COFACE ECONOMIC PUBLICATIONS

DECEMBER 2017

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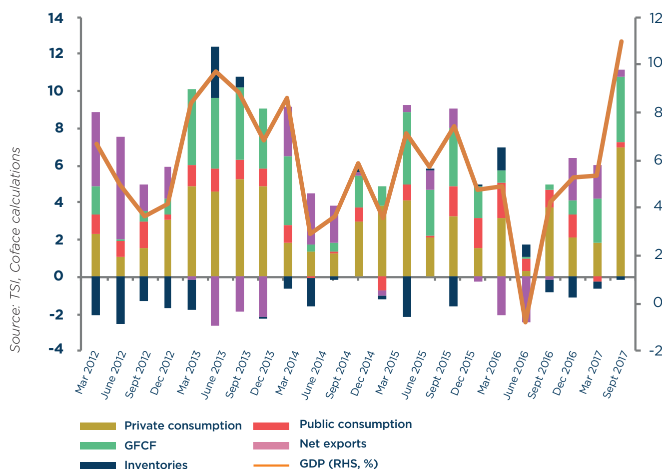
Turkey: Impressive growth but increasing vulnerability to external factors

Reasons behind growth

Turkey's economy grew substantially during the first three quarters of 2017, surging by 7.4% compared to a year earlier. During the third quarter, the economy expanded by 11.1% compared to a year earlier, the fastest growth among the G20 economies. This rise largely exceeded market expectations, especially considering the factors that negatively affected last year's economic activity. This year's growth has mainly been stimulated by government support, along with rising investments and exports. The recovery in private consumption has also contributed strongly to growth performance. Coface forecasts that the economy will expand by 6.5% in 2017 and 5.2% in 2018.

Turkey's economic performance was particularly impressive considering that the country had witnessed a series of shocking events in 2016 that threatened its political and economic stability, as well as its security. This resulted in Turkey registering negative growth in Q3 2016, while business confidence dipped and the lira lost 20% of its value against the US dollar over the year. The government subsequently decided to introduce countercyclical measures, by increasing the size of the credit guarantee fund (CGF) to ease small and medium companies' access to financing. The State acts as a guarantor for credit applications from non-financial companies and the size of the credit guarantee fund has been multiplied by more than ten, to reach 250 billion lira (nearly $64 billion). As of October 2017, the CGF had already allocated 219 billion lira. The impact of this credit supply shock to the second quarter's GDP is estimated to be +0.7 pp[1]. Nevertheless, this contribution was not visible in the growth figures for public consumption, which increased by only 3% (year on year) during the first three quarters of 2017. Most of the government's measures to support the economy were in the form of the CGF and tax cuts (such as on white goods and furniture). The economy has also been supported by mounting investments. During the first three quarters of the year, investments rose by 7.9% year on year, compared with 2.7% year on year in the same period of 2016. Total investments in the economy were led by a 12% jump in construction investments during

CHART 1
Contributions to GDP (pp)



