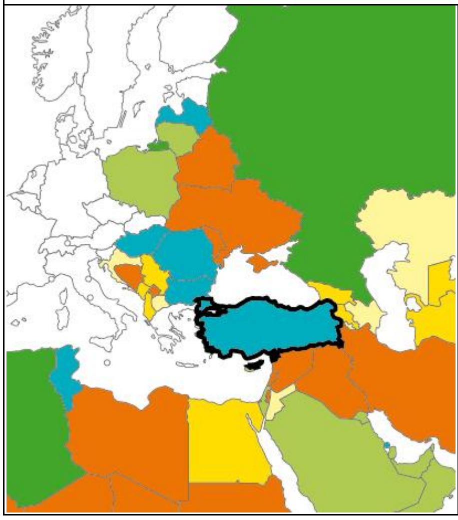
COUNTRY RISK ANALYSIS

Turkey

CREATING CONFIDENCE IN YOUR EXPORTS



COUNTRY RISK CATEGORY

4/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES ON THE COUNTRY

Short-term transactions: SEK 133 million

Medium and long-term transactions: SEK 4,362 million

EKN'S POLICY

Sovereign risks: Normal risk assessment

Other public risks: Restrictive risk assessment

Bank risks: Normal risk assessment

Corporate risks: Restrictive risk assessment

See “EKN'S POLICY” section

DATE

5/15/2014

Turkey's vulnerability exposed

There's no question that Turkey's economy has been stabilised under the rule of the AK Party. The economic growth and development of the past decade largely have no historical equal. But with domestic political battles, Erdoğan's increasingly authoritarian style of leadership and worse international conditions, the vulnerability of the Turkish economy has been exposed. Turkey's dependence on foreign financing is the biggest risk factor going forward. The Turkish lira has experienced heavy depreciation, but the economy still has a sizable current account deficit. There's no imminent risk of a balance of payments crisis, but growth will slow down. These risks are spilling over in the banking and corporate sector, which have a couple of tough years ahead of them. The rapid credit growth of the banks and the foreign currency debt of the companies will impact their credit rating.

STRENGTHS

- Public finances with sustainable debt and budget control.
- Improved prospects for the export sector following currency depreciation.
- Banking system with buffers that can withstand a temporary economic decline.

WEAKNESSES

- Large amount of external financing needed in a time of declining global liquidity.
- Corporate sector sensitive to falling growth, rising interest rates and currency depreciation.
- EKN's negative payment experience in the mining, construction and transport industries.

POLITICS

Erdoğan stays in office, in spite of protests

Prime Minister Recep Tayyip Erdoğan has suffered several setbacks following investigations of the government showing corruption and nepotism. The government says it is at war with international conspiracies and its US-based former ally Imam Fethullah Gülen, whose movement controls part of the Turkish judiciary. The investigations of the government have been quieted down and the government has taken legal measures to protect itself from the accusations. New legislation has strengthened the government's control over the judiciary and limited the freedom of information on the Internet. The authoritarian measures have damaged relations with the EU and intensified the domestic political crisis, resulting in additional protests. The radical parlance, police violence and authoritarian methods to control information will dominate domestic politics during the year. The political instability and polarization as well as the social tensions will persist until the Parliamentary Elections in June 2015.

