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Turkey's economic slowdown continues, but exports offer some support

Turkey is experiencing a severe economic slowdown, coupled with a jump in inflation, as a result of the sharp depreciation of the lira during 2018 . This sharp depreciation has resulted in reduced consumption, and has impacted investment dynamics in the domestic market. The import-dependent structure of production has pushed the inflation rate to all time high levels, which forced the central bank to deliver a large rate hike in September. Although this rate hike has helped the Turkish lira to recover from these historical weak levels, it caused borrowing costs to rise extremely high, making funding extremely costly for both businesses and households. Growth is expected to remain very subdued and inflation at double digits.

These conditions have highlighted exports as an important source of revenue for the economy, despite many challenges. Government support remains vital for exporters to gain new market shares. This support has been mostly in the form of incentives for trade fairs and accessing new markets, among other methods. However, limited sophistication and competitiveness are restraining factors for further expansion of Turkish exports. Clients' barganing power and the low level of technology incorporated in exported goods restrain higher gain from exports.

Industrial production weakened due to currency shock

The crisis has deteriorated Turkey's production and consumption dynamics. In 2018, industrial production posted an annemic growth of 1.6% while the manufacturing PMI[1] fell to 42.7 in September, indicating that business conditions remain challenging. Indeed, from the PMI to other consumer and business surveys, all indicators have declined, showing a sharp drop in confidence levels for both companies and consumers in the country. With high inflation (hitting an all time high of 25.24% in October 2018 YOY), increased borrowing costs, and rising unemployment, household demand is expected to remain low in the first half of 2019.

New economic plan suggests a new balancing in the economy...

According to the new economic program announced in September 2018 by the government, Turkey will enter a rebalancing period between 2019 and 2021, based on steady growth rates and narrower current account deficits. Recent data reflects with this perspective, as the country recorded a total current account surplus of USD 7.3 billion between August and November 2018. Total current account deficit narrowed to USD 47.3 billion in 2017 (5.5% of GDP) to USD 27.6 billion in 2018 (close to an estimated 3.3% of GDP) However, this decline in deficit is mostly related to the decline in domestic activity rather than a lower dependence of Turkey's production system on imported intermediate goods and raw materials. The financing side of the current account deficit, however, indicates that portfolio investments recorded an outflow of USD 3 billion in

1 - The Purchasing Manufacturer Index (PMI) is an indicator of the economic health and performance of the manufacturing sector, which covers several sectors mainly linked to industrial production. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The purpose of the PMI is to provide information on current business conditions within several

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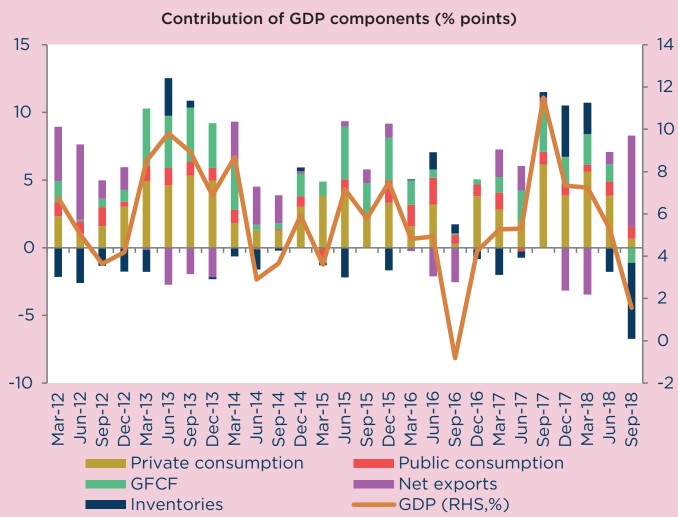
Insight of Turkey's currency crisis

