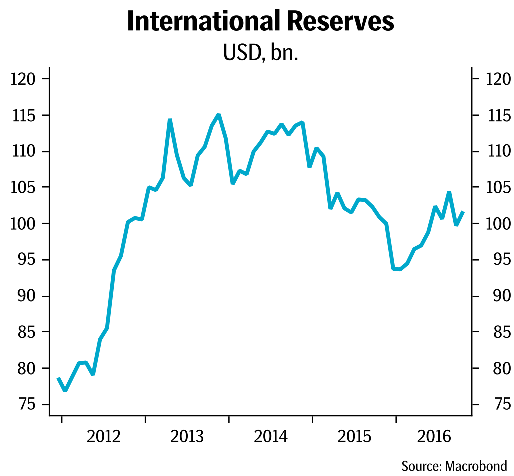
Current account deficit is broadly unchanged. External imbalances have long been a reoccurring vulnerability for Turkey. In fact, the partly structural deficit on the current account is sometimes referred to as Turkey's overarching macroeconomic challenge. A low savings rate by international standards and a high dependence on imported energy are the main underlying reasons for the deficit. In 2015, the deficit on the current account shrank to 4.5% of GDP on the back of lower oil prices and weaker domestic demand. In 2016 it looks to stay broadly unchanged.

Policy steps taken to raise savings. Attempting to stimulate households to raise their savings several, the authorities have taken several measures. For example, a law aiming to improve the incentives for individuals to invest in their retirement through personal pensions came into effect in January 2013. In addition, in mid-2016 the private pension law was amended to include the automatic enrolment of private sector employees, a measure that was applauded by the S&P's in their recent decision to improve the outlook for the sovereign rating. However, the IMF judges that its impact on aggregate savings is likely to be small and that the reform has design shortcomings which could impede its effectiveness. We assume a broadly stable current account deficit in the medium-term.

Deficit financing is dependent on volatile flows. Turkey's external vulnerability also stems from the fact that it finances its deficits mainly by borrowing abroad, by loans, bonds issuance and through other debt creating capital inflows. The large share of debt financing compares unfavourably to risk class peers. In 2016 financing needs have been met relatively easily, helped by ample global liquidity, although funding costs rose slightly following the ratings downgrades by credit rating agencies. This being said, we note that net portfolio flows has been decreasing since mid-2013. Initially, the trend was driven by the expectations of normalization of US monetary policy which prompted a general increase in risk aversion. However, in the years that have followed it has been exacerbated by domestic political uncertainty.

Relatively low foreign direct investment inflows. Although foreign direct investment (FDI) inflows rose in nominal USD terms during 2009-2015, Turkey's share of global investment flows to emerging markets is at roughly the same level as a decade ago. In 2016, net FDI are expected to be roughly half of what they were in 2015, and at mid-year they covered only about 20% of the country's financing gap. Rising labour costs, a deteriorating business climate and an uncertain geopolitical situation are generally seen as key factors discouraging FDI. The purge following the failed coup this summer is seen as adding further risks to the business climate (see further below).

Official reserves remain adequate according to headline numbers. Official reserves in the hands of the central bank remain reasonably adequate at just over USD 100 bn, equivalent to more than 6 months of import cover. That is a gross number though. The sum includes foreign exchange deposited by banks with the central bank in order to fulfil their reserve requirements for lira deposits from the banks' domestic customers. The risk of relying on these bank deposits is that they may be pulled out if commercial banks should experience reduced access to international capital markets.



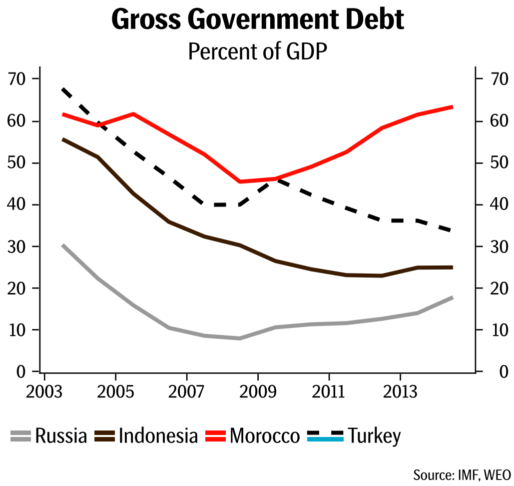
Subtracting also banks' reserve requirements related to their deposit taking in foreign exchange from the headline number gives a significantly lower net level of central bank reserves. Most estimates put net reserves at about USD 40 bn which would not finance more than 2-3 months' of imports. This is low by any standard for a country with a large current account deficit.