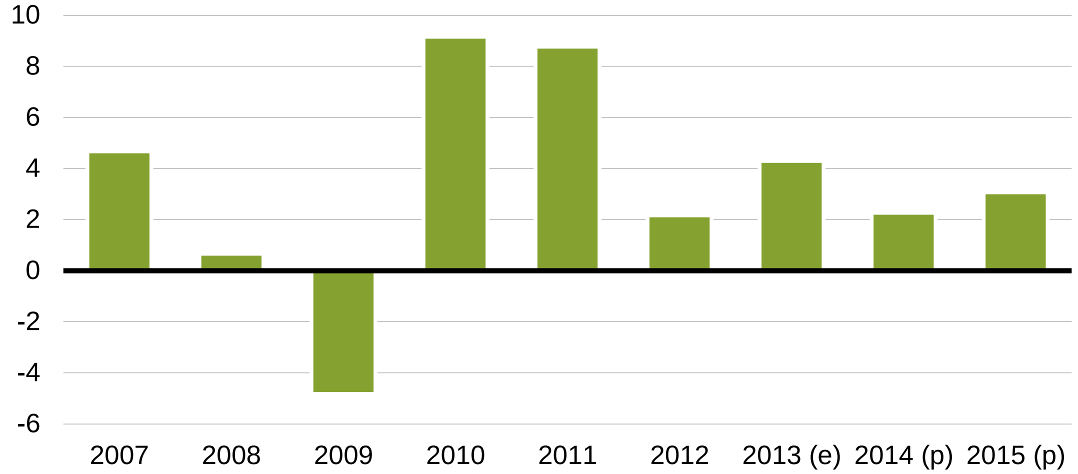
Erdoğan may have given up on his plan to become the president with expanded powers. In that case, Abdullah Gül is expected to continue in a second term of office as the president with a low profile and little influence. Erdoğan may instead try to change the by-laws of the AK Party so he can continue as the prime minister for a fourth term of office. The largest opposition party, the Republican People's Party, seems far too divided to pose a threat to Erdoğan and the AK Party, even though the AK Party probably is not in as strong a position as before in the upcoming elections. A high degree of political continuity is to be expected as long as Erdoğan is prime minister or president, but also a continuation of the authoritarian methods used to quiet the opposition and strengthen the AK Party's hold on power.

ECONOMY

Subdued growth risks falling even more

A less expansive monetary policy in the US and the EU will lead to lower growth in many emerging economies as global liquidity is reduced. Turkey has been one of the main recipients of capital inflows in recent years, which has driven both growth and the current account deficit. Turkey is currently one of the most exposed countries when foreign financing is reduced and gets more expensive. Household consumption, the main growth driver, will be hampered by the depreciation of the lira, high inflation and rising interest rates. Unemployment will increase to over ten percent. For Turkish business, greater competitiveness combined with the currency depreciation and increased foreign demand should benefit the export sector and tourism. In addition, public spending will increase in the run-up to the elections in 2014 and 2015. In total, a growth rate of between three to four percent is forecast for the coming years, but it risks being lower if capital inflows are further reduced.

GDP GROWTH (% PER YEAR)



The growth rate is dependent on continuing access to foreign capital. Data: IMF

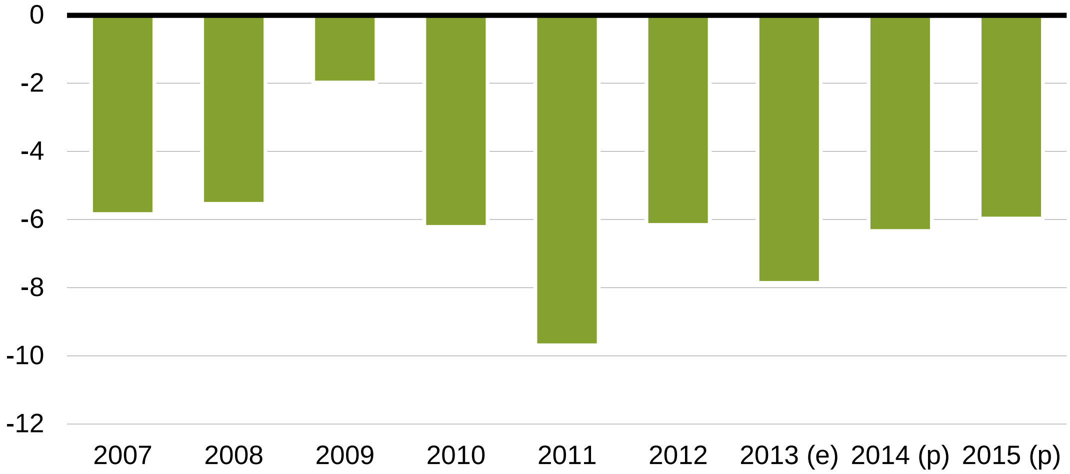
Turkey's public finances serve as a strength for economy stability. The government has set a relatively tight budget for 2014 in order to reduce domestic demand so that it can get its increasing current account deficit under control. But this budgetary discipline will not be maintained as long as the AK Party is fighting to keep the public's support during the corruption scandal. A decade of conservative fiscal policies has given the government the scope to pursue a counter-cyclical policy and increase spending in the coming quarters, with only a small risk for the country's public finances. The budget deficit of a couple percent of GDP therefore does not undermine the sustainability of the public debt, which is moderate and has an increasing proportion in local currency. No substantial structural reforms are to be expected in the current unstable political climate.

