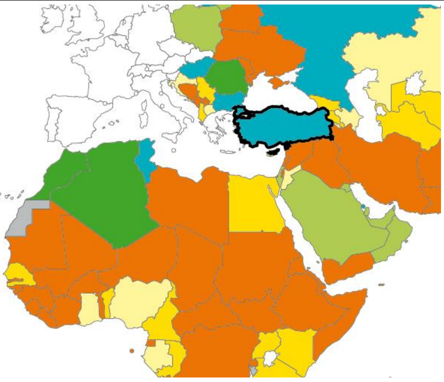
COUNTRY RISK ANALYSIS

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.

EKN'S OUTSTANDING GUARANTEES TO THE COUNTRY

SHORT-TERM TRANSACTIONS: SEK 69 MILLION

MEDIUM AND LONG-TERM TRANSACTIONS: SEK 4,212 MILLION

DATE

25/5/2015

Domestic power play and economic stagnation

The political stability in Turkey has been put in jeopardy in recent years. Political battles and Erdoğan's increasingly authoritative style of leadership have led to tensions between the government and the political opposition. Erdoğan's goal of strengthening the presidency raises the risk of continuing instability. The Turkish economy is showing early signs of stagnation. Its high dependence on foreign financing continues to be a risk factor for economic and financial stability. Turkey's currency has experienced heavy depreciation and current account deficit is still sizeable. A balance of payments crisis is not imminent, but growth is slowing down. The risks are spilling over into the banking and corporate sector. The rapid credit growth of the banks and the foreign currency debt of the companies will impact their credit rating. The balance of payments will remain weak in the long term, given that the capacity to increase exports and the inflow of foreign investment is limited.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

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

Weaknesses

- Increased domestic and regional instability.
- Large amounts of external financing required poses a risk in conjunction with lower global liquidity.
- Corporate sector sensitive to stagnant growth, rising interest rates and currency depreciation.

EKN'S POLICY

EKN has categorised Turkey in country risk category 4 out of 7 since 2008 – an assessment made in collaboration with the OECD. Budgetary discipline and relatively strong public finances justify a normal risk assessment policy for sovereign risks. As a result of poor transparency on the part of public entities that are less centralised, such as municipalities and state-owned companies, payment securities is sought in the form of a letter of credit, or a bank or government guarantee. There are no special restrictions for bank risks. The banking system is still in good shape with profitable and well-capitalised banks. The risk assessment policy for corporate risks is restrictive. Currency risk is a factor taken into account and assessed on a case-by-case basis.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- Less vulnerable balance of payments.
- Reinstated EU reforms that improve the business environment in the long term.

The policy may be made more restrictive in the event of

- Increased domestic instability and authoritarian political interventions.
- Lower capital inflow that creates balance of payment problems.

EKN'S EXPOSURE AND EXPERIENCE

Major exposure, mixed experience

Turkey is one of the countries that EKN has the highest exposure to. Guarantees totalled SEK 4.3 billion in March 2015. Offers were valued at SEK 3.3 billion at the same time. EKN's exposure is concentrated in the telecom sector, but sectors such as infrastructure, transport, construction and power also have major exposure. EKN's payment experience from Turkey has been mixed. The frequency of payment delays has been periodically high, but indemnifications have generally remained low.

COUNTRY ANALYST

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DISCLAIMER

POLITICS

Parliamentary elections and regional conflicts

President Recep Tayyip Erdoğan has suffered several setbacks in recent years. Investigations of the government have revealed corruption and nepotism. 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. These authoritarian actions have damaged relations with the EU. The radical parlance, authoritarian methods and the social tensions will leave their mark on domestic policies, at least until the parliamentary elections in June 2015. A high degree of political continuity is to be expected as long as Erdoğan is the centre of power in Turkey.