The Turkish economy is expected to go through an annemic expansion period in the next quarters as it was severely hit by risk aversion amid international investors against Turkish assets since the start of 2018. In the third quarter (Q3) of 2018 the economy grew by 1.6% year-on-year, slowing from 5.3% in Q2 2018 and 7.2% in Q1 2018. On a seasonal- and calendar-adjusted basis, GDP contracted by 1.1% in Q3 2018 quarter-on-quarter (QOQ). Leading indicators suggest that the economy slowed more sharply than expected in Q4 2018 due to the pass-through effects from the lira's weakness. Indeed, in the period before 2018, the economic performance had been already affected by several negative factors (failed coup attempt, political uncertainty, security issues, deteriorating relations with Russia, plunge in tourism revenues, etc.). However, authorities were able to implement some supportive measures to counter economic slowdown, such as the expansion of the Credit Guarantee Fund to 250 billion lira, the increase of the state's contribution to new manufacturing investments by 15%, and the possibility of loan restructuring for companies. The aforementioned factors helped boost economic growth above its potential by 7.4% in 2017 and delay negative spillover effects of the previous damages. Yet tighter global financial conditions, Turkey's foreign-capital dependent economic structure and rising political tensions with the United States until autumn 2018 have resulted in a heavy sell-off of the Turkish lira, which hit its all-time weakest level versus the US dollar in mid-August 2018. The sharp depreciation led the central bank to hike its rates by 625 basis points in September 2018, a move that pushed interest rates on loans close to 40% both for commercial and individual loans. As a result, total annual loan growth adjusted for foreign exchange impact plunged to below 1% end-2018 from around 18% at the beginning of the year. Annual growth for commercial loans plunged in negative territory at that time. This has had several dramatic impact on Coface assessments of Turkish sectors, with eight downgrades during 2018 (and six during our Barometer for Q3 2018[2]). **(Chart 1)**

CHART 1
Real GDP Growth



Sources: TSI, Coface calculations

2018 compared with an inflow of nearly USD 25 billion in 2017. At that time, the country continued to attract foreign direct investments worth USD 9.5 billion, of which 62% were in the real estate sector. Tighter monetary and financial conditions in the global markets and rising domestic risks have reduced total available funds for the banks. Coupled with lower demand for loans, banks have become net debt payers since July both in long term and short term debts. This has put, banks' 12-months long term roll over ratio at 76% in December 2018, several-year lowest level.

...with some continued interest from international investors

Although the uncertainty remains high about the future trend, the Treasury's successful five-year US dollar-denominated bond issue – where in October 2018 it sold USD 2 billion with an orderbook of more than three times the actual issue size – can be considered as a positive step towards the international markets, albeit at a higher yield. The fact that banks were also able to secure their syndicated loans indicate the willingness of global investors to extend credit to the Turkish banks and private sector.

Nevertheless, tightening global financial conditions and the lira's exposure to international markets' risk perception represent challenges for the external borrowing of the country. Turkey's total external debt reached USD 448 billion, around 54% of GDP, as of the third quarter of 2018, while the short-term external debt of the private sector stood at USD 90 billion, of which USD 50 billion belonged to non-financial private sector companies.

How have economic sectors coped so far?

While these factors contribute to a slowdown in the economy, prices continue to remain high due to increased production costs. Producer prises rose by a record 46% in September YOY, when consumer prices jumped 24%. Although upward pressures have somewhat eased since then, annual producer price increases on average stood at 31% for intermediate goods, 28% for capital goods and 40% for energy in 2018, which are still too high in terms of production costs. Although declining oil prices at the time of writing (Coface's forecasts for oil prices on average for 2019 is 75 USD per baril), the recent strengthening of the lira, and the economic slowdown are expected to contribute to the deflationary process during 2019, we expect average annual inflation to remain close to 17% in 2019 – above the central bank's end-2019 forecast of 14.6%.