BALANCE OF PAYMENTS AND DEBT ISSUES

The large amount of financing needed is making the economy vulnerable

The current account deficit increased to nearly eight percent of GDP in 2013, the second highest deficit historically. This change for the worse can be explained by strong domestic demand, credit growth, large capital inflows and above all the need to import energy. Turkey is now entering a period of lower growth, which will decrease imports and reduce the amount of external financing needed. The depreciation of the lira will give the competitiveness of Turkish companies a boost. Together with increased growth in the EU, this means that the country's export prospects are fairly good. The country's tourist sector will benefit from a weak lira and improved economic prospects for European households.

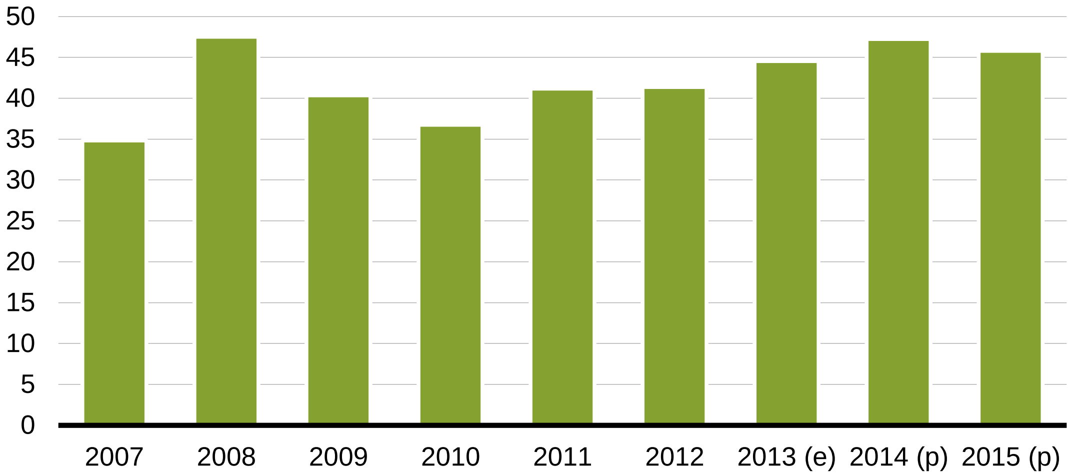
CURRENT ACCOUNT BALANCE (% OF GDP)



Current account deficits to remain large over the coming years. Data: IMF.

In spite of this, the current account deficit will remain at a precariously high level. Imports of oil and gas, which account for 75 percent of the deficit, as well as a small export sector make it hard to cut the deficit. The manufacturing industry for textiles, vehicles and electronics has developed into one of the most dynamic export sectors, but Turkey does not have a high-tech industry that can compete on the world market. The structural current account deficit has over the years created a large external debt and a high debt service ratio, which are now becoming difficult to finance. The financing of the current account deficit largely consists of portfolio investments and other short-term investments. With only a little bit of foreign direct investment, the volatility of capital inflows is high and the economy remains sensitive to fluctuations in the global economy. Increased political tensions will be an additional inhibiting factor for direct investments.

EXTERNAL DEBT (% OF GDP)



The external debt is relatively stable. Data: Datastream.

CURRENCY POLICY

The lira continues to be vulnerable

The lira is volatile and has weakened considerably over the past year due to Turkey's weak external balance and increasing political instability. Turkey's large current account deficit will continue to put pressure on the currency for lack of sizable capital inflows. As could be seen by the protests in the summer of 2013 and the recent corruption scandals, political instability leads to increased pressure on the lira. Continuing political turbulence leading up to the 2015 elections, together with the economic vulnerability, creates a risk of currency instability and depreciation over the coming year.

