Turkey in 2017: Complex Geopolitics and Risks of an Overheating Economy

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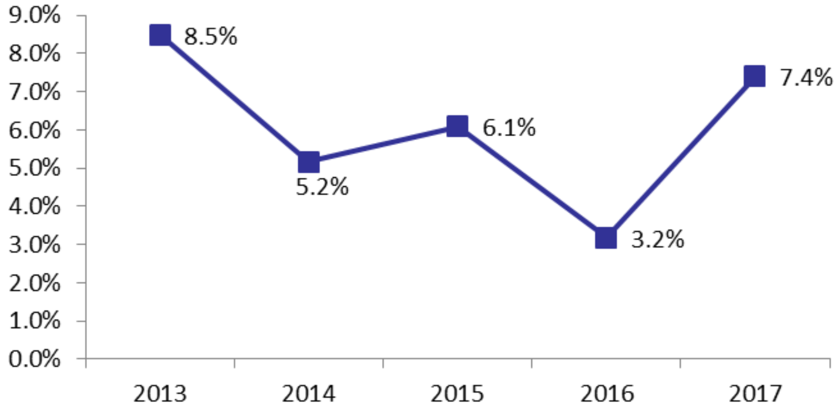
Introduction

2017 was a politically charged year for Turkey. On one hand, the tumult on the Turkish political scene started back in July 2016 after a failed coup attempt to topple the government of President Erdogan; the coup was heavily repressed and met with the arrest of thousands of suspects and with a purge that took the lives of 241 people and injured 2,914 others. On the other hand, the country rang the New Year 2017 with a deadly terrorist attack in a famous nightclub twhere an ISIS gunman killed 39 people and injured 70 others. Turkey has been involved in the Syrian civil war and launched "Operations Euphrates Shield" in late August 2016, in order to push away ISIS fighters from the country's borders. However, Turkey's involvement in Syria is also about fighting the Turkish-Kurdish rebels which have been leading a long fight for autonomy since the 80s.

Another controversial event that marked 2017 is president Erdogan consolidating his powers in a move condemned by the international community. In April 2017, Erdogan won a referendum for the amendment of the Turkish constitution, an amendment that would allow him to act as President, Head of Government and Head of the Ruling Party. More recently, Erdogan called for anticipated general elections (one and a half years ahead of the scheduled date).

Despite the political setbacks early during the year, the Turkish Gross Domestic Product (GDP) surged 7.4% to reach $863.4B in 2017, marking its fastest expansion in four years with robust growth in industry, services and construction. Turkey registered the highest growth among the OECD, EU and G-20 countries, surpassing China and India, which recorded respective growths of 6.8% and 6.4%. As such, the International Monetary Fund (IMF) has revised up its forecast for the 2018 Turkish economic growth to 4.4 percent, but its 2019 forecast was down to 4 percent for 2019 in its latest World Economic Outlook. However, this growth came at a cost as revealed by Turkey's core inflation, which accelerated to its highest level in more than 13 years, reaching 12.3%, while head inflation recorded11.1%.

Turkey Real GDP Growth (%)



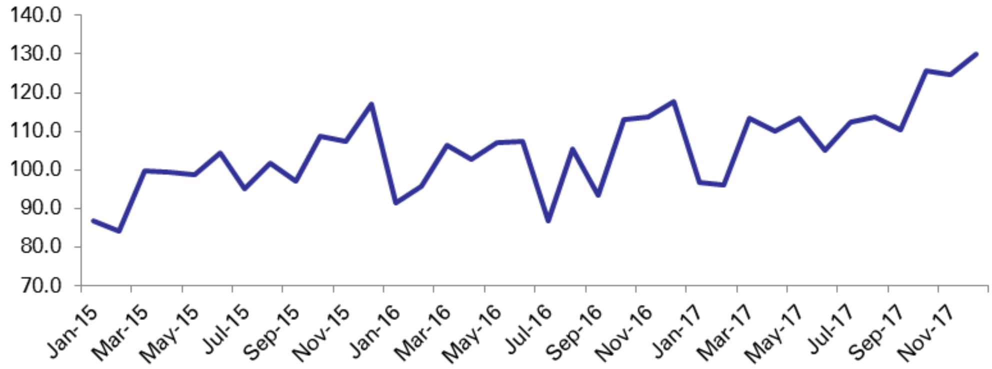
Source: IMF

Real Sector

Turkey managed to overcome 2016's setbacks and boost the performance of its main economic sectors, namely the industrial sector. In reality, and aside from the depreciation of the Turkish Lira, the government adopted an expansionary fiscal policy which partly helped in boosting domestic demand hand in hand with a monetary policy encouraging lending and private consumption.