1 - *Turkey: Credit Shock & the Economy*, BBVA, October 2017

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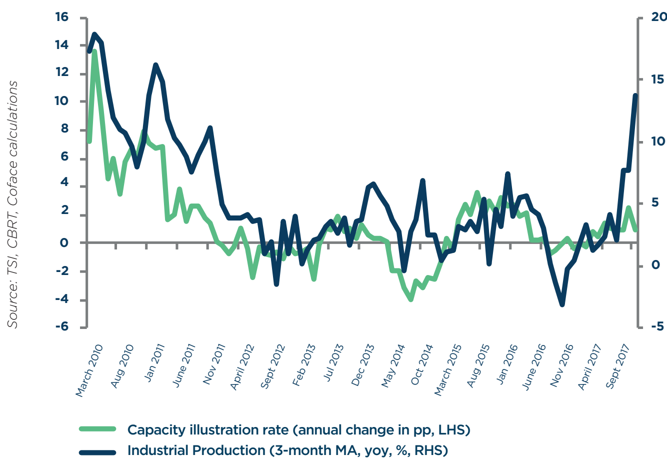
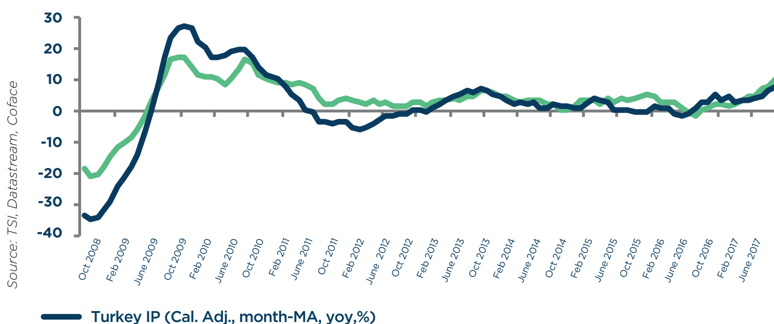
the third quarter, the most significant being a rise of 15.3% in investments in machinery and equipment (a leading indicator of increasing production capacity). The latter group notably witnessed an increase in the third quarter, after recording a continued decline for four quarters in a row. Political background noise and currency volatility contributed to the private sector's reluctance to invest in long term projects. With the capacity utilisation rate in manufacturing now approaching 80%, it is highly probable that investments will continue to increase production capacity in the upcoming period.

CHART 2
Industrial Production and Capacity Utilisation



Exports of goods and services, which rose by 13% year on year during the first three quarters of 2017, strongly supported the economy, while imports only increased by 5.6% year on year. The contribution of net exports to GDP growth stood at 1.4pp in the first three quarters and 0.3 pp in the third quarter of the year. The recovery in Europe is continuing to boost Turkey's export performance. In the January to October 2017 period, Turkey's exports to the EU-28 rose by 7% year on year, although the EU-28's share in the country's total exports slightly declined, down from 48.5% to 46.9%. The share of North American countries in Turkey's total exports rose from 5.1% to 6.2%, while the share of exports to Asian countries rose from 6.7% to 7.1%. This solid export performance was also influenced by the weakness of the lira and the flexibility shown by Turkish producers in terms of adapting their export market destinations. Following the European crisis, exporters switched their focus to Middle Eastern and African countries. Now, with European economies recovering and regional tensions rising, exporters are shifting back to Europe and North America. Nevertheless, exports to the Middle East and Africa still represent 23% of total exports.

CHART 3
Turkey's Industrial Production and German Manufacturing Orders



Private consumption also remained solid during the third quarter of 2017. After expanding by 3.1% year on year in the second quarter of the year, private consumption then hiked by 11.7% in the third quarter, adding 7 pp to GDP. A more detailed analysis reveals a recovery in the consumption of durable goods, which soared by 31% compared to a year earlier. This reflects the positive impact that tax cuts on products such as white goods and furniture have had on household consumption.

On the production side, industrial and construction activities accelerated, while services (which account for 22.3% of GDP) jumped by 20.7% year on year in the third quarter. Manufacturing posted a robust growth of 15.2% year on year in the third quarter of 2017. Looking ahead, strong industrial production and rising capacity utilisation across all sectors, combined with improving business sentiment, are expected to sustain growth performance - although the pace of growth could lose some momentum.

Supporting these expectations, industrial production rose by 6% year on year during the January to October 2017 period. Manufacturing PMI stood at 52.9 in November, indicating that business conditions among manufacturers continued to improve for nine months in a row - the longest period of consecutive growth since 2014. This phenomenon has been strengthened by solid growth in new orders[2]. Reports indicate that companies have increased their capacities to meet greater demand for output. This situation is confirmed by rising capacity utilisation ratios which surpassed 80% in the motor vehicles, electrical machinery, chemicals, paper and wood, textile and clothing sectors as of November 2017. Production in the automotive sector has been particularly supported by the recovery in Europe. In the January-October 2017 period, total automotive production rose by 17% year on year, while exports jumped by 21% year on year. In the white goods sector, where Turkey ranks as the second largest producer after China, with a production volume of 26 million units per year, domestic sales in four main product groups (refrigerators, washing machines, dishwashers and ovens) jumped by 18.2% yoy in the first eight months of 2017[3]. This surge in sales was led by the government's decision in February to remove the special consumption tax of 6.7% on white goods until the end of September. According to Turkbesd, the Turkish association of white goods manufacturers, sales should continue to develop further until the end of 2017, to record an annual growth rate of over 7%.