Slower domestic demand, higher borrowing costs, and the lira's depreciation have slowed sector momentum as well, a trend that looks likely to continue, particularly for domestic-driven sectors such as construction, retail and ICT[3]. Cost of material used in the construction sector rose 31% on average in the first eleven months of 2018 YOY, while labour costs rose by 16% on average. In December 2018, the pace of growth of calendar-adjusted turnover in construction sector plunged to 3% from around 50% in January 2018. The situation was bitter for buildings

2 - Each quarter, Coface publishes its Country and Sector Risk Barometer, which assesses risk levels for 161 countries, and 13 economic sectors in 27 countries that represent 87% of the world economy.
3 - Information & communications technologies

construction, where turnover growth stood at 1.8%fell by 11% in September YOY. Indeed, it is becoming harder for buyers to use bank loans at current levels of interest rates to buy a house. As a result, the annual increase in house prices fell to 9.7% in December, far below the inflation rate of 20%. The residential side of the construction sector in particular will continue to be exposed to increased pressure from higher borrowing costs and a weaker lira. Coupled with poor domestic and international investors sentiment for this sector, this would dampen large scale private real estate investments in the upcoming period. In contrast, transport and infrastructure projects – having been developed via Public Private Partnerships (PPP) and benefitting from government guarantees – face limited risks thanks to the low level of public debt (33% of GDP as of third quarter 2018).

Rising heavy downward pressure on Turkish consumers in terms of real income will continue to impact the retail sector as well. Retail sales have already begun to cool: In the whole 2018, retail sales inched up only by 1.3% yoy. After August, when the currency shock had hit the economy the most severely, total retail sales fell 5.2% YOY while non-food retail sales fell by 9% YOY, and electronic products sales fell by 16%. Imported discretionary products – such as luxury brands, furniture, and electronic products – would be among the most exposed to lower consumer confidence and real income. The 3-month moving average of consumer confidence index hit 58.4 in December 2018, its lowest level since 2012, Insufficient demand and financial constraints are among the principal factors limiting activities in the retail sector. Despite the government's temporary initiatives (lowering taxes on furniture, domestic appliances etc.), retail sales are expected to trend lower into 2019 due to lower purchasing power of households, rising borrowing costs, and rising unemployment. Conversely, discount retailers are expected to benefit from higher demand for more affordable products as consumers become more price-consious. Their biggest advantage lies in their supply chains, which are mostly focused domestically. This means they are able to sell good quality products at cheaper prices.

Would export-intensive related sectors help?

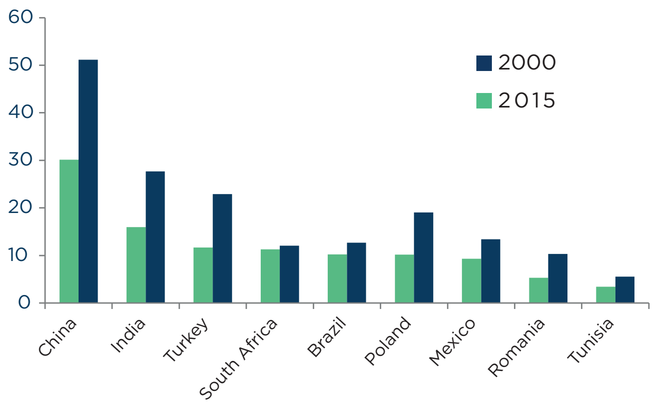
Under these economic circumstances, exports have become an important source of revenue for Turkish economy. In 2018, exports rose 7% year-on-year to USD 168 billion. Looking to the monthly figures, exports jumped after August when the lira was been hit by a heavy sell-off. During 2018, some of the biggest annual increases in exports have been recorded, notably in chemicals[4] (17%), motor vehicles (12%), and paper (11%). The textile-clothing and food sectors also saw increases (4.7% and 4%, respectively).

Acceleration in exports...

In 2018, automotive exports accounted for 17% of total exports, followed by textile-clothing (16.3%) and metals (11%). The automotive sector in particular has benefited from the economic growth in European countries, as the latter (EU-28) attracted 50% of exports in 2018, compared with 47% in 2017. While exports to the Middle Eastern countries fell to 17.5% of total exports in 2018 from 23% in 2017, the share of exports to North Africa rose from 4.8% to 5.6% thanks to measures implemented by the Turkish government designed to support exports. Exporters benefit from several types of incentives such as sectoral trade delegations support, overseas brand registration promotion support, overseas trade fair participation support, market access documents support, design support, market research support etc. They obtain additional supports if they export to the "target" countries determined by the Ministry of Trade. Coface expects this government's support to exporters to continue in order to expand their penetration in overseas markets in the coming quarters **(Chart 2)**.

