KFW ECONOMIC RESEARCH

Emerging Markets Spotlight

No. 5, 12th February 2015

Turkey – A bridge between East and West opening up opportunities

Author: Alexander Klein, phone +49 (0) 221 4986-1252, alexander.klein@deginvest.de

Economic situation

- Real growth
- Growth in private consumption
- Risk premium (government bonds)

Growth still below potential

At about 3 %, economic growth was relatively modest in 2014, despite a good start to the year. While the service sector remained comparatively robust, construction only improved marginally. Private consumption is important for Turkey and strengthened in the second half of the year but was impacted by mounting debt. Slightly higher growth is expected in 2015.

Growth financing

- Current account balance / GDP
- External debt / GDP
- Currency reserves (import months)

Continued sensitivity to shock

The chronic current account deficit, financed mainly by volatile portfolio investments and loans, is decreasing by trend. In light of the high import bill for energy, the evolution of oil prices will bring further relief. Foreign debt remains high and the currency reserves too low on account of the large proportion of short-term external debt.

Growth resources

- Investment ratio
- Energy use / production
- Relative unit labour costs (yoy)

Weaknesses – energy and competitiveness

Given its own low energy production, Turkey's growth is fundamentally too energy-intensive. Overall, the Turkish economy requires greater capital expenditure, in particular to boost productivity so as to maintain its ability to compete internationally and avoid a middle income trap.

Economic relations with Germany

- German share in goods exports
- German share in goods imports
- FDI inflows from Germany

Germany as an important economic partner for Turkey

Although its importance has tended to decrease over the last ten years, with an export share of just under 10 %, Germany continues to be Turkey's most significant bilateral sales market. In terms of imports, Germany is also a heavyweight with a market share of around 10 %.

Legend (for detailed explanation of methodology see p. 4)

excellent	good	neutral	weak	very weak
much improved	improved	stable	worse	much worse

Investment climate: assessment of our local experts

Turkey's recovery has lost momentum and the IMF is calling for economic reforms. The current low growth rates may still be significantly higher than those of the EU member states but structural reform is required to fully utilise Turkey's economic potential. The current reform path is likely to bolster the investment climate, even though far-reaching measures are not to be expected until after the parliamentary elections in summer.

Continued on p. 2

Focus: Turkey as a bridge to the East

Turkey was regarded as a potential success among the emerging economies for a long time. Its direct proximity to the conflict in Syria and Iraq, its domestic policy and its susceptibility to shocks originating elsewhere however lead to a quite different perception. But which impression is right? The fact is that Turkey's potential remains considerable, particularly as a crossover point between East and West, despite the challenges posed by its domestic economy and the country's susceptibility to shocks.

Continued on p. 2

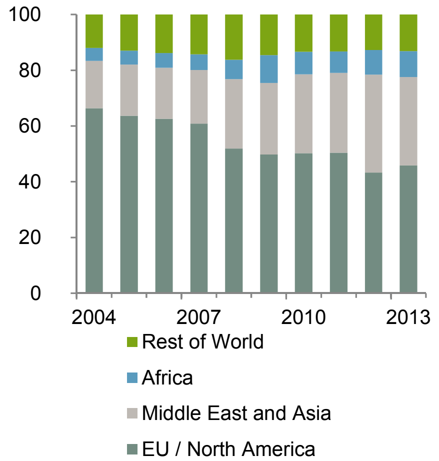
Investment climate: assessment of our local experts