2017's economic progress particularly highlighted an improving industrial production with the manufacturing Purchasing Managers' Index (PMI) rising for the 10th consecutive month in December 2017 and settling above the 50 neutral-mark that separates economic contraction from expansion. Accordingly, Turkey's PMI averaged 52.8 in 2017, up from an average of 48.78 in 2016. Similarly, the average Capacity Utilization Rate of the Manufacturing Industry also reached its highest level in 9 years, confirming the expanding industrial production in 2017. However, the headline PMI actually dropped from 55.6 in February 2018 to 51.8 in March, probably in the aftermath of January's terrorist attack.

Monthly Performance of Turkey's Industrial Production Index

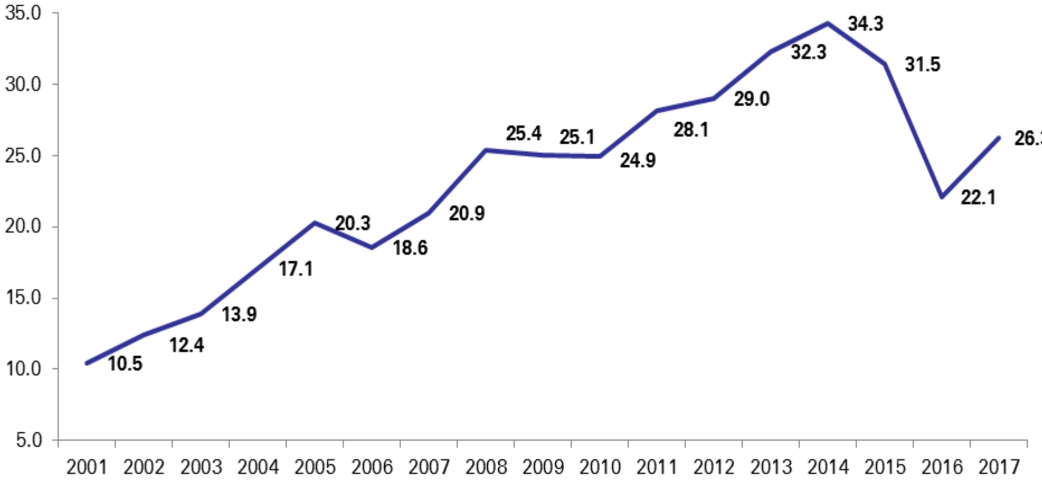


Source: Turkish Statistical Institute

It is worth noting that the Turkish economy heavily relies on its manufacturing activity that grasps around 17% of the country's GDP and is considered a gauge of the economic health of the country. That was reflected by the Industrial Production Index (IPI) released by the Turkish Statistical Institute and that averaged an annual 112.6 in 2017 as compared to 103.4 in the previous year. In details, each of the main sub-indices ("Mining and quarrying", "Manufacturing" and "Electricity, gas, steam and air conditioning supply") grew by a yearly average of 9%. It was noticeable that, within the manufacturing sub-category, the top three performers were the sub-indexes of "computer, electronic and optical products manufacturing", "motor vehicles, trailers and semi-trailers manufacturing" and "other transport equipment manufacturing", which respectively rose by 15%, 17% and 18% y-o-y in 2017.

One of the main reasons behind the progress in factory production was the recovering tourism sector after 2016's terror attacks and failed coup. Russia lifting the sanctions on Turkey, improving security situation in addition to hoteliers' marketing campaigns and rate reductions helped tourism to recuperate in 2017 after 18 months of slowdown. Tourist numbers surged by a yearly 23% to 38.62M while tourism income grew at a slower rate from $22.1B in 2016 to $26.28B in 2017. As a result, the average tourist expenses per capita contracted by 3% y-o-y to $681, noting that tourists were spending on average 8.8 nights in the country. Still, the tourism sector in Turkey failed to offset the drop registered over 2016 and remained below 2015's levels in terms of tourism income and number of tourists.

