**Risk Summary for Turkey**
To: *XYZ Company*

This summary has been prepared for *XYZ Company* by the World Trade Center – Kansas City to keep the company informed as to relevant market developments in Turkey.

**Key findings are:**

- Turkish President Recep Tayyip Erdogan will tighten his grip on power in the near term, following the failed coup on July 15-16. However, this will raise long-term political risks in the country, and further strain relations with the West.
- Turkey will operate under a de-facto executive presidential system under Erdogan, with negative implications for institutional quality and government checks and balances.
- Turkey faces a challenging foreign policy environment amidst heightened regional tensions and rising domestic security risks as the government attempts to cement its role as an economic and political power in the region.
- A collapse of the government's ceasefire with the Kurdish separatist PKK is a major step back for the country, weighing on growth potential.
- Relative to the past decade, BMI expects slower, more balanced growth in the next decade on the back of less abundant foreign capital inflows and slower domestic credit growth.
- While the government's debt load is low by regional standards, the private sector's rampant external borrowing in previous years has greatly increased macroeconomic risks.
- Despite cheaper oil, Turkey's current account deficit will remain large and a major macroeconomic vulnerability. Turkey will remain reliant on short-term foreign capital inflows to cover the sizeable current account shortfall, leaving it prone to tightening global liquidity and shifts in international risk sentiment.
- A dovish central bank will keep inflation above target and ensure a volatile growth trajectory.
- The increase in the statutory minimum wage by 30% to TRY1,300 (USD437 at exchange rate on May 11 2016) as of January 2016 will increase wage costs for employers, particularly small- and medium-sized enterprises (SMEs), and reduce the country's competitiveness in export-led industries. Although the government has stated that it will support 40% of the costs of the wage hike in 2016, this action will nonetheless weigh on profit margins for businesses. The sectors most affected will be retail and low-skilled manufacturing, with some job losses or cancellation of expansion plans expected as a result.

**The content of this report are as follows:**

| MACROECONOMIC FORECASTS (TURKEY 2014-2017) | | | | |
|---|---|---|---|---|
| **Indicator** | **2014** | **2015** | **2016f** | **2017f** |
| **Real GDP growth, % y-o-y** | **3.0** | **4.0** | **3.0** | **3.0** |
| **Nominal GDP, USDbn** | **799.1** | **717.3** | **732.4** | **748.3** |
| **Consumer price inflation, % y-o-y, eop** | **8.2** | **8.8** | **8.0** | **7.3** |
| **Exchange rate TRY/USD, eop** | **2.30** | **2.90** | **3.04** | **3.25** |
| **Budget balance, % of GDP** | **-1.3** | **-1.2** | **-2.0** | **-1.9** |
| **Current account balance, % of GDP** | **-5.5** | **-4.5** | **-4.5** | **-4.8** |
| ***National Sources/BMI*** | | | | |

**Security Risks Weigh On Overall Operating Environment**

**Turkey - Operational Risk Scores**


***100 = Lowest risk; 0 = highest risk. Source: BMI Operational Risk Index***

## 10 Year Forecasts - Turkey - Q4 2016

***BMI View:*** *Turkey will remain on a volatile growth trajectory, with average real growth rates slowing to 3.1% in the next decade, from 5.0% in 2003-2013. Although the size of the domestic market and strategic location will remain key selling points for foreign investors, weighing down on potential growth will be high operational risks, weakening institutional quality, and persistent macroeconomic imbalances.*

A series of economic and financial crises in the late 1990s and early 2000s helped usher into power the Justice and Development Party (AKP), whose structural reform programme laid the foundation for more sustainable growth by taming rampant inflation, significantly reducing the public debt ratio, and putting the banking sector on a much more solid footing. That said, macroeconomic imbalances remain prominent, ensuring a volatile growth trajectory moving forward. Meanwhile, the recent turn towards greater economic populism by the AKP - which looks set to remain in power for the foreseeable future - has dampened the outlook for robust long-term productivity gains. Between 2020 and 2025 BMI forecasts real GDP growth to average 3.1% annually, which while well above developed state averages, is below potential for an economy at Turkey's stage of development.

