Business Opportunity Report | Turkey

May 2016

Turkey: Downside risks to growth

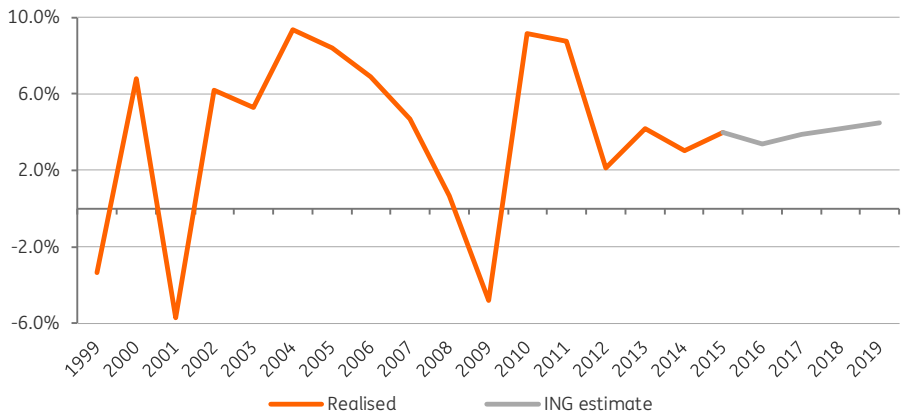
In the midst of a challenging (geo)political situation, we expect Turkish economic growth to slow somewhat to 3.4% this year but to accelerate from 2017 onwards. Further weakening of the Turkish lira is a risk however, because domestic political uncertainty is rising and monetary authorities are under pressure to loosen their policy. Turkey needs to manage this situation carefully to be able to attract the foreign direct investments that it depends on for economic growth. Rising income levels offer opportunities for companies that export to Turkey. On the other hand, the number of imposed measures that protect domestic producers far exceeded that of trade liberalisation measures in recent years. We expect imports to grow at an annual rate of 6-7% in US dollar terms through 2019.

Macroeconomic picture

In 2015 economic (GDP) growth in Turkey accelerated to 4.0% from 3.0% in 2014. Despite geopolitical risks in neighbouring countries, Turkey performed better than most other emerging markets. However, the economy grew slower than it did in recent years. 2015 activity was mainly driven by an acceleration of growth in household consumption to 4.5% from 1.4% in 2014. Public spending also accelerated as a result of two general elections. As opposed to recent years, growth in household demand could not be explained by consumer lending. As real income growth did not change significantly either over the last two years, we suspect that the increase in household consumption was driven by the influx of 2.7 million Syrian refugees. This source of growth may not be sustainable but their integration into the economy should be a plus.

Currently, the Turkish government is taking measures to stimulate the economy. In 2015 growth in government consumption accelerated to 6.7%, from 4.7% in 2014. The budget performance remains on track despite concerns that the expansionary policies might weigh on Turkey's fiscal metrics. We expect that the rise in budget deficit as a percentage of GDP will be very limited; from 1.2% in 2015 to around 1.6% in 2016.

Graph 1: GDP, annual real growth



Sources: Turkish Statistical Institute & ING

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We expect economic growth to slow down to 3.4% in 2016 but to accelerate to 3.9% in 2017, 4.2% in 2018 and 4.5% in 2019

Geopolitical issues and terrorist attacks weigh heavily on tourism. They are also impacting confidence of foreign investors. This is worrisome given Turkey's reliance on external funding to finance economic growth. The possibility of further (unexpected) raises in the United States (US) interest rate leading to capital flight from emerging markets to the US is another downside risk. We expect economic growth to slow down to 3.4% in 2016 but to accelerate to 3.9% in 2017, 4.2% in 2018 and 4.5% in 2019.

In April 2016 the annual rate of change in the consumer price index (CPI) decreased further to 6.6% from 7.5% in March, 8.8% in February and 9.6% in January. Producers in the Food & Non-Alcoholic Beverages industry saw their prices come down by 1.5% compared to March. The largest annual price increases were found in Alcoholic Beverages & Tobacco (12.8%) due to a hike in the special consumption taxes on these goods.

The Exchange Rate and Trade

In the first four months of 2016, the improving capital flow data for Turkey and the stimulatory policy of global central banks, combined with better than expected inflation figures, halted the fall of the Turkish Lira (TRY) against the euro. However, given a rise in domestic and geopolitical uncertainty and recent loosening of monetary policy by the Turkish central bank, we expect the TRY to resume its decline.

