Turkey Business Update

ECONOMIC SNAPSHOT | Uncertainty and rigor

Toward a bona fide high-income economy

National elections with unexpected outcomes, attacks by suicide bombers and global geopolitics have made 2015 a challenging year for the Turkish economy.

Back-to-back elections in June and November turned financial markets skittish. In June, the country's ruling party, the AKP, or Justice and Development Party, lost its legislative majority for the first time since coming to power in 2002.The AKP is the party of both Turkey's president (and former prime minister), Recep Tayyip Erdogan, and its current prime minister, Ahmet Davutoglu. Under Erdogan's leadership, Turkish gross domestic product more than doubled between 2003 and 2014, rising from $305 billion to $800 billion.

In the absence of a clear political majority following the June results, the major political parties could not agree about forming a coalition. The governmental paralysis exacerbated concerns by voters and investors about inflation and the slowing growth rate. The main index of the BIST (Istanbul Stock Exchange) dropped, and the Turkish lira weakened. Voters were also concerned about terrorism, since Turkey has seen a series of attacks this year.

On Nov. 1, a second national election was held, with President Erdogan counting on the AKP to recoup its parliamentary losses. Some commentators and critics doubted his strategy, but he succeeded in decisive fashion, capturing 49.5 percent of the votes and winning a comfortable 84-seat majority in the Grand National Assembly.

The political stability portended by this outcome was reflected immediately: the value of the Turkish lira jumped sharply the day after the election, while the BIST soared 5.5 percent.

These events took place within the context of an economy that grew less than 3 percent in 2014, below an originally forecast 3.3 percent. Placed in a wider context, this was more than double the 1.3 percent growth rate of the European Union during the same period. The Organization for Economic Cooperation and Development predicts that Turkish GDP will bounce back to 4 percent growth in 2017.

To give a longer-term perspective, Turkey's annual GDP grew at a average annual rate of 4.5 percent between 1960 and 2012, earning it the moniker "the China of Europe."

Not only has the economy grown almost consistently over time, it has done so without a widening discrepancy between elites and the middle class. The World Bank reports that the income of the bottom 40 percent of Turkey's population increased almost at the same rate as total population growth, indicating that wealth has been broadly shared among the country's almost 77 million people. The proportion of the middle class more than doubled, from 18 percent to 41 percent of the population, from 1993 to 2010.

To fuel this growth in coming years, analysts say, more foreign direct investment will be needed. In 2014, FDI amounted to $12.5 billion. This year, it is estimated to be $9.7 billion, which Ömer Gencal, treasury coordinator of Fibabanka, a Turkish private bank, calls "a relatively low figure when you consider the current-account deficit and financing needs of Turkey."

According to Mehmet Gerz, general manager of ATA Asset Management: "As a growing country with a low savings rate, Turkey needs more FDI to sustainably finance its investments. The more FDI Turkey attracts, the less foreign debt it accumulates to finance its current-account deficit."

The current-account deficit has been declining this year, stabilizing exchange rates, thanks in part to strong government budget discipline. Gerz points out that Turkey's ratio of public debt to GDP was an impressive 34 percent in 2014, around half the level of 10 years ago.

"It is one of the few countries that meets the budget and debt rules of Maastricht criteria," he says. "The government's medium-term program envisages further decline to 30 percent in public debt/GDP ratio by 2018. Without this rigor, Turkey would have probably lost its investment-grade status amid political uncertainty."

Future performance, however, also depends on external factors over which the country has no control. Changes in U.S. monetary policy since mid-2013 have reduced cheap dollar funding for Turkey. The probability looms that the U.S. Federal Reserve will raise interest rates. Should that occur, as expected, Turkish businesses will be paying more to service their dollar-based debts. Gerz and Gencal both suggest that Turkey will raise its short-term interest rates accordingly, "to compensate the country's risk premium," as Gencal says.

Notwithstanding these uncertainties, the World Bank predicts that Turkey will graduate from the ranks of "emerging economies" to become a bona fide high-income economy within a few years.

"With a per capita income of around $10,500, Turkey is just a few years away from crossing [this] threshold," wrote Laura Tuck, then World Bank vice president for Europe and Central Asia, in an institutional report in December 2014. The OECD estimates that Turkey will be the 12th-largest economy in the world by 2060. ■

SHUTTERSTOCK

The Organization for Economic Cooperation and Development predicts that Turkey's gross domestic product will grow by 4 percent in 2017.