Strong real GDP growth in Turkey from 2002 to 2011 was fuelled by cheap foreign borrowing and characterized by robust domestic credit growth, rapidly rising private sector indebtedness and unsustainably wide current account deficits. While the current account deficit has narrowed, the rebalancing process has much further to run, and will entail a period of slower but more balanced trend growth over the next ten years as less abundant global liquidity and slower credit growth keep economic activity on a more modest trajectory. Foreign financing needs will nevertheless remain large as a proportion of GDP, leaving Turkey vulnerable to changes in global risk appetite. External imbalances will remain a persistent threat to stability given the need for continued financial and capital account inflows to finance the deficit, which in turn depend on international investor confidence and a supportive global macroeconomic environment.

### Demographic Gains Waning

Making strong productivity gains even more crucial is the fact that demographic trends are turning less supportive of growth over the next ten years. According to BMI forecasts, population growth will slow to 0.6% y-o-y from 2020-2025, from an average of 1.5% from 2005-2010, while the working age population will peak as a percent of the total by 2022. That said, there remains significant uncertainty with regards to the demographic picture due to the influx of refugees into Turkey in recent years, which current estimates put at around 2.6 million (approximately 3% of Turkey's 2014 population). A small number have been granted work permits, while others have entered into informal labour, although it is too early to have a conviction view on what proportion will end up fully integrated, and how positive this will be for long-term demographic and growth trends. That said, such a large influx of potential labour poses upside risks to long-term growth forecasts.

### Bull Case Remains Compelling

Despite challenges, Turkey still offers a compelling long-term growth story. Although private sector indebtedness has the potential to pose problems in the coming years, conservative fiscal policy is expected to remain an important anchor for confidence. Turkey's banking sector is poised for slow growth in the coming decade, although prudent regulation means systemic risks are low and credit supply will remain supportive of growth.

Given its customs union access to the EU and strategic location straddling two continents, export-oriented manufacturing will remain an important sector as foreign industrial firms take advantage of lower wages and establish production centres in the country. The large size of the domestic market and the potential growth in domestic consumption will also prove attractive to foreign firms, as the potential for the economy lies as much with service sector growth as it does in manufacturing industries. With a population of more than 70mn, the potential for domestic households to drive economic growth is robust. From 2013 levels, BMI forecasts GDP per capita to expand by just over 30% in nominal US dollar terms. It is not just the potential in the domestic and EU economies that present long-term opportunities. Turkey's strategic location between Europe and Russia, the Caucasus and Middle East is highly significant. Turkish trade and investment relationships with these regions have been growing in recent years, with countries such as Iraq, Georgia, Saudi Arabia, Iran and the UAE accounting for an increasing share of the country's exports and investment flows. While geopolitical conflicts have stunted this process in recent years, BMI expects the broader trend of trade diversification to continue.

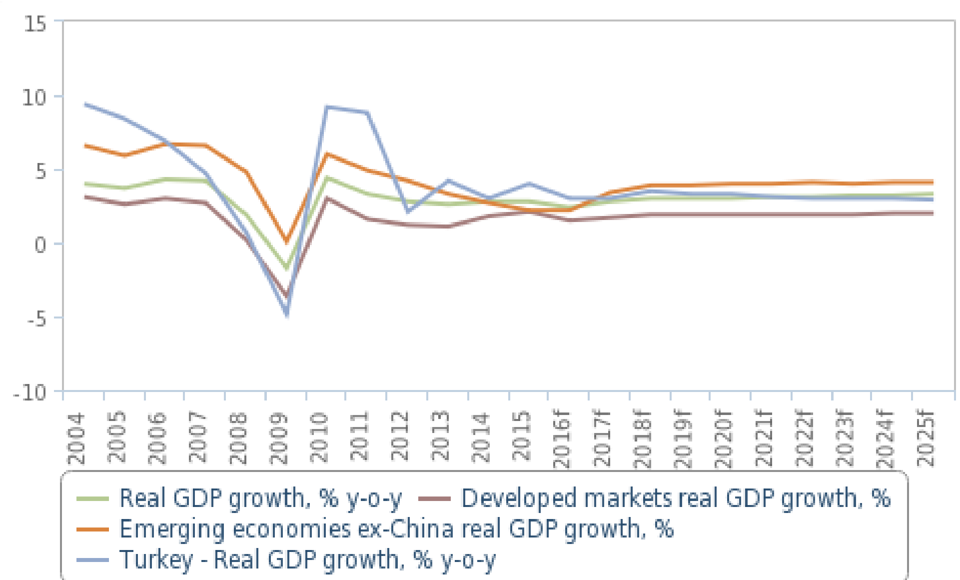
**LONG-TERM MACROECONOMIC FORECASTS (TURKEY 2016-2025)**