It is highly likely that the AK Party will come out of the elections in June victorious. The opposition is far too divided to pose a threat to the AK Party. Erdoğan and the AK Party are expected to attempt to push through constitutional amendments aiming to strengthen the presidency after the election. However, Erdoğan will need to win over the Kurdish parliamentarians, which will be difficult given that the ongoing peace process with the Kurds is progressing slowly. It is expected that the AK Party will be walking a thin tightrope as it is at risk of losing the support of nationalist Turks if they give the Kurds too high concessions. There is also a risk of a new armed conflict with the Kurdish PKK if the peace process breaks down. As a result, the plan to strengthen the presidency appears difficult to implement, which raises the risk of political instability.

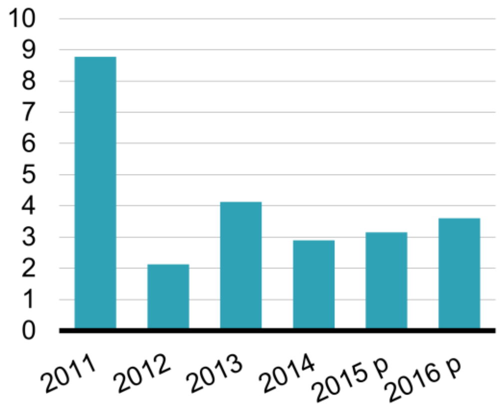
In terms of foreign policy, the regional conflicts, especially the civil wars in Syria and Iraq, take centre stage. Turkey is hosting around 1.5 million Syrian refugees who are having trouble finding employment. The conflict in Iraq is having a negative impact on Turkey in consideration of the economic relations between the countries. A more autonomous Kurdistan in northern Iraq is also concerning to the Turkish government, given that it could lead to increased demands for autonomy from Turkey's Kurds.

ECONOMY

Risk of stagnation

The growth forecasts for the Turkish economy indicate economic stagnation with a relatively low annual growth rate around 3% over the coming years. This level is not sufficiently high to create enough jobs for the young population. Unemployment is already over 10% and is on the rise. Turkey needs a new growth model and needs to move up in the economic value chain and not base its growth on consumption and credit expansion as it does now. However, the innovation to succeed in that is lacking at this time. Factors that can explain this include the authoritarian education system, weaknesses in the legal system, authoritarian political tendencies and discontinued EU reforms. The government's new economic growth plan includes initiatives to reduce the country's energy dependence, raise productivity and increase the quality of

GDP GROWTH (% PER YEAR)



Growth will stay between 3% and 4% per year. Data: IMF education. However, there are no budgeted funds or time schedules for these initiatives. There is a risk that the growth plan will remain a PR and paper product without real significance.

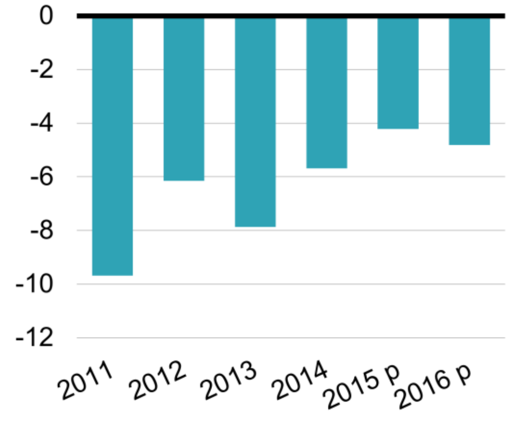
Turkey's public finances serve as a strength for economy stability. A decade of conservative fiscal policies has given the government the scope to pursue a counter-cyclical policy and increase spending as needed. The budget deficits are low and the public debt, mainly in domestic currency, is around 30% of GDP. The government's borrowing needs are low going forward. However, the budget has been kept in balance thanks to one-time factors, especially privatisation. As a result, the country's fiscal policies are not as austere as they seem, and recurring spending needs to be cut back in the future. The government's revenues are also slightly one-sided and cyclical, given that 70% comes from taxes on consumption. Ali Babacan's third term of office as deputy prime minister responsible for the economy ends in 2015. The AK Party's internal party rules allow a maximum of three terms of office and it is uncertain whether he will be able to continue as a minister. This creates uncertainty for the country's fiscal policies in the long term, given that Babacan, as a business-friendly technocrat, served as a stable anchor in an otherwise increasingly politicised and erratic political environment.