In March 2016 the 12-month rolling current account deficit fell to its lowest level since July 2010

Despite the depreciation of the lira, the volume of exports contracted 0.8% in 2015 after growing 7.4% in 2014. On the contrary, the volume of imports grew 0.3% in 2015 after contracting 0.3% in 2014. In March 2016 the 12-month rolling current account deficit fell to $29.5 billion; its lowest level since July 2010. This is mainly attributable to cyclical factors such as lower energy prices and to slower growth of domestic demand than in the economic boom around the start of the decade. We expect import growth to remain subdued for the rest of 2016. However, terrorist attacks and plunging tourism to Turkey limit the prospects for a significant further improvement in the current account.

Credit rating agencies Moody's and Fitch have assigned Turkey the lowest classes of the investment grade credit ratings. While Fitch has a stable outlook on the rating, Moody's has a negative outlook. A downgrade by either would demote Turkey's bonds to "high yield" class. S&P rates Turkey non-investment grade, albeit the highest speculative rating, with a stable outlook.

Doing business in Turkey

As a gateway between Europe, Asia and the Middle East, Turkey offers a unique geographical setting for international trade. In the World Economic Forum (WEF) Global Competitiveness Report 2015Turkey ranks 51st out of 140 countries evaluated. That is an improvement from 65th in 2005. The six-place drop from 45th in the 2014 ranking, however, was caused by deterioration in most of the factors identified by the WEF as driving competitiveness. In particular, Turkey scores low on Labour Market Efficiency (127th). This is due to inefficient use of (female) talent and a high number of weeks of redundancy pay.

On Market Size Turkey ranks high in the World Economic Forum Global Competitiveness Report driven mainly by Turkey's large domestic market

On Market Size Turkey ranks high (16th). The good score of this pillar is driven mainly by Turkey's large domestic market (14th). At 45th the country also scores better on Goods Market Efficiency than its overall ranking. This is due to a high intensity of local competition (10th), short time required to start a business (average of 6.5 days) and a high degree of customer orientation (36th). While high scores on intensity of local competition and degree of customer orientation are beneficial to Turkey's competitiveness, these are not always advantages for foreign investors. On restrictiveness on rules and regulations on Foreign Direct Investments (FDI) Turkey ranks 62nd.

In the World Bank Ease of Doing Business 2016 rankings Turkey scores relatively high on Protecting Minority Investors, Getting Electricity and Enforcing Contracts but time and cost to import are much higher than they are for OECD high income countries

At 55th (out of 189 countries) Turkey does somewhat better in the World Bank Ease of Doing Business 2016 rankings. It ranks just below Israel and Colombia and above Mongolia and Luxembourg. Turkey scores relatively high on Protecting Minority Investors (20th), Getting Electricity (36th) and Enforcing Contracts (36th). These positives are offset by Resolving Insolvency (124th) and Dealing with Construction Permits (98th). On Trading Across Borders Turkey ranks 62nd. Time and cost to import are much higher than they are for OECD high income countries.

In Transparency International's Corruption Perceptions Index Turkey comes out as having the 66th lowest perceived level of public sector corruption out of 168 countries evaluated. This is better than fellow emerging economies China (83rd) and Russia (199th) but behind Saudi Arabia (48th) and South Korea (56th) and European countries including The Netherlands (5th) and Italy (61st).

Investment Needs

Investments are needed most in construction, residential and non-residential buildings, transportation and the energy sector

According to the Turkish government investments are needed most in construction, residential and non-residential buildings, transportation and the energy sector. Between 2014 and 2018 this investment need amounts to $350 billion. Turkey is very dependent on foreign energy. The energy import ($55 billion or 7% of GDP in 2014) is the largest contributor to the current account deficit. Turkey aims to increase its own capacity to produce electricity from 71 GW in 2015 to 100 GW in 2023, of which at least 3 GW from solar capacity.