| Indicator | 2016f | 2017f | 2018f | 2019f | 2020f | 2021f | 2022f | 2023f | 2024f | 2025f |
|---|---|---|---|---|---|---|---|---|---|---|
| Nominal GDP, USDbn | 733.8 | 752.0 | 789.5 | 799.9 | 805.4 | 816.8 | 841.3 | 880.9 | 936.0 | 1,000.2 |
| Real GDP growth, % y-o-y | 3.0 | 3.0 | 3.5 | 3.5 | 3.3 | 3.1 | 3.0 | 3.0 | 3.0 | 2.9 |
| Population, mn | 79.6 | 80.4 | 81.1 | 81.7 | 82.3 | 82.8 | 83.3 | 83.8 | 84.3 | 84.9 |
| GDP per capita, USD | 9,469 | 9,613 | 10,002 | 10,045 | 10,028 | 10,084 | 10,298 | 10,693 | 11,270 | 11,947 |
| Consumer price inflation, % y-o-y, ave | 8.0 | 7.7 | 7.2 | 6.8 | 6.2 | 6.0 | 6.0 | 5.8 | 5.5 | 5.5 |
| Current account balance, % of GDP | -4.5 | -4.8 | -4.6 | -4.5 | -4.4 | -4.3 | -4.1 | -4.0 | -3.9 | -3.7 |
| Exchange rate TRY/USD, ave | 2.96 | 3.20 | 3.40 | 3.60 | 3.90 | 4.20 | 4.40 | 4.60 | 4.70 | 4.70 |

***National Sources/BMI***

**Turkey Underperforming**

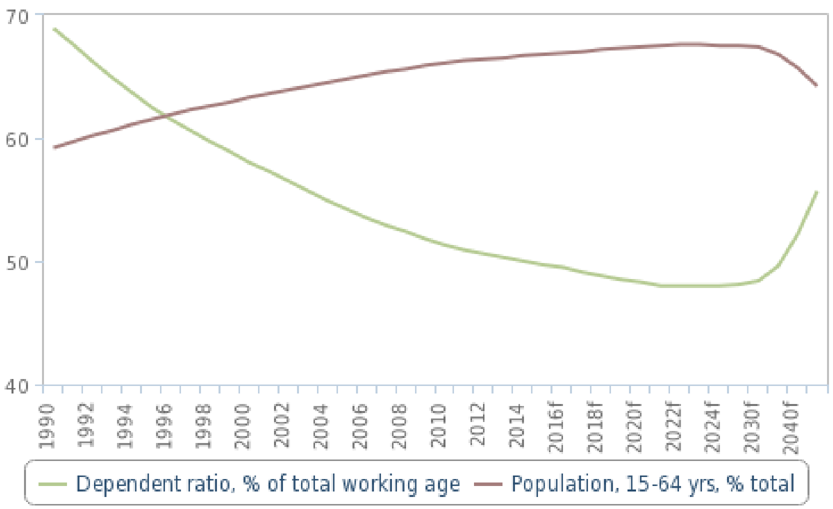
**Real GDP Growth**




**BMI/Turkish Statistical Institute**

**Demographic Boost Dissipating**

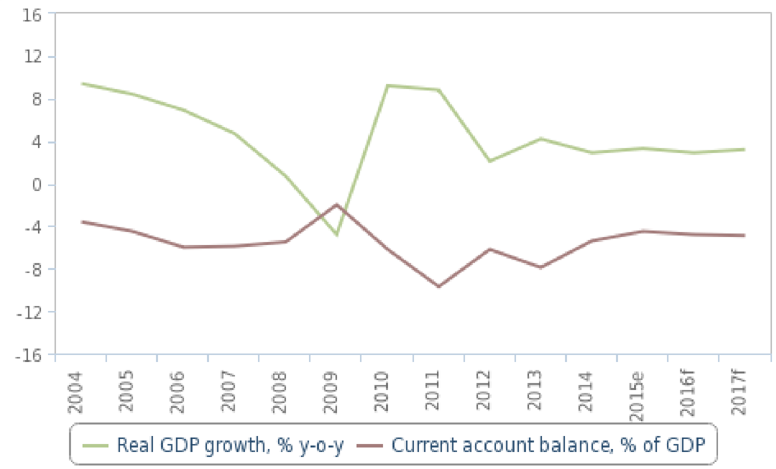
**Turkey - Dependency Ratio & Working Age Population, % of Total**