BALANCE OF PAYMENTS AND DEBT ISSUES

Current account running a structural deficit

More austere monetary policies in the US and the EU in the long term will have a negative impact on Turkey's balance of payments as global liquidity decreases. Turkey has been one of the main recipients of capital inflows from the western world in recent years, which has driven both growth and the current account deficit. The current account deficit came in at around 6% of GDP in 2014, in line with the average over the past decade. The deficits are driven by strong domestic consumption, credit growth and energy imports. The lower oil price will be positive for the balance of payments, resulting in a slightly lower current account deficit this year.

CURRENT ACCOUNT BALANCE (% PER YEAR)



The current account deficit is temporarily decreasing this year. Data: IMF

The textiles, vehicles and electronics manufacturing industries are the main export sectors, but Turkey does not have a high-tech industry that can compete on the world market. Exports are benefiting from the depreciation of the lira which has boosted the competitiveness of Turkish companies. The country's tourism sector will benefit from a weaker lira and an improved economic outlook for European households. Exports to the EU, Turkey's most important export market, are on the rise thanks to a slightly better economic climate. A certain degree of market diversification from the EU to the Middle East has also taken place. In spite of this, the limited size of the export sector makes it difficult to cut the current account deficit permanently. The turbulence in the Middle East and Russia's weak economy have cut demand for Turkish goods and services on these markets.

Over the years, the current account deficit has created high external debt and high debt service which is expensive to finance. In the early 2000s, much of the deficit was financed by foreign direct investment. Now, capital inflows mainly come in the form of portfolio investments, a more volatile form of financing. The balance of payments will continue to be sensitive to fluctuations in the global economy. As a result of stagnant growth and decreased imports, along with a lower oil price and slightly improved export opportunities, the overall risk to the balance of payments is manageable.

CURRENCY POLICY

Lira still unstable

The Turkish lira is volatile and has weakened over the past years due to the country's weak external balance and increasing political instability. As could be seen by the corruption scandals over the past years, political instability leads to increased pressure on the lira. Continuing political turbulence leading up to the 2015 elections, along with the vulnerable external balance and low real interests rates, creates a high probability 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, the key interest rate was raised sharply in January 2014. However, the interest rate already began to be cut again in the summer. 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 addition, the monetary policies are far too expansionary to keep inflation and credit growth at satisfactory levels. 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 stabilise. The lira has a high degree of convertibility and may be considered by EKN in transactions financed in local currency.

FINANCIAL SECTOR

Banks on stable ground, but debt burden on the rise

The Turkish banking sector consists of around 50 banks, with the 10 largest accounting for 80% of the sector. 45% of the sector is foreign-owned. Turkish banks have shown steadily improved credit ratings since reforms were made after the country's 2001 financial crisis. The banking supervision authority exercises strict supervision. Asset quality and profitability are satisfactory 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. The loan portfolio has doubled since the 2009 financial crisis and the banking sector's assets are equal to around 100% of GDP. The outlook for the banking sector is bleaker as a result of increased domestic political risk, growth slowdown, currency fluctuations and the future consequences of a more austere monetary policy in the western world.

The banking sector is Turkey's largest external borrower and financier of the country's current account deficit. A large portion of foreign loans go on to the corporate sector, often to companies without sufficient revenues or assets in hard currency. Regulations largely prohibit this lending and it is lower now than in the early 2000s. Much of the foreign financing has gone to the domestic services sector, the property sector and the construction industry as well as to SMEs. The depreciation of the lira will make it difficult for some Turkish companies to repay their loans. While the banks hedge their currency positions, borrowers are often exposed to exchange rate risks. However, a satisfactory equity-asset ratio and sufficient buffers give the banking sector the capacity to absorb these credit losses. The external financing required by the banks is a major vulnerability that can lead to problems if the outlook of foreign investors toward Turkey deteriorates.