BANKING | Potential for growth

Tight fiscal policy puts the accent on financial-sector assets

With the second-largest banking system among Europe's more than 20 emerging markets (Russia's is first), Turkey offers attractive opportunities for global investors. Almost 90 percent of the Turkish financial sector consists of bank assets, and the country's 51 banks finished 2014 with $860 billion in total assets in spite of a slowing economy, according to Mehmet Gerz, general manager of Ata Asset Management. Nonperforming loans were 2.8 percent at the end of 2014. Capital-adequacy ratios in 2014 were more than 16 percent, far above the minimum Basel III ratio of capital-to-risk weight assets of 10.5 percent.

More convincing than any individual economic indicator is the Turkish regulatory environment: independent and cautious. Fiscal policy is equally tight and consistently supportive of the government's monetary policy.

> **The challenges facing Turkey's banking system are more than balanced by a series of infrastructural strengths**

"Banks' capital ratios are still in double digits thanks to the cautious approach of banking regulators," says Gerz, "requiring banks to retain most of their earnings."

Return on equity (ROE) declined in 2015, in part because of restrictive regulations imposed by Turkish bank regulators regarding credit, according to Ömer Gencal, treasury coordinator of Fibabanka, a Turkish private bank. A similar view was expressed by Deloitte Touche Tohmatsu in its February 2015 report on Turkish banks.

Gencal cites a second reason for bank ROE declines: exchange-rate volatility. Fluctuations in the Turkish lira for much of the year caused banks to hedge their foreign-exchange liabilities by buying up lira. "The cross-currency-swap yield curve shifted dramatically during this time," he says, "whereby Turkish lira deposits also increased and narrowed net interest margins, leading to a decline in ROEs."

Loan-to-deposit ratios are above 100 percent, which has compelled banks to rely on foreign funding, further exposing them to foreign-exchange liabilities.

This exposure to both credit risk and currency fluctuations is one of the weaknesses of Turkish banking these days. Another is the relatively low savings rate: the savings-to-GDP ratio was 13 percent in 2013 and is expected to rise slowly to 14.3 percent by 2018, according to the International Monetary Fund.

The challenges facing the banking system are, however, more than balanced by a series of infrastructural strengths. First, the market offers significant growth potential. The population of almost 77 million is young and dynamic. Almost 43 percent are between the ages of 25 and 54, making Turkey's the youngest population in Europe. Second, bank account penetration is 58 percent, low for the 17th-largest global economy (the world average is 62 percent), so there is ample opportunity for expansion. Third, the ratio of total customer deposits to GDP is 60 percent, compared with 112 percent in the eurozone.

Confidence is key in leveraging such growth. "We are talking about a sector where trust is crucial between lenders and borrowers," says Dündar Parlar, assistant general manager of HSBC Turkey, in the Deloitte report. "If the trust in the sector increases, both the deposit base and the loans granted will grow."

The basis for such trust exists. Four of Turkey's top 10 most valuable brands in 2015 were banks, according to research by the international brand valuation company Brand Finance. Heading the list was Akbank, with a brand value of $2.516 billion, beating out Turk Telekom, Turkish Airlines, the BIM supermarket chain and the country's most popular soccer team.

For Akbank, consumer-bank trust resulted in a 25 percent increase in deposits in the first nine months of 2015, topping 152 billion Turkish lira ($51 billion). "The strong growth in our deposits will strengthen our hand in providing higher loan support," says Akbank's chief executive officer, Hakan Binbasgil — a benefit for customers, the banking sector and the government. ■

SHUTTERSTOCK

In the pipeline: Lower commodity prices should help reduce Turkey's import expenditures as well as its current-account deficit, forecast to fall below $35 million this year.

Bright spots on the economic horizon: A stronger currency and falling energy costs

Economists may disagree on whether a strong Turkish lira is good for the overall economy, but there is no doubt it is good for Turkey's energy needs. As an emerging market, the country has a voracious appetite for oil and natural gas, having imported 70 percent of its needs in 2014. Turkey's energy-import bill is around $50 billion, $10 billion more than the country's current-account deficit of $40 billion. So reducing reliance on energy imports would both strengthen the economy and protect it from political and foreign exchange uncertainties.

Despite government efforts to bolster domestic energy sources, Turkey remains dependent on imported oil, natural gas and most other commodities, according to Mehmet Gerz, general manager of Ata Asset Management. In 2014, Turkey produced 13 percent of its own crude-oil supply. Iraq and Iran each provided more than a quarter. Russia, which had previously been the largest source for Turkey's crude oil, supplied only 3 percent last year.

As for gas, Turkey is well positioned to become a significant natural gas pipeline hub, says the U.S. Energy Information Administration. At present, Turkey's domestic energy demands mean that gas is being imported rather than exported, but this is expected to change in the future.

Gerz predicts that "lower energy and commodity prices as a result of China's slowdown are going to reduce Turkey's import bill." As a result, Turkey's current-account deficit is projected to fall below $35 billion in 2015.

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