External debt – a rising challenge. External debt has continued to rise gradually and is likely to register 62% of GDP in 2016. While the debt level is somewhat higher than average for the risk class, it is fairly comparable to those seen in similarly developed emerging economies. Furthermore, average maturities have lengthened slightly in the past few years. Banks and the corporate sector stand for the major and rising part of the debt. Banks' foreign funding amount to just above 40% of the country's total external debt while the non-financial corporate sector's share is about 35%.

Economic Policies

Fiscal consolidation put on hold. Public finances strengthened considerably over the past decade and has been an important component in boosting Turkey's international credibility and our country risk class. While the budget discipline is broadly holding up it appears that the budget deficit for 2016 will be slightly higher than expected and planned, mainly due to the slower economic growth which should depress tax collection. A negative balance of 1.6% in 2016 is likely to be followed by a further widening in 2017 to nearly 2%. While this is not alarming and reportedly supported by the IMF, we see some risk that increased spending to counter what many believe is a partially structural economic downturn could jeopardize the government's long established fiscal anchor (or at least investors' perception thereof).

Government debt edging down from relatively low levels. A logical outcome of years' of relatively prudent fiscal policy is a low level of government debt. By the end of 2016 it is expected to be about 32%. The composition of the debt has improved steadily in the past decade shifting in favour of domestic currency debt (65% of total) and longer average maturity. The government's debt burden is expected to remain highly manageable in the coming years as it is likely to hover around 30% of GDP.



Contingent liabilities are manageable but rising. Contingent liabilities for the government are on the rise. They are mainly in the form of PPP guarantees and guarantees for foreign currency borrowing by state-owned banks and companies.

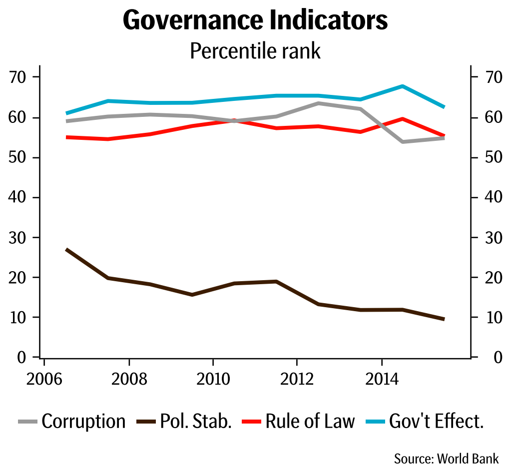
Monetary policy has become increasingly expansionary. Although the central bank practices an inflation targeting framework it has attempted to use monetary policy to address other challenges — credit growth, capital inflows and the exchange rate — simultaneously. This approach has been challenging which is reflected, in particular, in inflation staying above target for an extended period. Despite this, the central bank started easing policy in early 2016. By decreasing the overnight lending rate (upper band of interest rate corridor) it aimed also at simplifying the monetary policy framework and ultimately providing funding via a single rate. This was aimed at quelling criticism regarding the effectiveness of the transmission of monetary policy in the past. In July it also cut reserve requirement for banks. More recently, the drop in the value of the lira and the risk it poses for inflation forced the central bank to reverse its actions and hike two of its policy rates.

Banks are relatively well capitalised. The banking sector is well capitalised and asset quality is reasonably sound with non-performing loans making up about 3% of total loans. The banking sector's direct FX exposure is limited but indirect exposure has risen through their FX lending to the corporate sector to which most of their lending is directed. The past year's lira depreciation should raise pressure on the balance sheet of the corporate sector and thus pose a risk for the banks. The banking sector is regarded as well regulated.

Quality of institutions is eroding. The quality of Turkey's institutions had been on a slowly deteriorating path already before this summer's failed coup. However, the authorities' policies embarked on since then appear to be exacerbating this process.

While it is difficult to quantify the extent and short-term economy-wide effects of the deterioration, worsening scores in various qualitative surveys shed some light. Institutional health according to the World Economic Forum's competitiveness index has worsened, reflected by a country ranking of 74 out of 138 countries, down from 56th place in 2013. The World Bank's rule of law index dipped into negative territory this year and places Turkey at 55 among 189 countries. Similarly, the latest World Justice Project's rule of law index ranks Turkey at 99 out of 113 countries.

Furthermore, indicators of corruption and press freedom have slipped, in some cases quite significantly which is uncommon for countries at Turkey's level of development. Worsened institutional quality will make it more difficult for the authorities to lift economic growth and to implement the structural changes they have identified are needed to reduce the economy's external vulnerabilities.