Loan volumes have also risen, due to the government's supportive measures, and this has somewhat eased the pressure on cash flow for businesses. As of mid-October 2017, annual growth in loans stood at 17.9% (adjusted for foreign exchange effects). Commercial loans (spot and commercial loans) rose by 36% yoy, while personal loans grew by 17%. A calming of currency volatility and political noise boosted confidence indexes. After dipping to 63.4 points in December 2016, the consumer confidence index rose as high as 72.8 points in May 2017, before falling to 65.2 points in November. Confidence among businesses has also improved significantly, reaching a 4-year high in October 2017. Expectations have improved markedly with regards to future production volumes, total orders and export orders. This is in line with Turkey's higher imports of intermediate goods, reported since the beginning of 2017. During the January to October period, imports of intermediate goods rose by 28% yoy, to $140 billion. These indicators suggest that the dynamics of consumption, production and exports remain solid and that growth will continue to be

2 - Istanbul Chamber of Industry Turkey PMI Manufacturing Index, Nov. 2017
3 - ÖTV desteğiyle Ağustos'ta rekoru kıran beyaz eşya sektöründe toplam satışlar ilk sekiz ayda %9.2 büyüdü, yılsonu tahmini %7.2, Reuters, 19/09/2017

strong throughout the first half of 2018. Nevertheless, the termination of government stimulus measures could weigh on the pace of growth in 2018. However, with local, parliamentary and presidential elections scheduled for 2019, the government could decide to introduce further measures towards the end of 2018, in order to support economic activity ahead of the elections.
After peaking to reach 13% in January 2017, Turkey's unemployment rate declined to 10.6% in August. The fast-paced increase in the country's population has resulted in high unemployment. The labour force has increased by 1.3 million people since August 2016 while 1.4 million people were able to find work. As a result, the number of unemployed declined by 89,000. With the rising labour force participation rate (53.7% in August 2017, compared to 52.6% in August 2016), the economy is struggling to create sufficient jobs within such a short space of time.

External vulnerabilities indicate risk of overheating economy

Turkey's structural lack of savings will continue to be the economy's Achilles heel over the years ahead, resulting in widespread current account deficits. The government's CGF programme has encouraged bank lending, thus pushing the banking sector's loan to deposit ratio up to as high as 125% during the second quarter of 2017. In addition to augmenting risks in the banking sector, this situation also heightens risks related to foreign exchange rates and dampens the rebalancing of the country's external deficit (as it boosts imports). The recovery in domestic consumption and the recent increase in energy prices could bring about a wide current account deficit in the period ahead. The forecast for the current account deficit to GDP ratio is expected to be 4.6% of GDP in 2017 and 4.3% in 2018. This would leave the economy dependent on external financing and vulnerable to volatility in exchange rates. The exit strategies of major central banks, along with rising regional tensions, could quickly deter investor sentiment, meaning that foreign direct investments would remain limited over the coming years.
The current account deficit during the first ten months of 2017 stood at $35.3 billion, up from $26.4 billion for the same period in 2016. During the same time, the trade deficit of $46.4 billion widened the external gap, although tourism revenues of nearly $20 billion helped to narrow it. The largest share of the current account deficit was related to trading in gold and energy. During the first ten months of the year, Turkey reported trade deficits of $26.1 billion in energy and $7.9 billion in gold trade. If these effects were excluded, Turkey's current account deficit would be reduced to $1.3 billion. Gold is particularly important in Turkey as a savings instrument for households. They benefit from the high convertibility of gold into cash, should they need money to meet their liabilities. This demand from households has led to an increase in gold imports since the beginning of 2017.
The main vulnerability remains on the funding side of the current account deficit, as it is largely financed by short-term capital inflows. In the January to October 2017 period, almost 65% of the deficit was financed by portfolio investments which amounted to $25.3 billion – up from $11 billion for the same period in 2016. Foreign direct investments inched down to $6.3 billion for the first ten months of 2017, compared to $7.5 billion for the same period in 2016. If there were to be a further decline in foreign direct investments, Turkey could become more reliant on short-term capital in order to finance its external gap. This would