f = BMI forecast; Source: National Sources/BMI

**Foreign Borrowing Fuels Growth**

**Turkey - Real GDP Growth & Current Account Balance**




e/f = BMI estimate/forecast; Source: National Sources/BMI

## Political Risk

Political risk in Turkey is expected to remain significant through the long term. Social divisions between moderate Islamists in government and secularists in the opposition parties are expected to continue posing challenges to the stability of the policy agenda, particularly as Turkey seeks to rewrite its constitution, with outbreak of protests and demonstrations likely. Moreover, long-standing ethnic divisions between the majority Turkish and minority Kurdish populations will remain a key variable raising security risks, especially in the south-eastern part of the country. Foreign relations have also become increasingly strained, while the conflicts in Syria and Iraq have increasingly spilled over into Turkish borders in the form of terrorist attacks.

| SWOT ANALYSIS | |
|---|---|
| **Strengths** | • Turkey maintains a military alliance with the US, which has consistently supported the country in multilateral institutions such as the IMF. The country's NATO membership is a strong deterrent to external security threats.<br>• In contrast to some other Muslim states, the strong traditions of secularism and the gradual entrenchment of parliamentary democracy limits the appeal of extremist groups. |
| **Weaknesses** | • There has been no resolution to the decades-old conflict over the partition of Cyprus - a key impediment to deeper EU integration.<br>• Kurdish desire for autonomy or separatism - which could be encouraged by Kurdish groups' push for autonomy in northern Syria Iraq - presents a threat to stability and political reform.<br>• Political divisions between moderate Islamists and secularists, as well as between different factions of Islamists, are a constant source of tension that are likely to become more severe as the ruling AKP moves to consolidate power further.<br>• Turkey's attempts at extending its foreign policy influence in the region have resulted in strained diplomatic relations with Israel, Egypt, Iraq and Syria, among others. |
| **Opportunities** | • Turkey has sought rapprochement in its long-strained ties with Cyprus, Iran and Armenia.<br>• Cooperation with NATO partners and the EU in fighting Islamic State and coping with the refugee crisis may breathe new life into Turkey's EU convergence efforts. |
| **Threats** | • Security risks from Kurdish separatist militants and anti-government organizations remain a concern in Turkey, especially in the south-eastern part of the country.<br>• There is a significant risk that Turkey could face reprisal from Islamic extremists now that it is taking a more active role in the fight against the Islamic State in Iraq and Syria.<br>• Turkish President Recep Tayyip Erdogan will tighten his grip on power in the near term, following the failed coup on July 15-16. However, this will raise long-term political risks in the country, and further strain relations with the West.<br>• The AKP's commitment to maintaining the independence of key institutional such as the judiciary, and checks and balances more broadly is now in question. |

## Political Outlook - Turkey - Q4 2016

***BMI View:*** *Turkey is likely to move in a more authoritarian direction over the next few years, as President Recep Tayyip Erdogan tightens his grip on power following the failed military coup in July 2016. Meanwhile, Turkey will face rising security risks from Islamic State (IS) and Kurdish separatist groups. In terms of foreign policy, BMI expects Turkey to drift further away from the West in favour of closer ties with its eastern neighbours.*

The failed coup in Turkey on the night of July 15-16 was an extraordinary event by current political standards, and will substantially raise long-term political risks in Turkey. Around 232 people (including 145 civilians) were killed in a night of violence that brought Turkey perilously close to civil war, as a rebel faction within the military attempted to seize power. President Recep Tayyip Erdogan will use the occasion to tighten his grip on power, but this is likely to lead eventually to political overreach, prompting a backlash. Meanwhile, Erdogan's moves will accelerate Turkey's drift away from the West.

**Purge of Military and Judiciary to Further Politicize Institutions**

Following the failed coup, the authorities have arrested 3,000 troops and 2,700 judges, accusing them of supporting the plot. The Turkish authorities have spoken of punishing the plotters by means of death penalty, having abolished capital punishment in 2004 as part of a process of harmonizing Turkey's laws with EU regulations. If the death penalty is reintroduced, this would scupper Turkey's EU membership bid, according to Germany, and raise further tensions with the EU, which have been dominated over the past year by the migrant crisis facing Europe which emanates from the Middle East.