Business conditions have worsened. Turkey still represents a reasonably dynamic place to do business compared to many peers. Nevertheless, investor sentiment is eroding. In the World Bank's Doing Business Survey, Turkey dropped 14 positions last year to number 55 among 189 countries (trailing peers such as Hungary and Russia). The purge following the coup initially targeted the public sector and the media, but has gradually spread also to other business sectors. The authorities have reportedly taken over management of around 200 private companies with alleged affiliations to the Gulen movement. Actions such as these may affect the country's growth path negatively by raising concerns regarding the protection of private investment and the investment climate in general.

Politics

Political uncertainty. Political risk has long weighed on Turkey's sovereign rating through concerns about discretionary policy making and government effectiveness, and their potential to discourage capital inflows. One of the main current and near-term determinants of Turkish political developments is the purge that AKP launched in the aftermath of the July coup. Other key contributors to the political risk are Turkey's military campaign in Syria and the Kurdish issue which have led to increased violence. A more longer-term factor is the EU accession process. Here we do not assume future EU membership in our risk rating.

Sovereign credit rating agencies downgraded Turkey following coup. Following the failed coup, Standard&Poor's which already had the sovereign in sub-investment grade downgraded their rating one notch and introduced a negative outlook. More recently, they reaffirmed their rating and revised the outlook to stable. The rationale behind the outlook revision was a perception of policymakers' determination to implement key economic reforms. In the summer, Fitch affirmed its BBB- rating on Turkey but lowered the outlook to negative. In September Moody's downgraded Turkey's long-term sovereign credit rating one notch to BB. According to the agency, the downgrade was caused by the increase in risks related to sizeable external funding requirements in addition to the weakening in previously supportive credit fundamentals including growth and institutional strength.

Outlook

Muddle-through is main scenario. The Turkish economy is widely expected to muddle through in the near and medium-term. Our house forecasters Oxford Economics see GDP growth at 2.9% in 2017, roughly in line with the IMF's 3%. The government in its budget rather optimistically assumes growth of 4.4%. While the past years' slow growth has had a cyclical component and Turkey has a relatively favourable demographic structure, the disappointing pace of structural reforms needed to raise productivity have led many analysts to downgrade their view on long-term (potential) growth. Oxford Economics see long-term growth at less than 3.1%, a significant downward shift compared to average potential GDP in the past decade of 4.6%. The IMF has a slightly higher estimate.

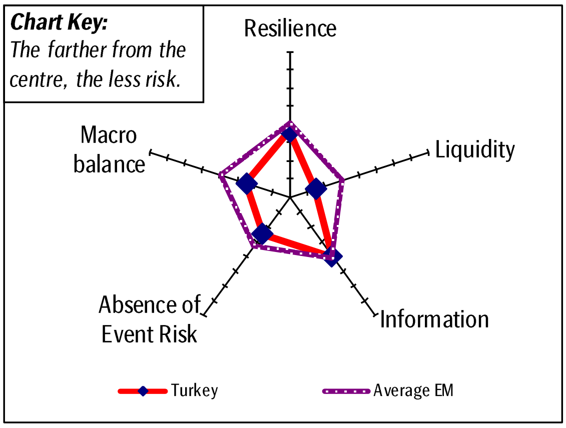
The government has made some progress on its reform agenda during 2016. We assume a continued progress in implementing politically non-sensitive reforms while fundamental reforms that move the economy away from being consumption-driven to a more broad based economy are not very likely in the medium-term.

Capital flow reversals is the key risk. One of the main risks to our main scenario is that of a prolonged outflow of capital. We do assume that foreign capital flows to most emerging market economies will be weak and that markets will force these economies to tighten policies. Continued currency depreciation and/or rising interest rates will then act to cool domestic demand and thereby shrink trade deficits. However, a sudden and more marked capital outflow should be seen as a key downside risk. Possible triggers include political/security related domestic events and an unexpected pace of monetary tightening in the US or sharper than expected USD appreciation.

Real and financial risks from Europe and the Middle East. Another important risk to the economic base scenario is a more modest than expected economic recovery in Europe. With a share of 45%, the continent is the largest destination of Turkish exports. Similar reasoning goes for the Middle East which is the second largest export destination with a share of some 30%. Europe also poses risks on the financial side as Turkish banks source part of their foreign funding from European banks.

Turkey: Risk Profile

Key ratios	2016
Population (mn)	80.4
GDP/capita (USD)	9 232
Real GDP (% chg)	2.8%
Inflation (%)	7.8%
Current Account (% of GDP)	-4.8%
Gross reserves/imports (months	6.2
Budget balance (% of GDP)	-1.6%
Government debt (% of GDP)	36%



External ratings:
Fitch: BBB- / Neg.
Moody's: Ba1 / Stable
S&P: BB / Stable

Peers:
Brazil
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.