Economic potential and current challenges: Turkey's key advantages are its large, growing domestic market and the international integration of its economy. While the country has produced competitive enterprises and, in recent years, demonstrated flexibility in tapping into new markets, domestic demand and private sector investment are currently declining. The once high growth rates of 8 % and more are a thing of the past. One side effect of the consumer-led growth is that indebtedness has been increasing, both among companies and households. The traditionally high imports of energy, intermediate products and consumer goods are leading to a chronic imbalance on the current account. Energy imports, which make up approximately 6 % of GDP, should therefore be reduced by investing more in domestic power generation, including renewables and the use of coal. The current account deficit is predominantly (and increasingly) covered by short-term portfolio investments and no longer mainly by long-term direct investment, meaning the economy is susceptible to external shocks, particularly against the backdrop of a change in direction of US monetary policy. Even the first announcements on this in May 2013 exerted a significant impact on the foreign exchange market. That is why the IMF recently warned Turkey about this vulnerability and, in light of an inflation rate that was almost back in double-digit territory, called for a more restrictive monetary and fiscal policy alongside urgently necessary structural reforms. This would make the country more attractive for foreign direct investments and lessen its dependency on short-term inflows of funds by increasing the domestic savings ratio. The goal is to make Turkey more competitive in the hope of preventing the country from languishing in a middle income trap and, over the medium to long term, helping it to again achieve growth levels in excess of 5 % p.a. The Turkish government recognises this challenge and is responding with the "Medium-term Economic Plan 2015–2017". This includes reform plans that are intended to both decrease reliance on imports and have a positive effect on the business climate, government spending and the labour market. Some elements, such as the promotion of technology investments, were taken up promptly. Other, and in particular more painful, steps will probably not be taken until after the parliamentary elections in summer. The continued economic success of the country will also depend on whether the recent doubts regarding legal security and the independence of the central bank prove to be groundless.

There is investment potential despite a slowdown in growth: The challenges faced at present and lower GDP growth should not, however, conceal the fact that with growth rates of well over 3 %, the economy of Turkey, as a member of the EU Customs Union, is expanding far faster than that of the European Union. The currently low oil price will relieve pressure on the current account balance, at least for a while, and give a little boost to the economy. In spite of foreseeable lower future growth in private consumption, a number of sectors in Turkey continue to offer (catch-up) potential, for example the petrochemical, automotive and food industries, as well as the health and energy sectors. The promotional offerings for direct investors are not only being used by the thousands of German companies present in Turkey. Enterprises from Asia in particular are attempting to raise the potential in the above-mentioned sectors by setting-up production facilities, while at the same time gaining duty-free access to the EU.

Based on an interview conducted on 18th December 2014 with Winfried Nau (Director, DEG Representative Office in Istanbul).■

Figure 1: Turkish exports, percentage share



Source: Turkish Statistical Institute

Focus: Turkey as a bridge to the East

International trade is an important economic factor for Turkey. The EU is Turkey's major trade partner, thanks to the country's membership in the EU Customs Union. About 40 % of exports, worth some USD 60 billion, are destined for EU member states. But imports from the EU also play a key role. Around 36 % of Turkey's imports come from EU members. Germany, the United Kingdom and Italy are the most important trade partners within the EU. Germany is the main bilateral export market, accounting for almost 10 % of all Turkish exports..

But membership in the EU Customs Union also has its downside, as it compels Turkey to reduce its import duties on goods from third-party countries with which the EU has negotiated bilateral free trade agreements, even though Turkey does not automatically enjoy duty-free market access. As Turkey is only a member of the Customs Union, it is excluded from the bilateral agreements with the EU and is therefore compelled to negotiate separate agreements with those countries. Given this state of affairs, Turkey regards the free trade agreement being discussed between the EU and USA with some concern as it