BUSINESS ENVIRONMENT

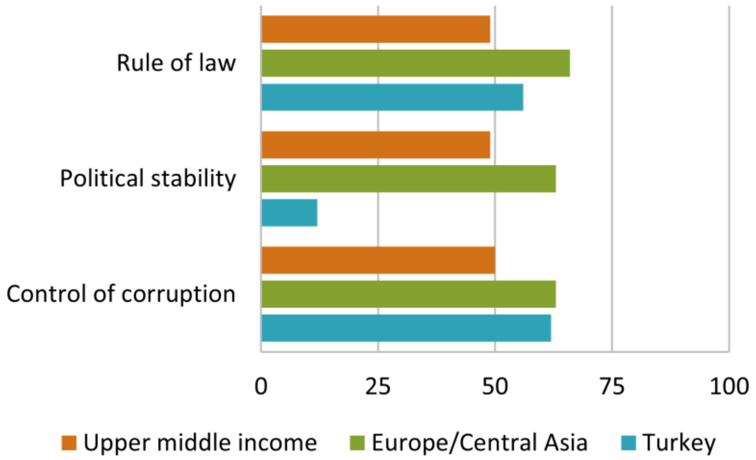
Continuing EU reforms necessary

Turkish companies are vulnerable to the current trend of stagnant growth and a weaker local currency. The lack of cheap medium-term financing in local currency restricts the room for manoeuvre of Turkish SMEs, which are instead attracted by US dollar and euro loans with lower interest rates. Companies have to either rely on shorter term US dollar and euro loans or convert a weaker lira to pay their US dollar loans, which increases 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 have currency exposure though and this is taken into account in the credit assessment of companies.

The shortage of local currency has stimulated the growth of the domestic capital market. Turkey's commercial and capital market legislation was revised in 2012. The reforms stipulate modernisation of equities trading and force listed companies to become more financially transparent. These improvements will stimulate the development of a local capital market in the long term. Until then, the banks will be just about the only source of financing.

Political intervention is still influencing individual sectors, companies and projects. High consumption taxes and frequent tax changes are affecting companies that sell to consumers. 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. EU reforms in the judiciary were initiated in 2003 and have come a long way. New courts have been established for commercial disputes, but structural problems remain in the form of time-consuming legal proceedings. The World Bank ranks Turkey's business climate in 55th place out of 189 countries, in line with countries in the Balkans and Eastern Europe, but better than its neighbours in the Middle East.

BUSINESS ENVIRONMENT
Ranking from 0 (worst) to 100 (best)



Turkey is ranked high in terms of rule of law and corruption, but lower with respect to political stability. Source: World Bank

EKN'S EXPOSURE

Large but decreasing exposure

In the period between 2010 and 2014, EKN issued guarantees for 130 transactions totalling SEK 13.5 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 decreased. Slightly lower Swedish exports to Turkey and an improvement on the international financial markets drove this trend by reducing the demand for risk coverage. 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 Turkish government, municipalities and banks bear the payment risk.