The central bank's credibility has been damaged by what has been considered political control and a focus on growth instead of price and exchange rate stability. In an attempt to stabilise the lira's fall, the Turkish central bank sharply raised the key interest rate in January 2014. The dramatic tightening will hardly restore the credibility of Turkish monetary policy. Regardless whether the central bank is under political influence or not, there is evidence that it has shown greater tolerance for currency depreciation recently. In the coming years, it is probable that the central bank will keep the key interest rate at a level that secures the external financing needed, but is insufficient for the lira to appreciate. The lira has a high degree of convertibility and may be considered by EKN in local currency financing transactions.

FINANCIAL SECTOR

Credit growth has increased vulnerability

Turkish banks have shown steadily improved resistance and credit ratings since reforms were made after the country's 2001 financial crisis. The loan quality is good, profitability is good and capitalisation is strong. The banks have now reached a point where some of these strengths are coming under pressure, mainly due to the rapid credit growth in recent years. Since 2010, the domestic loan book has increased by over 20 percentage points as a proportion of GDP and is approaching 60 percent. As a result of increased domestic political risk, growth slowdown, currency fluctuations and the consequences of a tighter monetary policy in the western world, the prospects for the banking sector have worsened. Turkish banks are more exposed to an economic slowdown than they have been for a long time.

The high proportion of loans in foreign currency, which have gone to companies without earnings or assets in hard currency, is especially disconcerting. Regulations largely prohibit this lending and it is much lower than in the beginning of the 2000s. Much of the foreign financing has gone to the domestic service sector, the property sector and the construction industry. Lower growth will lower the credit rating of these lenders. Together with the depreciation of the lira and rising interest rates, several Turkish companies will have trouble paying their loans. While the banks hedge their currency positions, borrowers are often exposed to currency risks. The effects have thus far been limited, but will be felt in 2014 in the form of worse supply quality and profitability. It will also get more expensive for the banks to refinance their short-term external debts. A good equity-asset ratio and sufficient buffers give the banking sector the capacity to absorb these losses.

BUSINESS ENVIRONMENT

Currency exposure increasing credit risks

Turkish companies are sensitive to the current trend of falling growth, rising interest rates and a weaker local currency. The lack of cheap medium-term financing in local currency restricts the room for manoeuvre of Turkish companies, which are instead attracted by US dollar and euro loans with lower interest rates. With worse access to hard currency, it will be more difficult to refinance these loans. Companies have to either rely on shorter term US dollar and euro loans or exchange a weaker lira to pay their US dollar loans, which increase their debt burden. Lending in foreign currency is regulated and the recent growth in loans to households and SMEs has mainly been in local currency. Individual companies are nevertheless currency exposed and this is taken into account in the credit assessment of companies.

The lack of local financing has stimulated growth of the domestic capital market. In 2012, Turkey's commercial and capitals market legislation was revised. The reforms result in modernisation of share trading and the forcing of listed companies to become more financially transparent, to allow market operators to better understand credit risks. These improvements will stimulate the development of a local capital market in the long term.