CHART 4
Turkey's current account balance

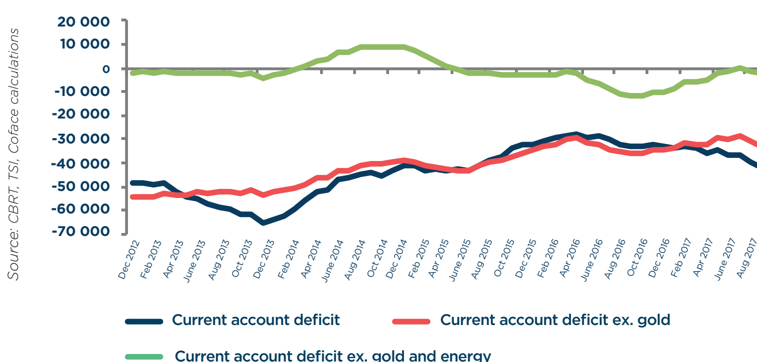
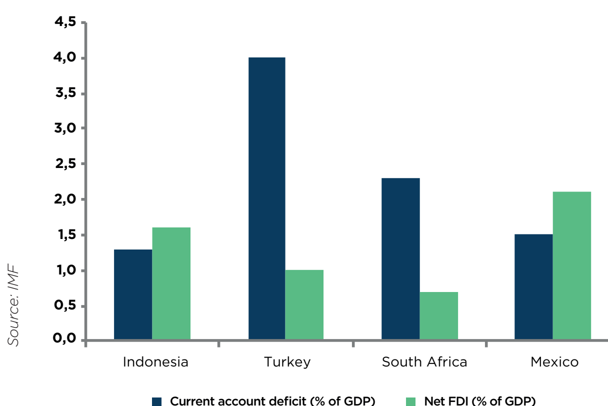
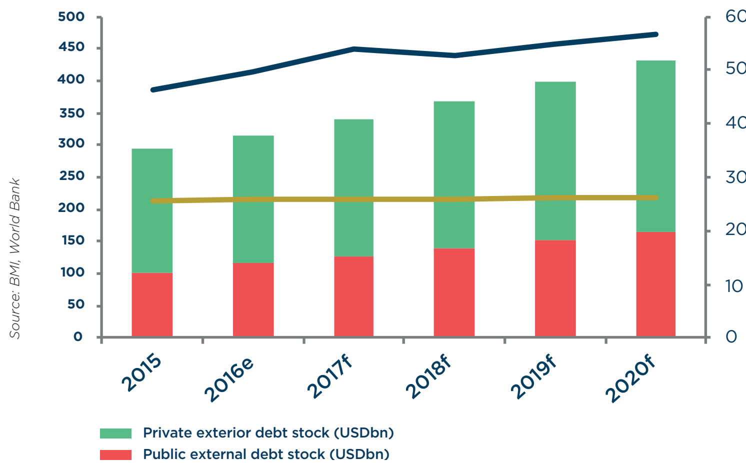