Figure 2: Gas imports 2013, percentage shares

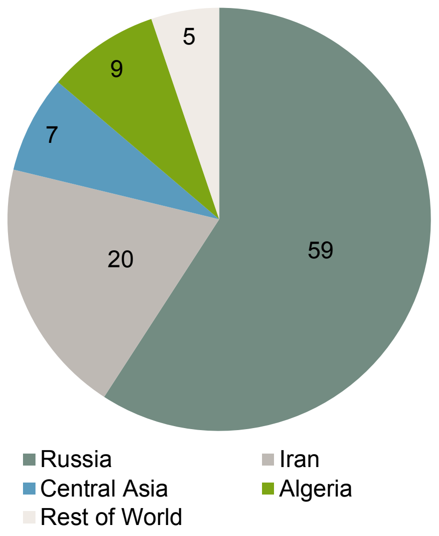
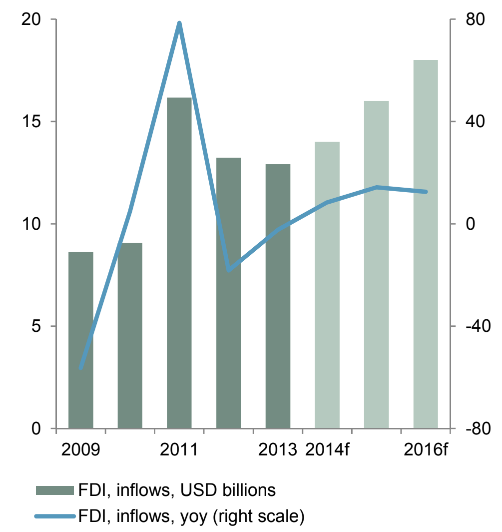


Figure 3: Direct investments



Source: EIU, UNCTAD World Investment

would open the door for competing American companies not only to the Turkish sales market but also to the country itself, without Turkish goods automatically being permitted to move in the opposite direction.

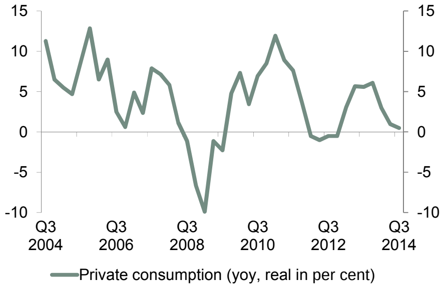
This is why Turkey is using its geostrategic position to build up additional trade relations. The focus here is on both states in the Middle East and all those along the Silk Road to Asia. For example, Iraq is the country's biggest bilateral trade partner after Germany. Ten years ago, the country's share in Turkish exports stood at less than 3 %. Around 7 % of Turkish exports now find their way to Iraq. Another example of additional markets outside the EU is the Shanghai Cooperation Organisation (SCO), a regional organisation for economic and military cooperation. Among its members, including countries with observer status, are China, Russia, Pakistan, India and Iran. Turkey is currently an official dialogue partner and in 2013 it applied for the next highest status of observer. Trade with the members accounts for a good 10 % of Turkey's exports and nearly 30 % of its imports. But not only trade is significant here. We are also seeing strategic direct investments from these countries. In 2009, direct investments from the EU still accounted for three quarters of the total. This share is now declining and companies from Asia and the Middle East are filling the gap. This is how, for example, banks from China, Japan and the gulf states have recently been expanding their presence in Turkey through equity interests and the opening of branches.

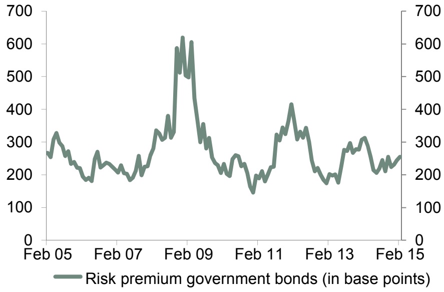
The economic relationship with Russia is worth noting. Despite foreign policy differences (Turkey is an opponent of the Assad regime in Syria, Russia supports it), the relationship has grown in importance. Presidents Erdogan and Putin once again underlined the importance of the bilateral economic relations during the Russian president's most recent visit to Turkey and formulated ambitious expansion plans. Russia is already the most important supplier of gas to Turkey with a share of about two thirds. The construction of the country's first nuclear power plant by Russia is also planned for the future.