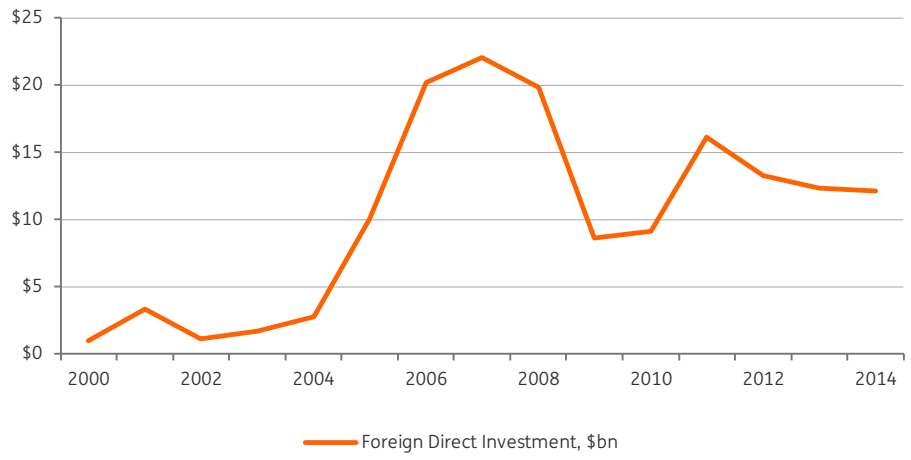
While the full electrical grid has been privatised, one third of the electricity generation capacity is state-owned. In March 2016 the Turkish state energy company and Qatar Solar Technologies signed an agreement to work together to further develop the Turkish solar industry.

Foreign Direct Investment

Increasing political risks, terrorism and high core inflation have been damaging investor confidence

In 2014 FDI in Turkey decreased 2% to $12 billion. Services saw a 28% decrease to $5 billion. This was mostly caused by 55% and 44% lower FDI in financial services and public utilities respectively. FDI in real estate and manufacturing increased 29% and 30% to $4 billion and $3 billion respectively. Recently, increasing political risks, terrorism and high core inflation have been damaging investor confidence in Turkey.

Graph 2: Foreign Direct Investment in Turkey



Source: UNCTAD

Foreign companies that want to invest in Turkey can benefit from several (fiscal) incentives including three types of Special Investment Zones:

- Technology Development Zones are designed to support Research & Development activities and attract investments in high technology fields.
- Organized Industrial Zones provide infrastructure and social facilities (such as health care) focused on investors.
- Free Zones are geographically located in Turkey but considered to be outside the customs area.

Currently there are 59 Technology Development, 290 Organized Industrial and 20 Free Zones operational or under construction.

Petroleum products, vehicles, durable consumer goods, tobacco and alcoholic beverages are subject to special consumption taxes

Producers considering doing business in Turkey should be aware of the fact that petroleum products, vehicles, durable consumer goods, tobacco and alcoholic beverages are subject to special consumption taxes in addition to the standard value-added tax rate. On tobacco and alcoholic beverages an additional strip-stamp tax is imposed. Half of government revenue is collected through value-added and special consumption taxes.

Political Risk

Internal political tensions have led to concerns that President Erdoğan could be taking populist measures that might damage the Turkish business climate

According to political risk research firm Eurasia Group, Turkey is one of ten top risks for 2016. Internal political tensions have led to concerns that President Erdoğan, as part of his efforts to increase his power, could be taking populist measures that might damage the Turkish business climate. At the same time, terrorist attacks are worrying investors and tourists. On the other hand, the refugee crisis is leading to more cooperation with the European Union (EU) which could have future economic benefits.

Geopolitical tensions have hurt Turkish exports to Russia

The geopolitical tensions with Russia have hurt Turkish exports. After Turkey shot down a Russian warplane on its border with Syria in November 2015, Russia imposed economic sanctions on Turkey. These include bans on the import of Turkish fruit, vegetables, poultry and salt and on the sale of charter holidays for Russians to Turkey. In January 2016 this already contributed to a drop in Turkish exports to Russia of more than two-thirds.

Industry developments

Looking at Turkey's industries the highest annual growth rates from 2011 until 2014 were observed in Mechanical Engineering, Castings and Metal Products at 10%, 9% and 9% per year respectively. From 2016 until 2020 research firm Oxford Economics (OE) expects this annual growth to decelerate to 6%, 3% and 7% respectively, making Metal Products the fastest growing industry. Repair & Installation of Machinery would become the second fastest growing industry with an annual rate of 7%.

Consumer Demand

Turkey's median age is much lower than that of the EU

Between 1995 and 2014 Turkey's income equality improved significantly. The so-called Gini coefficient, the most common indicator of inequality, decreased from 0.49 to 0.39. The 30% raise in the minimum wage as of 2016 should further equalise incomes. This should lead to extra growth of household consumption because those with lower incomes spend a larger share of their earnings on consumption.