CHART 5
Current account balances and net FDI (12-month cumulative, % of GDP)



increase the country's dependence on global financial investors and worsen its vulnerability to exchange rate shocks. External funding of the banking sector will therefore continue to be an important source of financing for the economy. Nevertheless, these inflows could become very volatile if domestic or regional instabilities intensify. For now, however, these risks appear to be contained, as the central bank's tight monetary policy is supporting carry-trade flows into the country.
Turkey's vulnerability to external factors is similar to those of South Africa, Indonesia and Mexico, which all have current account deficits - although Turkey's deficit is large compared to its peers. During the first half of 2017, South Africa witnessed net outflows of $2 billion in the form of foreign direct investments. It attracted total portfolio investments of $5.5 billion, which helped to finance its external gap of $3.7 billion. In this regard, Turkey's external accounts seem to be in similar shape to those of South Africa, insofar as its current account balances remains high compared to GDP levels. In contrast to South Africa, however, Turkey is still able to attract direct investments, which are partially helping to finance its current account deficit.
Despite this, Turkey's external debt is increasing and the country's gross external debt stock reached $432.4 billion (the equivalent of 51.8% of GDP) at the end of the second quarter of 2017, compared with 37.8% at the end of 2010. This could create pressure on growth if there is a further depreciation in the lira. 25% of Turkey's debt stock is short-term (i.e. less than one year) and this is a high percentage by emerging market standards.

CHART 6
Turkey External Debt Forecast



Rising interest rates on banking loans represent another challenge for the country's investment dynamics. Higher borrowing by the Treasury, an aversion to volatile risks in emerging countries and the central bank's tight monetary stance are all contributing to the rise in interest rates. Weighted-average interest rates on commercial loans reached 15.8% at the end of October 2017, up from 12.9% in December 2016. During the same period, interest rates for individual loans rose as high as 17.1% - up from 14.8%. These high levels of interest rates could hamper cash flow management in the corporate sector and dampen business enthusiasm for making new investments. This is also due to the central bank policy measures which increased average funding costs to 11.95% at the end of October 2017, up from 8.3% at the end of 2016.

Higher prices and taxes could weigh on private consumption by reducing purchasing power. Growing inflationary pressure has forced the central bank to tighten itspolicies. In November 2017, consumer prices rose by 1.49% on a monthly basis, contributing to an annual rise of 12.98%. Inflation has continued to increase, pushed by rising food prices, the weak lira, strong economic activity and demand-driven dynamics (such as growth in loans and tax cuts on white goods and furniture). The current level of annual inflation is well above the central bank's target of 5% and its 9.8% end of year forecast for 2017[4]. In annual terms, core inflation rose to 12.08% in November, up from 11.82% in October, marking a several year-high. Inflation is likely to remain high due to the recent weakness of the lira against the dollar and the euro. The prices of durable consumer goods are particularly sensitive to the lira's value against the euro, as most of these goods are imported in euros. For producers, however, it is the lira's exchange rate against the dollar which is more important, as most commodities are imported in dollars. The depreciation of the lira against these two currencies since September (approximately 12% versus the dollar and 11% versus the euro) is therefore likely put upward pressure on inflation both in terms of consumer and producer prices - although there could be a temporary easing in consumer prices during the first few months of 2018 due to the base effect. On the other hand, any deterioration in inflation expectations may deteriorate pricing behaviours in the upcoming period. The central bank would therefore need to keep its monetary stance tight, meaning that interest rates will remain high. The central bank has been providing liquidity to the banking system at a rate of close to 12% since early May. The bank could further tighten its monetary policy by increasing its average funding rate. During its monetary policy meeting in December 2017, the bank increased the lending rate of its late liquidity window by 50 basis points to 12.75% and said the tight stance in monetary policy will be maintained until inflation outlook becomes consistent with the targets. The bank also said it may deliver further monetary tightening, if needed.

In summary, it would appear that risks to Turkey's short term growth are contained and that debt levels remain manageable. Nevertheless, rising inflation, unemployment and recent tax hikes could weigh on private consumption. In the medium-term, if domestic or regional tensions rise, there will be increased pressure on the management of the country's twin deficits. The risk aversion of global financial markets to emerging countries and the monetary policies of the major central banks will also be important factors to monitor, as will the lira's exchange rate - which could have very negative consequences if there were to be a sharp depreciation.

4 - Inflation Report IV, November 2017, CBRT

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