Turkey: Key Indicators

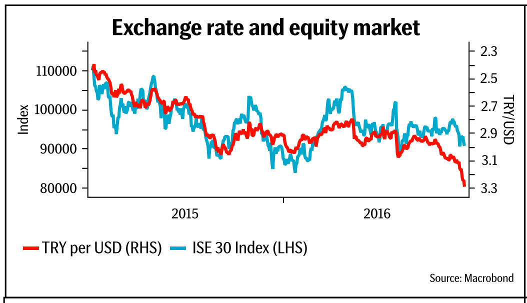
Key data:	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP (USD mn)	824	800	719	736	767	817	883
GDP/capita (USD)	10783	10297	9121	9232	9540	10078	10803
GDP (change)	4.2%	3.0%	4.0%	2.8%	2.9%	3.3%	3.4%
Investments/GDP	25%	24%	24%	23%	23%	23%	23%
Budget balance/GDP	-1.2%	-1.3%	-1.2%	-1.6%	-1.8%	-1.4%	-0.9%
Govt debt/GDP	38%	37%	37%	36%	35%	34%	32%
Money & Prices							
CPI inflation (%)	7.5%	8.9%	7.7%	7.8%	7.8%	7.1%	6.2%
Money demand (%)	53.9%	48.7%	59.5%	52.2%	48.3%	38.6%	34.9%
Stock prices	76398	77685	78782	79675	80434	81102	81723
Interest rates	6.8%	10.1%	10.7%	9.9%	8.4%	8.2%	7.9%
Exchange Rate (USD)	1.90	2.19	2.72	2.95	3.18	3.28	3.31
Trade/GDP (%)	49%	50%	49%	46%	45%	45%	45%
Oil price (Brent)	$109	$99	$52	$44	$50	$52	$59
Balance of payments (USD mn)							
Export of goods	161 789	168 926	151 970	148 959	149 340	160 339	174 063
Imports of goods	241 706	232 523	200 127	192 995	196 996	204 916	221 105
Other:	16 309	20 045	15 916	10 081	9 880	6 938	6 498
Current account	-63 608	-43 552	-32 241	-33 955	-37 776	-37 639	-40 544
Current account (%/GDP)	-7.7%	-5.4%	-4.5%	-4.8%	-5.5%	-5.2%	-4.9%
FDI	8 757	5 476	11 827	5 227	8 465	9 082	9 561
Loan repayments	-47 773	-41 372	-36 927	-30 539	-35 722	-40 574	-46 436
Net other capital flows	135 924	101 955	48 590	53 063	57 073	77 501	91 075
Balance of payments	33 301	22 507	-8 752	-6 203	-7 960	8 371	13 657
External Debt & Liquidity (USD bn)							
Reserves	106 360	107 410	97 609	100 157	99 450	105 979	113 814
Total debt	371 532	398 448	400 811	426 448	453 086	484 243	517 487
o/w short term debt	123 234	129 977	118 777	108 623	112 339	118 146	124 795

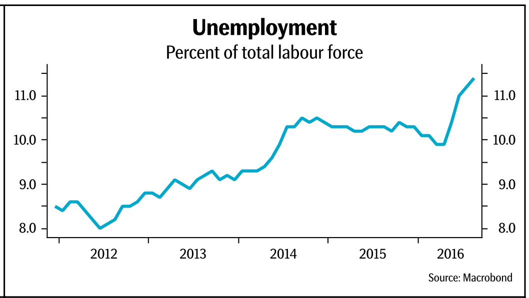
Sources: Oxford Economics and SEB estimates

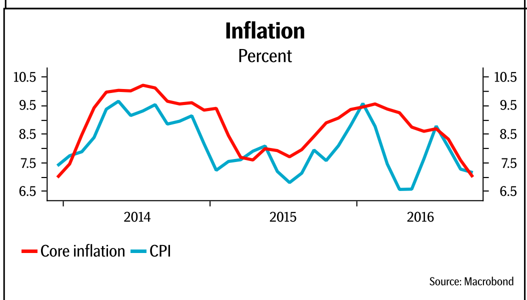
Rating history			
Moodys	Ba2	Ba1	Baa3
Fitch (eoy)	BB+	BBB-	BBB-

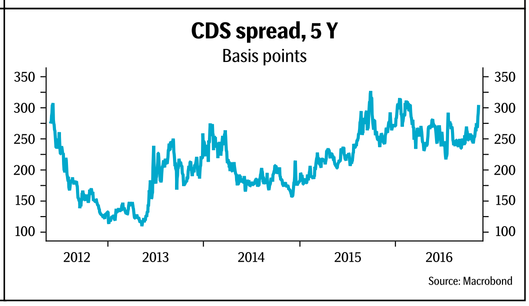
Type of government: Parliamentary Democracy
Next elections: Legislative: by October 2019; Presidential: August 2019

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









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