A younger population has a different demand mix for products and services such as discretionary consumer goods and pharmaceuticals

At 30.1 years the Turkish median age is much lower than that of the EU (42.5 years). Therefore, the composition of demand for goods and services will differ from that of the EU. A younger population has a different demand mix for products and services than a more mature population (discretionary consumer goods and pharmaceuticals for example). The Turkish Statistical Institute expects the Turkish median age to increase to 34.0 years by 2023.

In 2014 household consumption in Turkey grew the most in Miscellaneous Goods & Services, Restaurants & Hotels and Housing, Water, Electricity, Gas & other Fuels, by 17%, 17% and 14% respectively.

Trade

Import

From 2016 until 2019 we expect nominal imports to resume growth at an average yearly rate of 6-7%

In 2015 imports represented 29% of GDP, up from 23% in 2000. This is somewhat above the global average of 25%, as a result of Turkey's dependence on other countries for energy. In 2015 the value of Turkey's imports fell 14% to $207 billion, mainly due to the declining oil price. From 2016 until 2019 we expect nominal imports to resume growth at an average yearly rate of 6-7%. All our trade growth estimates in this report include our expectation that the euro will appreciate against the US dollar at an average annual rate of 3.8% through 2019.

Table 1: Import by origin country

	Import partner	CAGR 2010-14	Import 2014, $bn	CAGR E2016-19	Import E2019, $bn
1	Russia	5%	25	8%	35
2	China	14%	25	15%	48
3	Germany	10%	22	4%	27
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26	Vietnam	35%	2	24%	6

Source: ING Trade Model

Table 2: Import by product group

Product group	CAGR 2010-14	Import 2014, $bn	CAGR E2016-19
Other manufactured goods	11%	34	9%
Other products	23%	29	-3%
Chemicals	13%	26	9%
Industrial machinery	11%	25	6%
Telecom & electrical equipment	9%	20	11%
Road vehicles & transport equipment	11%	19	6%
Ores & metals	11%	14	6%
Fuels	-5%	13	10%
Textiles	10%	11	8%
Basic food	15%	9	5%
Pharmaceuticals	1%	4	7%
Unprocessed agricultural prod.	12%	3	5%
Beverages & tobacco	10%	1	10%

Source: ING Trade Model

From 2016 until 2019 we expect Office, Telecom & Electrical Equipment, Beverages & Tobacco and Fuels to be the fastest growing sectors at annual rates of 11%, 10% and 10% respectively

In 2014 Turkey's main partner countries for imports were Russia, China and Germany. We expect that the growth in imports from China to Turkey will rise slightly from a yearly rate of 14% from 2010 until 2014 to 15% from 2016 until 2019. That would make China the largest exporter to Turkey by 2019. Imports from Germany will decelerate from an annual 10% (2010 – 2014) to 4% (2016 – 2019). In recent years Turkey and Vietnam have been strengthening their bilateral relations. As a result we foresee imports from Vietnam to grow the fastest of any country that Turkey imports from. We do however, expect this annual rate to slow from 35% (2010 – 2014) to 24% from (2016 – 2019).

By product group, the highest import growth from 2010 until 2014 was observed in Basic Food, Chemicals and Unprocessed Agricultural Products, at 15%, 13% and 12% per annum respectively. We expect that from 2016 until 2019 this import growth will decelerate to an annual 5%, 9% and 5% respectively. Instead, we expect Office, Telecom & Electrical Equipment, Beverages & Tobacco and Fuels to be the fastest growing sectors, at annual rates of 11%, 10% and 10% respectively.

In 2015 Turkish exports represented one-fifth of Turkey's nominal GDP

Export

In 2015 Turkish exports represented one-fifth of Turkey's nominal GDP. The value of Turkey's exports fell 9% to $144 billion. This was due to the depreciation of the euro against the US dollar that caused the value of Turkish exports to the Eurozone to decline when expressed in dollars. Exports also suffered from increased geopolitical risks that led to diminished demand from neighbouring countries. Furthermore, lower energy prices have negatively impacted demand from countries whose incomes depend on the sale of oil. Combined with the 14% contraction of imports this resulted in the trade deficit falling by 25% to $63 billion.