**Turkey's Relations with the US to Deteriorate Further**

Turkey under Erdogan has gradually been shifting away from its traditional alignment with the West, which was solidified during the Cold War. This drift could now accelerate. Turkey is one of the most geopolitically crucial countries in the world, owing to its strategic location between Europe, Russia, the Middle East, and Asia, and its large population, economy, and military. During the Cold War, Turkey was the West's main bulwark against the USSR in western Eurasia, and it now serves as a key buffer between the West and the Middle East. Although Erdogan initially maintained a broadly pro-Western alignment in the early 2000s, this has changed in recent years, as Turkey has sought to become a more independent player in the Middle East. Notably, Turkey has been accused by Western observers of not doing enough to contain Islamic State, or even blamed for enabling its rise.

**BMI highlights several key themes for the coming five to ten years:**

- Erdogan will continue seeking to consolidate power under the presidency, with a view to re-election to a second five-year term in 2019, which would allow him to rule until 2024. In the process, Turkey will become increasingly authoritarian.
- Erdogan's consolidation of power is eventually likely to lead to greater opposition, which could take the form of mass protests of the kind seen in 2013. BMI cannot preclude a future coup attempt and expects opposition parties eventually to regain greater clout over the coming decade.
- Turkey will continue to drift away from the West, and is extremely unlikely to join the EU, which will become more critical of the country's authoritarian drift. Turkey will probably remain a member of NATO, but feel increasingly marginalized in the alliance, and thus develop closer ties with Russia, China, and Middle Eastern states.
- The prospects of economic liberalization have dimmed. As Erdogan consolidates power, he is likely to adopt a more interventionist stance towards the economy.

## Economic Risk

Turkey's need to reduce its reliance on foreign capital, narrow external deficits and rebalance away from private consumption towards more domestic saving and investment will necessitate a period slower trend growth. Although the government and central bank have clearly demonstrated an aversion to allowing rebalancing to play out through lower GDP growth rates in the medium term, BMI believes this is simply delaying the inevitable. Risks of a sharp slowdown in headline growth remains high in light of a deterioration in the global macroeconomic outlook for emerging markets that has seen investor confidence suffer and capital inflows dry up. As it stands, BMI forecasts real GDP growth to be significantly slower over the next few years than the 6.1% average reading recorded in 2010-2013.

| SWOT ANALYSIS | |
|---|---|
| | |
| **Strengths** | • **Turkey enjoys a strategic geographic location and an open, liberal trade and investment climate.**<br>• **Customs union with EU has helped bolster exports and attract FDI from Western Europe.** |
| **Weaknesses** | • **Reliance on short-term foreign capital inflows and borrowing from abroad presents a danger to economic stability by leaving Turkey susceptible to capital flight during periods of tightening global liquidity or risk aversion.**<br>• **A structural current account deficit, driven by Turkey's massive energy import needs, implies that economic rebalancing will proceed at a sluggish pace in the coming years.** |
| **Opportunities** | • **Despite a lack of progress in the EU accession process, Turkey is still a major convergence play for investors.**<br>• **Structural reforms and continued privatizations will increase the opportunities for investors.** |
| **Threats** | • **Monetary policy credibility and independence from government influence has recently been called into question.**<br>• **A significant reduction in public debt in the past decade has coincided with a rapid increase in private debt, with much of the borrowing sources from abroad.**<br>• **Regional instability has contributed to increased sectarian hostility towards the government with sporadic incidence of violence along border regions with Syria. Instability in Syria or Iraq, or domestic (or regional) terrorism could lower investor confidence and cap much needed fixed investment levels.** |

## Economic Growth Outlook - Turkey - Q4 2016

***BMI View:*** *The attempted coup in Turkey in July will reinforce several negative trends that have been undermining the business and investment climate in recent years, while policies being pursued by the government will exacerbate the country's main structural macroeconomic imbalances. With external headwinds also rising in light of slower EU growth, BMI remains below consensus in their real GDP growth forecasts for both 2016 and 2017.*

The attempted coup against Turkey's ruling Justice and Development Party (AKP) on July 15 has significantly raised political and economic uncertainty, reinforcing BMI's relatively bearish view on the country's growth outlook. Headwinds to growth have risen significantly on both the domestic and external demand fronts, and from a policy perspective the government's response to the coup will exacerbate some of the negative trends which are damaging Turkey's business and investment climate. BMI forecasts real GDP growth of 3.0% in both 2016 and 2017, well below current consensus estimates.