The presence and investment activities of many multinational companies make it clear that, in view of its external economic relations with the East and West, Turkey is an advantageous location for their regional business, despite the challenges presented by its domestic economy and its sensitivity to shocks from beyond its borders. ■

Overview of figures

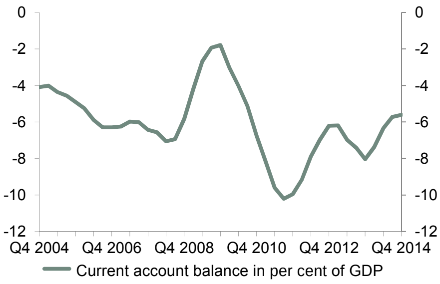
Economic situation

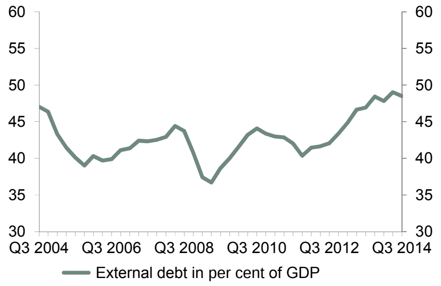


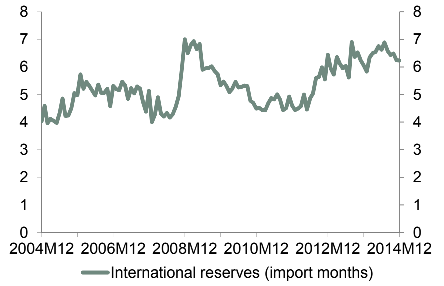


Source: Datastream; OECD, JP Morgan; own calculations.

Growth financing

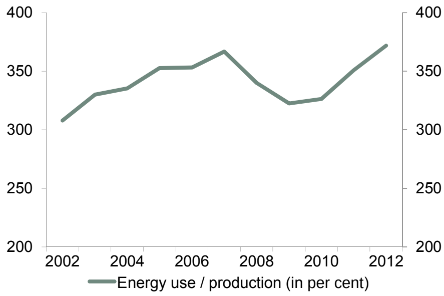






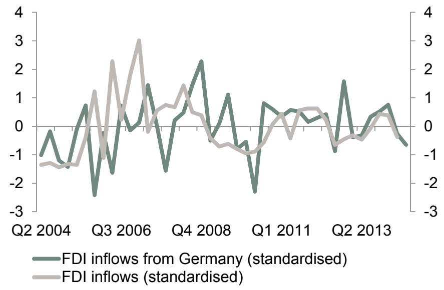
Source: Datastream; IWF, Central Bank of the Republic of Turkey, Worldbank; own calculations.

Growth resources



Source: Datastream; OECD, Worldbank; own calculations.

Economic relations to Germany



Source: Deutsche Bundesbank; Datastream; IMF, OECD; own calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

Firstly, the development of the indicators over time is examined for the country itself. As a rule, the analysis is based on the last ten years. The direction of arrow is determined by the current change in comparison to the previous period. An improvement in the indicator is shown with an arrow pointing upwards, while a deterioration is shown with an arrow pointing downwards. A horizontal arrow indicates that the variable is practically unchanged. For example, a higher inflation rate compared to the previous period signals a deterioration, and – depending on the extent of the change – is labelled with an arrow pointing diagonally or straight downwards. The magnitude of the absolute change compared to the average historical absolute change determines the extent of the change and therefore the direction of the arrow.

- ⇧ Strong improvement in the given indicator: > 3/3 of the historical absolute change
- ⬀ Improvement in the given indicator: 1/3 – 3/3 of the historical absolute change
- ⇨ Slight change in the given indicator: <1/3 of the historical absolute change
- ⬂ Deterioration in the given indicator: 1/3 – 3/3 of the historical absolute change
- ⇩ Significant deterioration in the given indicator: > 3/3 of the historical absolute change

Secondly, the indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours:

- Quintile 1
- Quintile 2
- Quintile 3
- Quintile 4
- Quintile 5

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

Disclaimer

This paper represents the authors' opinions and does not necessarily reflect the views of KfW. Any data and information contained in this publication has been prepared to the best of KfW's knowledge. KfW does not assume any liability for the correctness, comprehensiveness or timeliness of such data and information. By providing this publication, KfW does not render any individual investment, legal or tax advice nor does this publication supersede such individual advice.