Table 3: Export by destination country

	Export partner	CAGR 2010-14	Export 2014, $bn	CAGR E2016-19	Export E2019, $bn
1	Germany	9%	18	4%	21
2	Iraq	11%	14	-12%	8
3	UK	8%	11	8%	16
4	France	3%	8	7%	11

Source: ING Trade Model

We expect Germany, the UK and France to be Turkey's largest export destinations in 2019

In 2014 Turkey's largest export markets were Germany, Iraq and the United Kingdom. Due to a 12% annual decline in export to Iraq (driven by geopolitical conflict) and an acceleration in export growth to France from 3% (2010 – 2014) to 7% (2016 – 2019) per annum, we expect the United Kingdom and France to be Turkey's number 2 and 3 export destinations respectively in 2019.

Table 4: Export by product group

Product group	CAGR 2010-14	Export 2014, $bn	CAGR E2016-19
Other manufactured goods	9%	30	7%
Textiles	8%	27	5%
Road vehicles & transport equipment	7%	17	12%
Basic food	11%	14	2%
Telecom & electrical equipment	10%	11	10%
Industrial machinery	14%	10	10%
Chemicals	15%	7	9%
Ores & metals	18%	6	10%
Fuels	6%	4	14%
Other products	5%	4	14%
Beverages & tobacco	4%	1	15%
Pharmaceuticals	11%	1	13%
Unprocessed agricultural prod.	13%	0	3%

Source: ING Trade Model

From 2010 until 2014 the highest export growth by product group was observed in Ores & Metals, Chemicals and Industrial Machinery with annual rates of 18%, 15% and

14% respectively. We expect that from 2016 until 2019 export will grow most in Beverages & Tobacco, Fuels and Pharmaceuticals with annual rates of 15%, 14% and 13% respectively.

Trade in Services

At 9.5% of GDP Turkey's international trade in services is relatively low

Turkey's international trade in services is relatively low. In 2014 the sum of its service exports and imports was equal to 9.5% of GDP, below the world average of 13%.

Trade Barriers

At rank 62 (out of 189 countries) Turkey scores a little lower on the Trading Across Borders pillar than it does on its overall World Bank Ease of Doing Business 2016 ranking of 55. In its evaluation of this pillar, the World Bank does not take into account the tariffs applied. Looking specifically at trade tariffs, Turkey ranks 72nd in the WEF Global Competitiveness Report 2015 (lower than its overall ranking of 51). On this pillar the EU ranks 1st.

The highest import tariffs are applied to food and agricultural goods with an average rate of more than 80%

The World Trade Organization (WTO) found that from 2011 until 2014 the average tariff applied by Turkey was 12.8%. That is 2.7 percentage points higher than the average tariff applied by the G20 developing nations between 2009 and 2011. The highest tariffs are applied to food and agricultural goods with an average rate of more than 80%. Trade tariffs per product and country can be found in the European Commission's Market Access Database (MADB) and the WTO's Tariff Download Facility.

The WTO notes that Turkey has relatively wide margins to set its tariffs because half of its tariff schedule is unbound and for many of the products with bound rates the applied tariffs are currently below their maximums.

On prevalence of non-tariff barriers Turkey ranks relatively well in the WEF Global Competitiveness Report 2015, at 42. The MADB lists 11 key trade barriers including tariff and non-tariff barriers. Global Trade Alert provides more specific information on international trade policy developments.

Trade Agreements

The EU and Turkey share a customs union from which unprocessed agricultural products, services and public procurement are excluded

The EU and Turkey share a customs union that allows for free trade of all industrial goods, specifies a common external tariff for these products and sets standards for several internal market areas. Unprocessed agricultural products (to which bilateral trade concessions apply), services and public procurement are excluded from the customs union.

Besides the customs union with the EU, Turkey has free trade agreements with the European Free Trade Association and with several countries. In March 2016 Turkey ratified the WTO's Trade Facilitation Agreement (TFA). The negotiations on this agreement, that contains provisions on facilitating trade of goods between WTO members by setting out procedures for effective cooperation between the authorities involved in the trade process, were concluded in December 2013 at the Bali Ministerial Conference. The TFA will enter into force once it has been accepted by two-thirds of WTO members. As of 10 May 2016, 79 out of 162 WTO members have ratified the TFA.

Concluding remarks

Even if the (geo)political environment were to deteriorate Turkey should be an attractive export market in the long-term

We expect Turkish economic growth to slow this year to 3.4%, but to accelerate in coming years to 4.5% in 2019. Due to the (geo)political environment we see more downward than upward risks to this scenario. But even if these situations were to deteriorate, Turkey should be an attractive export market in the long-term.

Disclaimer