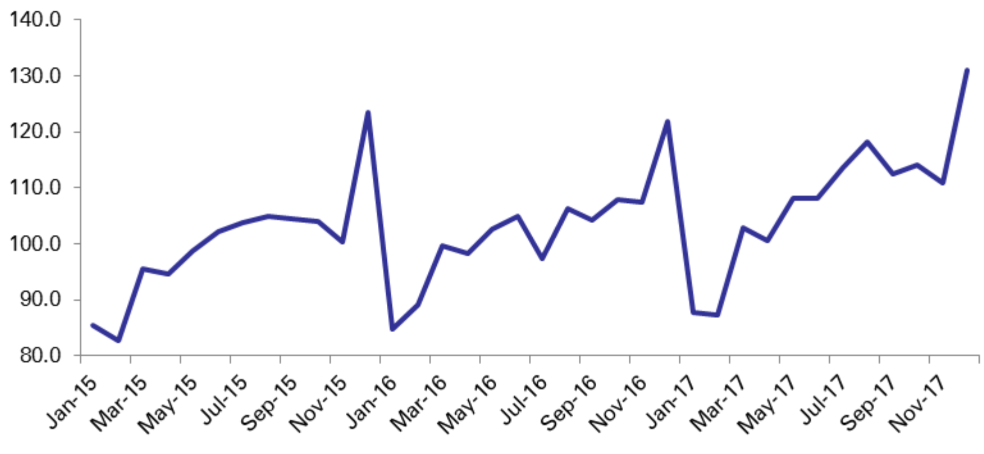
Yearly Evolution of Tourism Income in Turkey (In $B)



Source: Turkish Statistical Institute

Another main economic activity that drives growth in Turkey is related to the Wholesale and Retail Trade that almost had an 11% contribution in 2017's GDP. In particular, Retail Sale Volume Index grew by a yearly 6% in 2017, up from a 2% progress in 2016. This was mostly attributed to higher sales volume across the index's three main categories: the Food, drinks and tobacco added 2% on a yearly basis, Non-food (except automotive fuel) Index rose by 8% and Automotive Fuel Index increased by 6% from 2016's level. Worth mentioning that the growth in the Non-food Index was linked to higher sales volume of mail orders and internet that edged up by 16% and sales of "Textiles, clothing and footwear products" and "Audio and video equipment, hardware, paints and glass, electrical household appliances, furniture, etc" that recorded each a yearly progress of 9%.