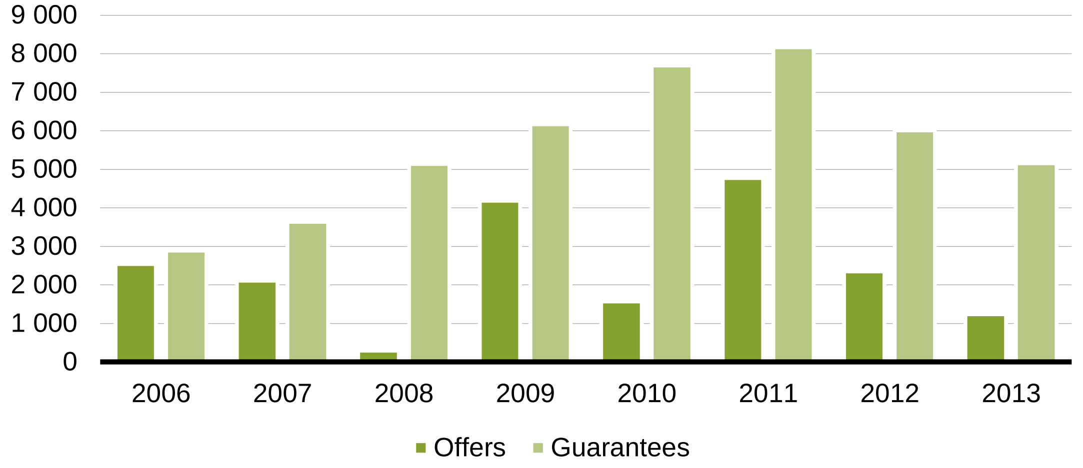
Political intervention is still influencing individual sectors, companies and projects. High consumption taxes and frequent tax changes are affecting companies that sell to consumers, such as in the automotive and telecom sectors. Public procurement legislation, regional development and investment support, employment and exports are under constant review, as well as barriers to trade in agriculture, textiles and other sectors. Unpredictability also surrounds the powers and independence of supervisory bodies. State-owned companies with competitive advantages continue to be a problem in areas such as the banking and energy sectors. The World Bank ranks Turkey's business climate in 69th place out of 189 countries, in line with countries in the Balkans and Eastern Europe, but better than its neighbours in the Middle East.

EKN'S EXPOSURE

Falling exposure in recent years

In the period between 2009 and 2013, EKN has issued guarantees for 141 transactions totalling SEK 15.7 billion for Swedish companies exporting to Turkey. The flow of guarantees and the outstanding exposure increased until 2011, when there were outstanding guarantees totalling SEK 8.2 billion. Since then, the portfolio of both offers and guarantees has been reduced. Slightly lower Swedish exports to Turkey and an improvement on the international financial markets that reduced the demand for risk coverage contributed to this trend. In the same manner, the currently increasing political and economic uncertainty in Turkey may increase EKN's provision of guarantees in the coming year.

EKN'S EXPOSURE AT 31 DECEMBER (SEK MILLION)



The portfolio of guarantees has been on a downward trend since its peak in 2011.

EKN's exposure is concentrated in the telecom sector, but sectors such as infrastructure, transport, construction and power also have major exposure. For several guarantees, the payment risk rests on the Turkish sovereign, municipalities and banks.

PAYMENT EXPERIENCE

Worse experience in recent years

EKN's payment experiences have been mixed in Turkey, especially during the recent financial crisis. The frequency of arrears has been periodically high, but indemnifications have remained small. Over the past five years, transactions totalling SEK 76 million have been indemnified. The majority of the problem transactions have been in the mining, construction and transport industries. The recovery processes in these transactions have been sluggish. Retention of title clauses have not always been able to be enforced and auctions of recovered assets have been manipulated. Our experience is that buyers have not kept their promises following renegotiations and have often prioritised other claims. The lesson for EKN is that small buyers in cyclically sensitive industries should be dealt with carefully, even if the buyer looks financially acceptable on paper.

EKN'S POLICY

EKN has classified Turkey in country risk category 4 since 2008, an assessment undertaken in collaboration with the OECD. Budgetary discipline and relatively strong public finances justify normal risk assessment for sovereign risks. A lack of transparency for public entities that are less centralised, such as municipalities and state-owned companies, result in payment collateral being sought in the form of a letter of credit, or a bank or sovereign guarantee. There are no special restrictions for bank risks. The banking system is still in relatively good shape with profitable and well-capitalised banks. The risk assessment of corporate risks is restrictive. Currency risk is a factor that must be taken into account and assessed on a case-by-case basis.

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NORMAL RISK ASSESSMENT

There are not any limitations to the risk assessment or preconditions for risk assessment stipulated in advance.

RESTRICTIVE RISK ASSESSMENT

EKN places higher demands on the risk assessment to guarantee a transaction. EKN may have specified special criteria that are central to the risk assessment of the debtor category in question.