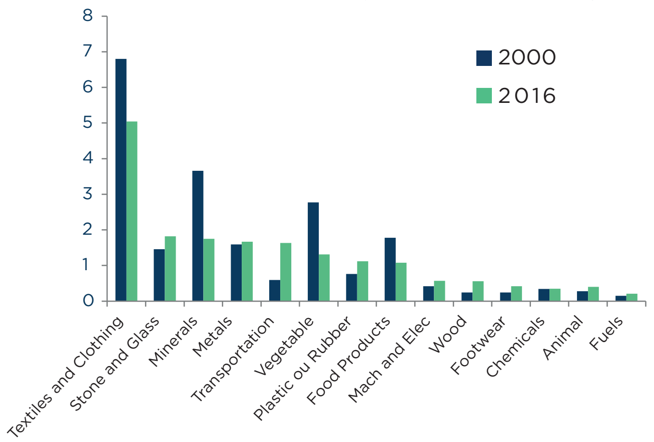
Despite the dynamism and flexibility of Turkish exporters, the technological basis remains limited. In order to improve the research and innovation of small-and medium-sized enteprises (SMEs), KOSGEB (a government-related agency with the aim of providing technical and financial support to SMEs) has implemented several initiatives. This type of supports helped to raise the share of total manufactured exports with medium-to-high and high-technology goods to 40% in 2018, up from 26% in 2012. Other exports are based on low technological industries. Therefore, the sharp depreciation of the lira does not result in high levels of gains, as the low content in terms of technology reduces exports' competitivness.

CHART 2
Index of export market penetration[5], 2015



Sources: World Bank, WITS

CHART 3
Revealed Comparative Advantage (RCA) Index of Turkey*



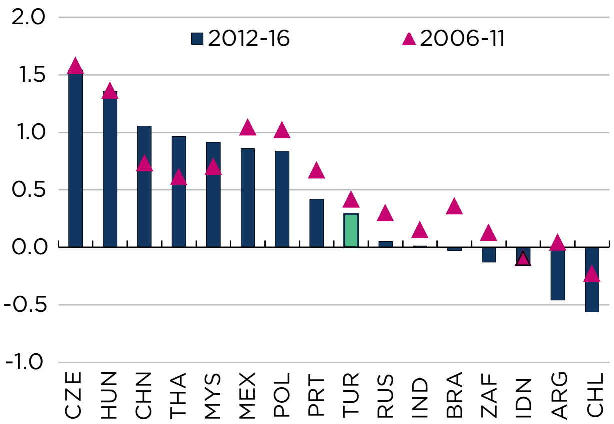
Sources: World Bank, WITS

4 - The Coface sector assessment methodology includes plastic products in the Chemicals sector.
5 - As per the World Bank, this indicator measures the extent to which a country's exports reach already proven markets. It is calculated as the number of countries to which the reporter exports a particular product divided by the number of countries that report importing the product that year. A higher index indicates that a country already exports to a greater percentage of existing markets for its products; a low value indicates potential for expansion.

...in a context of sound exports base in Turkey, despite challenges

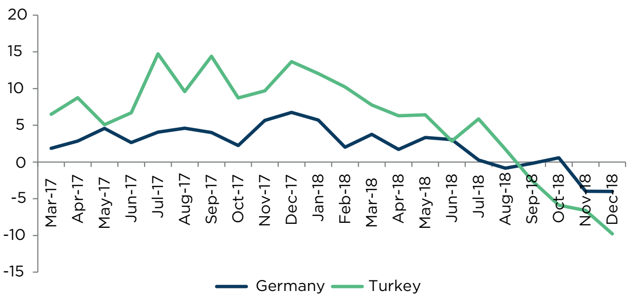
Turkey enjoys a higher degree of advantage in terms of exports in textile-clothing, metals, and plastics **(Chart 3)**. Although these sectors have not changed much in recent years, the country saw its comparative advantage decline in textile-clothing, minerals, vegetables and food products between 2000 and 2016. On the other hand, the level of its comparative advantage in transportation and plastics has increased.