Monthly Performance of Turkey's Retail Sales Volume Index

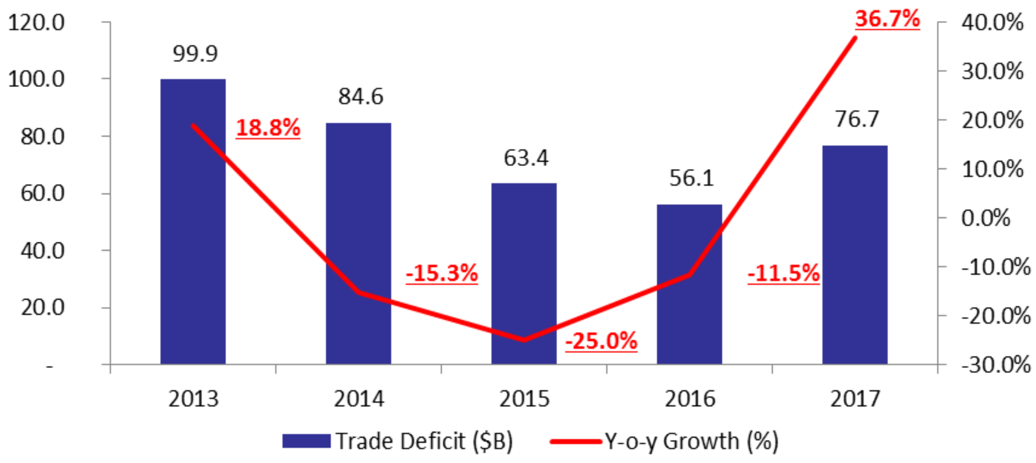


Source: Turkish Statistical Institute

External Sector

Bolstered by a weak lira and an improving Business Confidence Index, exports' competitiveness increased drastically during the year of 2017; nonetheless, the 10% rise of exports wasn't enough to offset the 17% rise in imports, inflated by a commodity price effect. Turkey's trade balance widened by 36.81% y-o-y to record a deficit of $76.7B. In fact, exports rose to $157.1B, the second-highest export volume in the history of the Turkish Republic. The automotive sector was the country's top exporter with exports worth $23.9B (15.2%), followed by the machinery sector and the clothing sector with exports worth $13.8B (8.78%) and $8.8B (5.6%), respectively. In 2017, Turkey's main export destinations were Germany, grasping a share of 9.61% of total exported value, followed by the United Kingdom and Iraq with respective shares of 6.11% and 5.79%. Meanwhile, imports climbed to $233.8 billion in 2017, on the back of the 36.91% rise to $37.20B in mineral fuels. The top import destinations were Germany, China and Russia.

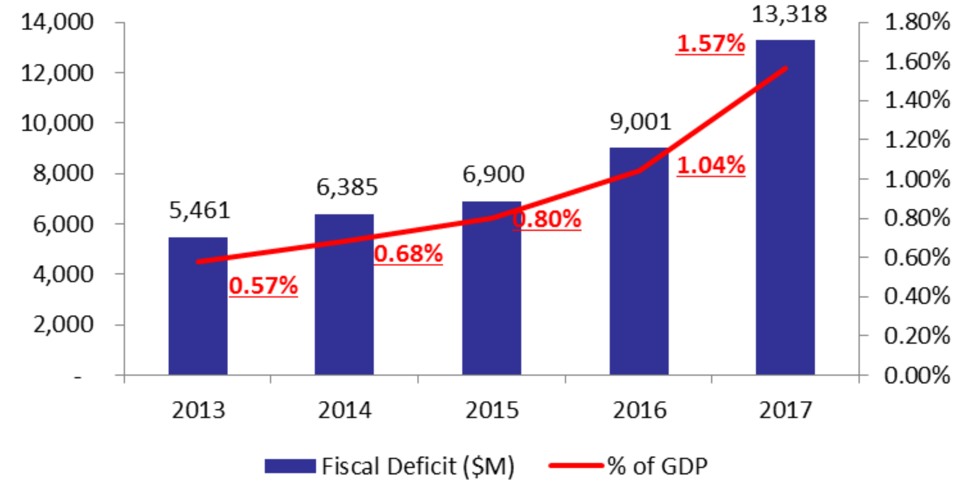
Turkey's Trade Deficit ($B)



Source: Turkstat

Fiscal Sector

On the fiscal front, Turkey's central government's budget balance saw its deficit rise from TL 31.7B ($9B) to TL 48.6B ($13.8B) during 2017, 1.5% of GDP. In details, total budget expenditures, which rose by 15.8% to TL 658.9B ($180.5B), outpaced the total budget revenues, which increased by 13.8% to TL 610.3B ($167.2B). In the third quarter of the year, the government introduced the country's new Medium Term Program (MTP), whose objective is to reach sustainable growth by maintaining macroeconomic stability and raising the quality of human sources and the labor force. As such, according to the MTP, the budget deficit to GDP ratio is targeted to be at 1.9 percent in 2018, 1.8 percent in 2019, and 1.6 percent in 2020. This would mainly be on the back of increasing tax revenues, which already consist 88% of revenues, as well as increasing expenditures on defense and security. Moreover, Turkey's public debt reached 27.9% of GDP in 2017 down from 28.3% in 2016, mainly due to the nominal GDP growing at 19%, a higher pace than the deficit. Public debt increased by an annual 15.7% to stand at TL 855B ($243B), Turkey's Yearly Fiscal Deficit ($M)



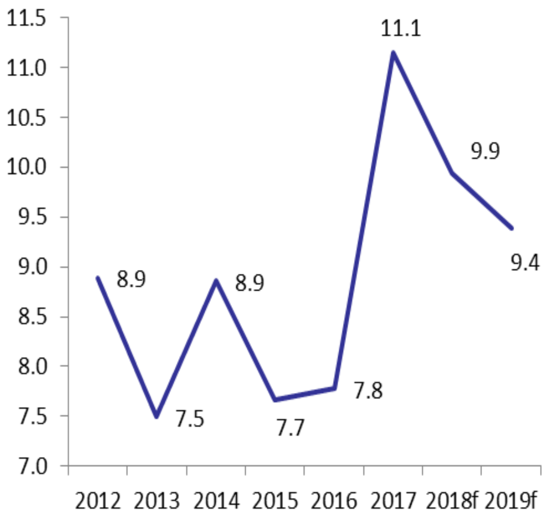
Source: Turkstat

Monetary and Banking

The Turkish economy is overheating, experts warn. Indeed, the economy is showing signs that could back this claim; soaring inflation, a depreciating Turkish Lira and high growth. Normally, the Turkish Central Bank should intervene by increasing interest rates; however, the Central Bank's policy rate has been steady at 8.00% in both 2016 and 2017.