Specifically, BMI is referring to two trends. The first is the steady consolidation of power under President Recep Tayyip Erdogan which has undermined the independence of key institutions such as the central bank, judiciary and media, and which increasingly has embroiled private sector business interests. Second, the government is attempting to keep intact an economic growth model characterized by foreign borrowing, rapid domestic credit growth and widening external imbalances. This growth model is no longer viable in BMI's view. By pushing for much looser monetary conditions, the government will raise downside growth risks and exacerbate the economy's biggest structural macroeconomic imbalances: insufficient domestic savings, a wide current account deficit financed by 'hot money', and persistently elevated inflation. This will ensure a volatile growth trajectory, despite the underlying strengths of the Turkish economy which include low public debt and a well-capitalized banking sector.

### Monetary Easing Exacerbating Structural Imbalances

The Central Bank of Turkey (CBRT) has cut interest rates five times in 2016, including in its first meeting after the attempted coup, and BMI expects additional monetary easing in the coming quarters. This comes in the wake of sustained calls from the highest level of government for lower interest rates, and the consolidation of power underway following the attempted coup suggests that the independence of key institutions such as the central bank will come under increasing pressure.

### Post-Coup State of Emergency a Major Drag on Investment

Investment growth was already weak in the quarters leading up to the attempted coup, and it is unlikely to pick up in the near term. The Turkish government implemented a three-month state of emergency following the attempted coup and is undertaking mass purges encompassing most public sector institutions, as well private sector interests. Heightened uncertainty as to the eventual duration and scope of the purges and what will follow in their aftermath will act as a significant impediment to investment in the coming quarters.

Industrial production growth and capacity utilization were both slowing heading into the second half of 2016, further suggesting that investment demand will be subdued in the quarters ahead. Meanwhile, surveys for July indicate a sharp decline in expectations for future fixed investment spending, and these are unlikely to yet account for the full impact of the most recent bout of political and economic instability on general business confidence.

Deteriorating relations with the West and an uncertain political and economic backdrop will also impede foreign direct investment (FDI), which in addition to boosting growth is also sorely needed to increase the stability of Turkey's current account deficit financing. The post-coup political trajectory suggests that foreign firms will have to be on good terms with the AKP, and will be increasingly skeptical of having recourse to fair and impartial courts to settle any legal disputes. As for specific sectors, infrastructure has been a major contributor to inward FDI as positive macro and demographic fundamentals have supported the commercial viability of transport, energy and social infrastructure projects. However, project financing is highly dependent on foreign capital, leaving infrastructure investment vulnerable to a deterioration in Turkey's credit rating and relations with Europe.

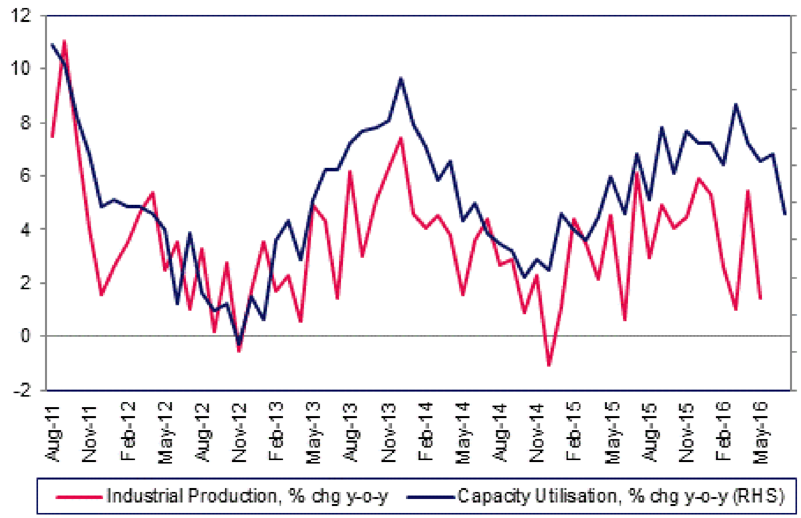
**Current Account Deficit Still a Major Vulnerability**
The global investment climate following the coup attempt has been characterized by rising risk appetite amidst falling developed state yields, with has supported demand for higher yielding Turkish assets and reduced near-term financing risks. However, Turkey's reliance on 'hot money' flows to fund the current account shortfall leaves the external account highly vulnerable to capital flight. June data suggests that the current account rebalancing spurred on by lower oil prices has run its course, and BMI expects the deficit to come in at 4.6% of GDP in 2016, thus remaining one of the highest shortfalls among comparable emerging market peers. At the same time, real interest rates are some of the lowest among emerging market peers, significantly raising risks associated with ongoing monetary easing. The coup has only increased the risk that a shift in global risk appetite could quickly destabilize the financial account, lira and growth outlook. Such a shift could come about relatively quickly, for example if the US Federal Reserve raises interest rates unexpectedly in the coming quarters.