CHART 4
Turkey Economic Complexity Index



Sources: OEC, OECD Economic Surveys Turkey July 2018

CHART 5
Manufacturing Production in Germany and Turkey (% change YOY)



Sources: Thomson Reuters Datastream, TSI
**Germany figures are seasonally adjusted*

Recent research about the composition of Turkish exports indicates that the country has reached a threshold in terms of sectoral specialisation, which would push it to record additional sophistication and market share[7] in the future. Turkey's economic sophistication (complexity) – which measures the relative knowledge intensity of an economy through the diversity and ubiquity of its exports – remains above than some of its peers, such as Russia, India and Brazil **(Chart 4)**.

Further expansion of the export sophistication is in line with the government's new 2019-2020 economic programme, which is based on rebalancing the economy via higher exports and a narrower trade deficit. In order to do so, the authorities have picked the pharmaceutical, chemical, petrochemical, energy, machinery and software sectors as having priority in terms of investments. Within this framework, the government's strategy to establish industrial and technological zones, where high-tech products will be produced by large-scale domestic and foreign investments, may provide additional advantage for Turkish exports yet this strategy would need time to be realised.

In this regard, the limited competitiveness and sophistication of exports represent a challenge. Regarding competitiveness, Turkey ranked 61st out of 144 countries in the Global Competitiveness Report of the World Economic Forum in 2018. In the sub-categories, Turkey ranked lower regarding labour market efficiency (111/140), institutions (71/140), and human capital skills (77/140). Nonetheless, its rank was higher for infrastructure (50/140) and innovation capability (47/140).

Global growth performance will also impact Turkish exports. Turkey is integrated in the global value chains, as its companies are able to manufacture and assemble a particular good in more than one country. In this sense, there is a close relation between the industrial production in Europe, particularly in Germany (Turkey's biggest export market) and in Turkey **(Chart 5)**. As long as economic growth in Europe remains resilient, Turkish exporters will benefit from higher sales (although profit margins will continue to remain tight). Yet recent indicators about a possible stalling in growth performance in Europe can be seen as a potential challenge for Turkey's export revenues, especially for the automotive and textile-clothing sectors, as their sales are mostly concentrated on European markets.

SMEs account for around 55% of Turkish exports. Due to lack of necessary financial buffers, they are negatively impacted by the lira's sharp depreciation and high volatility. The latter makes pricing of export products very difficult. SMEs are struggling heavily from equity insufficiency and deteriorated cash flow, as payment terms in the domestic market have significantly expanded due to both the currency shock and rising costs of production and financing. In addition to these challenges, during the period of lira's weakening, SMEs suffer from bargaining power of their buyers, as their foreign customers usually put pressure on them to provide higher quality products at lower prices. This is another risk that weighs on exports' profits.

6 - As per the World Bank, "measures of revealed comparative advantage (RCA) have been used to help assess a country's export potential. The RCA indicates whether a country is in the process of extending the products in which it has a trade potential, as opposed to situations in which the number of products that can be competitively exported is static. It can also provide useful information about potential trade prospects with new partners." If the index is higher than 1, it means there is a comparative advantage. If the RCA is less than unity, it means the country has a disadvantage in the sector or commodity.
7 - Turkey, July 2018 Overview, OECD and Hausmann, R. (2017), What should countries do to catch up? The challenge of technology diffusion, *New Approaches to Economic Challenges – OECD* https://oecdtv.webtv-solution.com/4020/or/naec_seminar_ricardo_hausmann_what_should_countries_do_to_catch_up_the_challenge_of_technology_diffusion.html

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