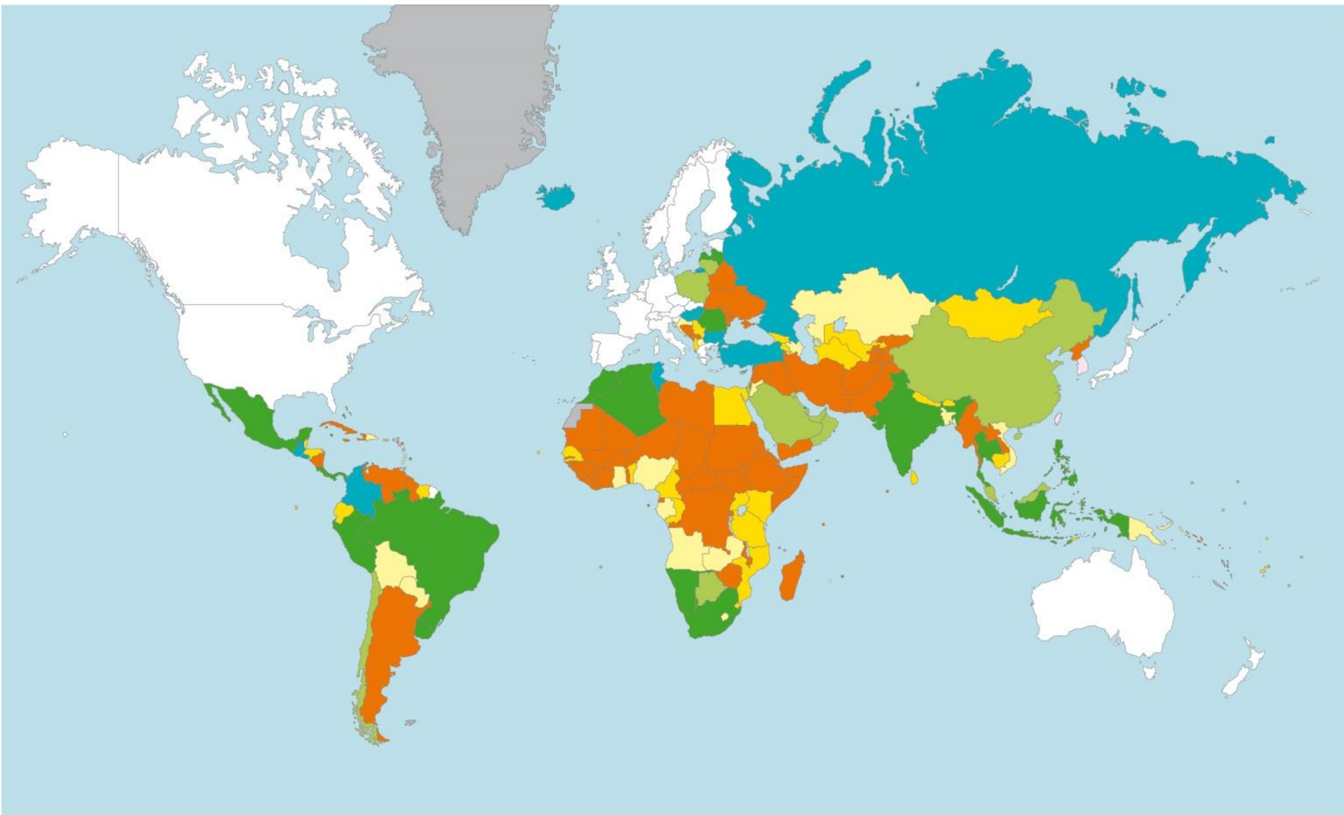
PAYMENT EXPERIENCE

Payment problems in certain sectors

EKN's payment experience has been mixed in Turkey, especially since the 2009 financial crisis. The frequency of payment arrears has been periodically high, but indemnifications have generally remained low. Transactions totalling SEK 137 million have been indemnified over the past five years. The majority of the problem transactions have been in the mining and construction sectors. The recovery proceedings in these transactions have been slow. Retention of title clauses have not always been successfully enforced and auctions of recovered assets have been manipulated in some cases. EKN has had experiences where buyers have not kept their promises following renegotiations and have often prioritised other claims. The lesson is that small buyers in cyclically sensitive industries should be dealt with carefully, even if the buyer looks financially acceptable on paper.

COUNTRY DATA	CREDIT RATING	
Area: 783,562 km² (1.7 times Sweden)	**Moody's:**	Baa3
Population: 82 million (2014)	**S&P:**	BB+/negative
GDP: USD 806 billion in 2014 (Sweden USD 570 billion in 2014)	**Fitch:**	BBB-/stable
GDP/capita: USD 10,482 in 2014 (Sweden USD 58,491 in 2014)		

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.

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