**GDP by Expenditure Outlook**
Strong real GDP growth in Turkey from 2002 to 2011 was fuelled in part by cheap foreign borrowing and characterized by robust domestic credit growth, rapidly rising private sector indebtedness and unsustainably wide current account deficits. While external deficits have since declined, the rebalancing process has much further to run, and will entail a period of slower but more balanced trend growth as less abundant global liquidity and subdued external demand keep economic activity on a modest trajectory. Foreign financing needs will nevertheless remain large as a proportion of GDP, meaning that volatility in global risk appetite will maintain a volatile growth trajectory. With exports making up relatively a small share of GDP and population growth slowing, high levels of investment and productivity gains will be crucial in keeping Turkey's convergence prospects alive. On that front, the government's increasingly authoritarian tendencies, crackdown on free speech, waning reform momentum and support for the construction sector in recent years have dampened the outlook for moving up the value chain and escaping the middle income trap.

| GDP GROWTH FORECASTS (TURKEY 2014-2025) | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Indicator** | **2014** | **2015** | **2016f** | **2017f** | **2018f** | **2019f** | **2020f** | **2021f** | **2022f** | **2023f** | **2024f** | **2025f** |
| **Nominal GDP, TRYbn** | 1,748.2 | 1,953.6 | 2,171.9 | 2,409.7 | 2,671.8 | 2,923.2 | 3,185.4 | 3,455.3 | 3,748.4 | 4,057.2 | 4,381.3 | 4,731.5 |
| **Real GDP growth, % y-o-y** | 3.0 | 4.0 | 3.0 | 3.0 | 3.5 | 3.3 | 3.3 | 3.1 | 3.0 | 3.0 | 3.0 | 2.9 |
| **GDP per capita, TRY** | 23,051.6 | 25,473.3 | 28,030.2 | 30,803.6 | 33,849.5 | 36,714.1 | 39,663.6 | 42,657.8 | 45,886.3 | 49,252.7 | 52,754.8 | 56,520.2 |
| ***f = BMI forecast. Source: BMI Calculation/Turkish Statistical Institute*** | | | | | | | | | | | | |

## Industry Growth Slowing Heading into H216

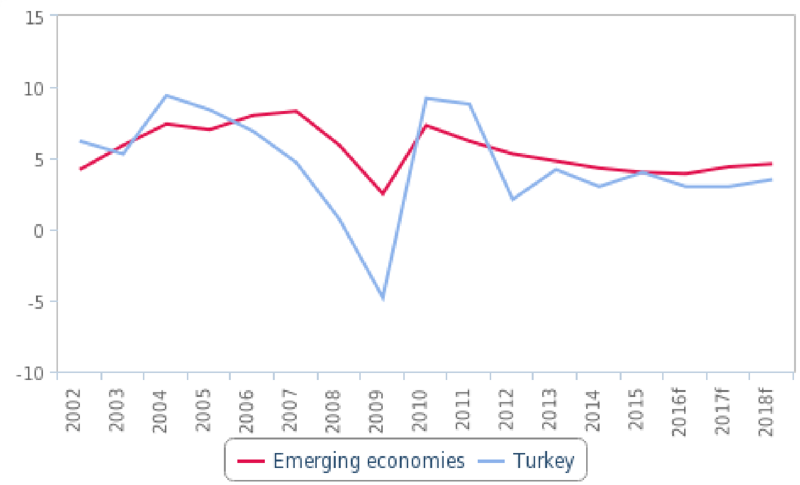
**Turkey - Industrial Production & Capacity Utilization**