Turkish Lira versus USD

Average Change in Consumer Price Index (CPI)

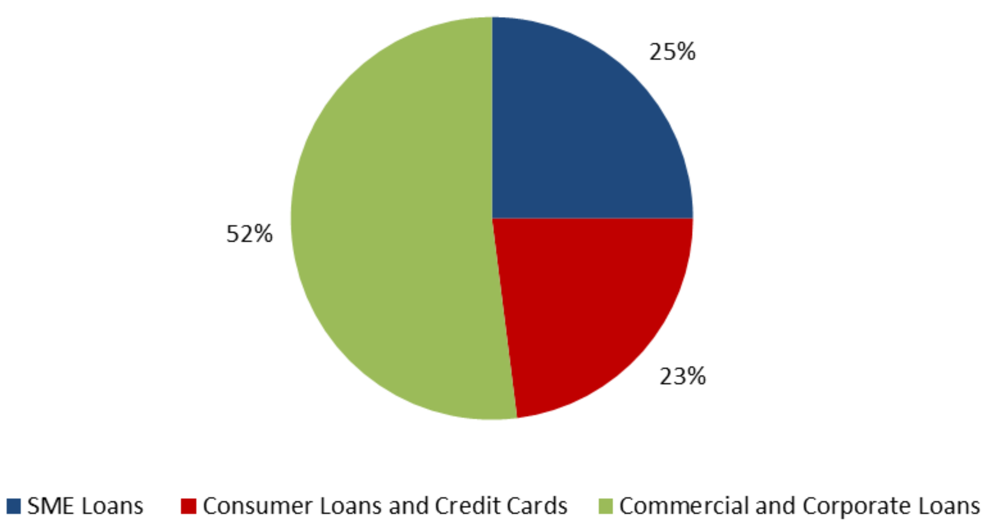


Source: IIF, Reuters

It appears that President Erdogan's stance favors growth over all. The government's pro-growth policy was apparent in 2017. In fact, the Credit Guarantee Fund (CGF), which is a government fund that guarantees loans to Small and Medium Enterprises (SME), backed more than 200 billion Turkish Liras worth of loans in 2017. Moreover, Erdogan is publically opposing increasing interest rates as he believes this move will deter investments and hinder Turkey's economic growth. This is not to say that the Central Bank stood idly by. According to the International Institute of Finance (IIF), the Central Bank stopped lending through repurchase operations at 8% in late

November and instead provided liquidity through its "late liquidity window facility" at 12.25% as of November 21st. This move helped ease some, but not all the pressure on the Turkish Lira. The depreciation of the Turkish lira has not only upped inflation but also led to a wave of corporate debt restructurings. While the exchange rate of the Turkish Lira versus the USD stood at 2.33 in January 2015, it reached 3.79 in December 2017. This depreciation compelled major conglomerates such as Dogus Holding to approach several banks to restructure $5.81 billion worth of debt. This is a major element to keep an eye on especially as commercial and corporate loans together account for a little over half of the total loans granted in the Turkish Banking sector.