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 783,562 km² (1.7 times Sweden)

Population: 81.6 million (2013)

Population growth: 1.1% (2013)

GDP: USD 788 billion in 2012 (Sweden USD 524 billion in 2012)

GDP/capita: USD 10,527 in 2012 (Sweden USD 54,815 in 2012)

CREDIT RATINGS

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	Baa1	Baa3/stable
S&P:	BBB	BB+/neg
Fitch:	BBB	BBB-/stable

COUNTRY ANALYST

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COUNTRY RISK ANALYSIS

Turkey

DATE

5/15/2014

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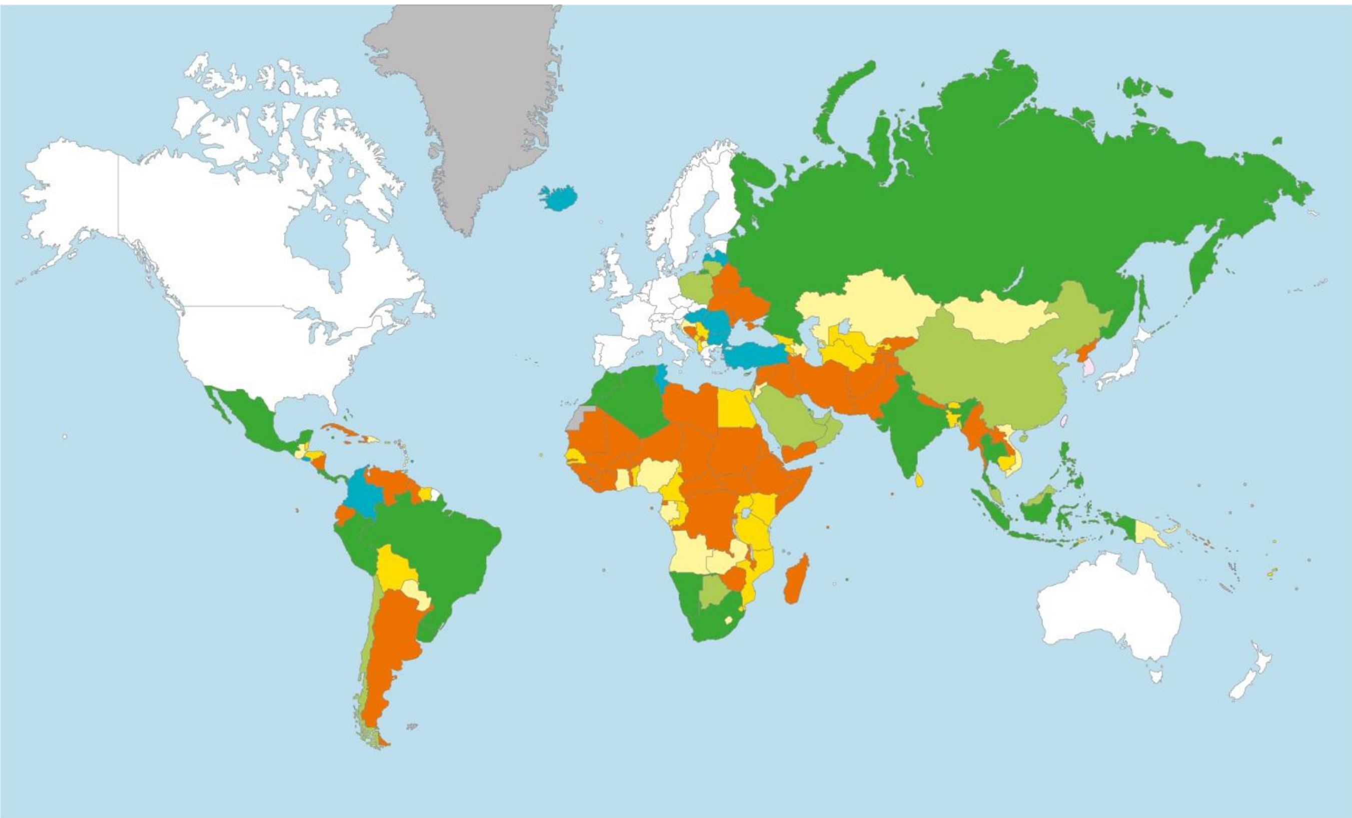
EKN'S VIEW OF THE WORLD



The country risk categories range from 0 to 7.
The lower the number the better the credit rating the country has.

EKN – CREATING CONFIDENCE IN YOUR EXPORTS

EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

The Swedish Export Credits Guarantee Board
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