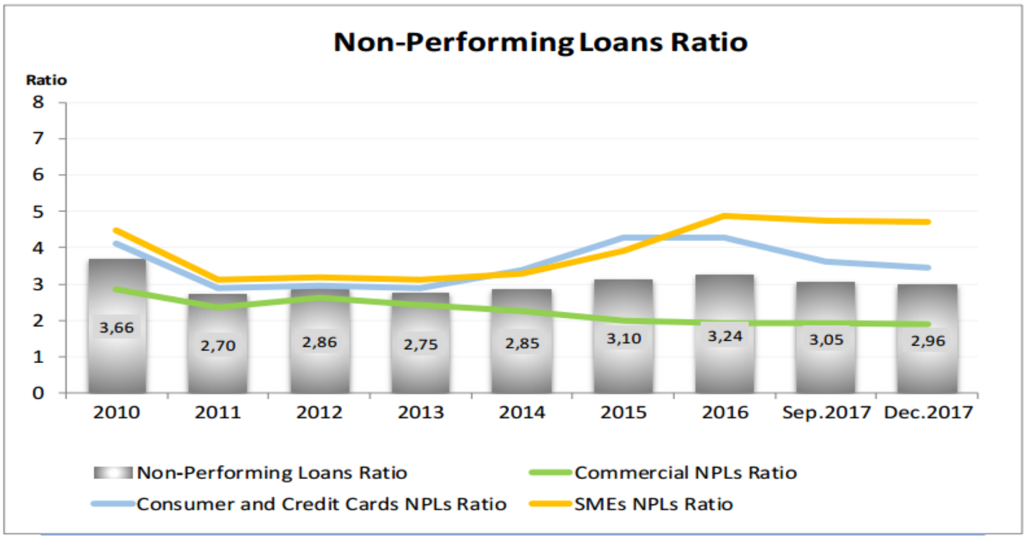
Composition of Loans in the Turkish Banking Sector - 2017



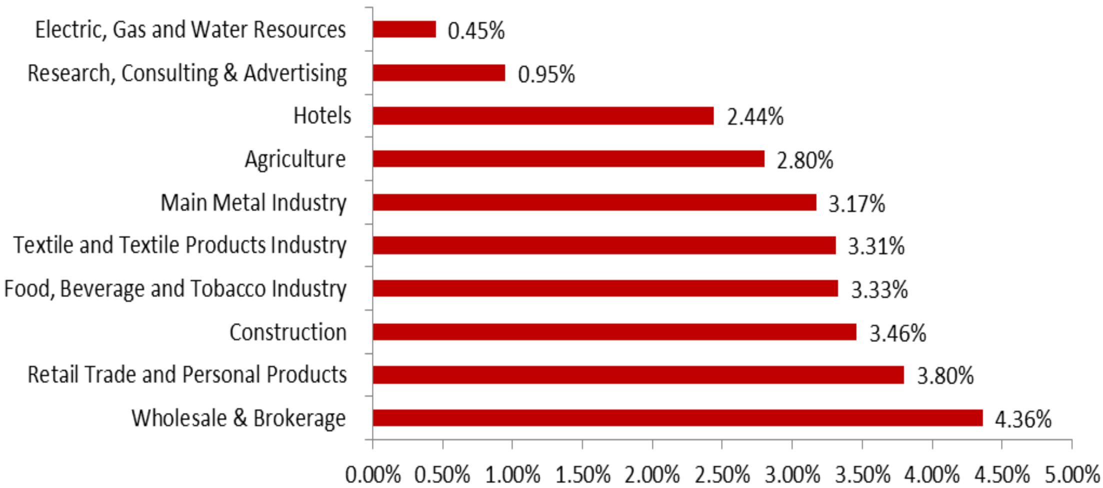
Source: BDDK

Overall, 2017 was a bright year for the banking sector. According to the Banking Regulation and Supervision Agency (BDDK), annual profits in the banking sector reached a record-high of $13 billion in 2017 up from $10.7 billion in 2016. Banking assets also rose by an annual rate of 19.4% to reach $862.7 billion. As for loans, which make up the biggest bulk of total assets (65%), they rose by 12% year-on-year to reach $555.8 billion in 2017. As for deposits, they amounted to $453.4 billion in 2017, up by a yearly 18%.

Return ratios and asset quality improved in 2017. The ratio of non-performing loans dropped in 2017 from 3.24% in 2016 to 2.96% in 2017. Both Return on Equity and the Return on Assets ratios increased from 14.28% and 1.89% in 2016 to 16.04% and 2.04% in 2017.



NPL Ratios in Selected Sectors



Source: BDDK

Stock Market Performance

The Boursa Istanbul Index (BIST 100) registered a 37.38% yearly increase to stand at 30,453.39 points, by the end of 2017. The market capitalization in Turkey rose from $174.49B in 2016 to $233.34B in 2017, mainly as a result of an increase in the number of listed companies from 411 to 414. The average daily traded volume reached 1.48B shares at an average traded value of $1.71B during 2017, compared to 922.9M shares worth $954.7M in 2016.

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