***Source: Turkstat, CBRT***

## Underperforming EM Aggregate

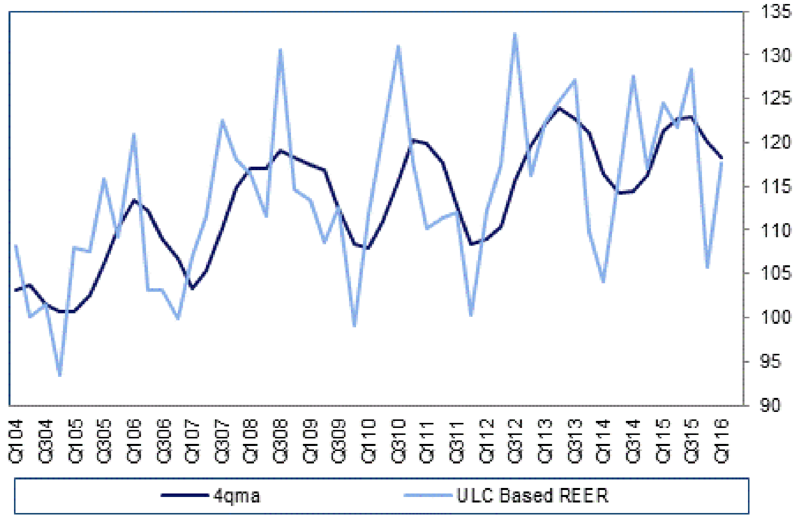
**Turkey - Real GDP, % chg**




**f = BMI forecast. Source: BMI/Turkish Statistical Institute**

## Unit Labour Costs Rising Faster Than In Trading Partners

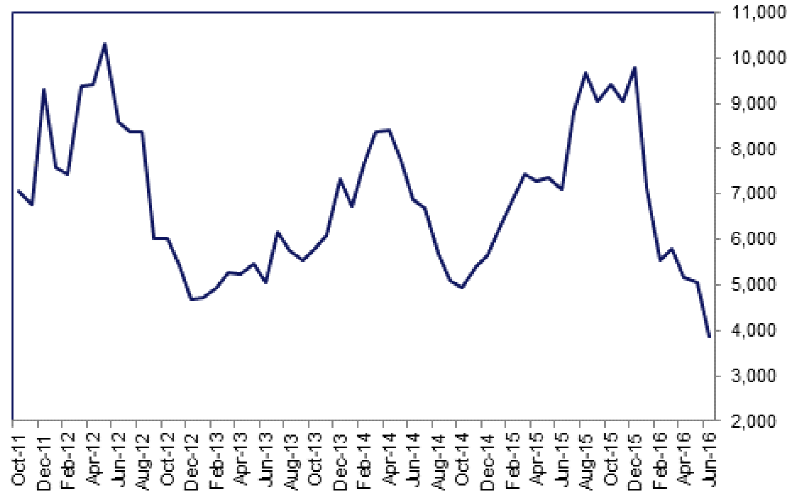
**Turkey - Unit Labour Cost Based Real Effective Exchange Rate, 2003 = 100**




***Source: CBRT, BMI***

## FDI in Decline

**Turkey - Foreign Direct Investment Inflows, USDmn, 6mma**




***Source: CBRT***

## Currency Forecast - Turkey - Q4 2016

***BMI View:*** *Following a period of relative stability in 2016, the Turkish lira's trajectory will be characterized by continued depreciation and volatility in the coming years. This will be driven by a variety of factors including loose monetary policy, elevated inflation and wide external deficits.*

**Short-Term Outlook (three-to-six months)**

After an initial period of volatility following the failed coup attempt in Turkey on July 15, the lira held crucial short-term support near its previous all-time low of TRY3.06/USD, recovering to TRY2.96/USD at the time of writing. BMI forecasts the currency to depreciate modestly but remain range-bound in the coming months, coming in at TRY3.04/USD by end-2016. Given the well-defined short-term trading range, any break through support at TRY3.06/USD or resistance at TRY2.82/USD would be a strong signal that a change of outlook was warranted.

Despite rising economic and political uncertainty on the back of recent domestic developments, BMI expects global trends to be more significant determinants of the currency's trajectory in the short term. The failed coup occurred during a period of rising global risk appetite and demand for higher yielding emerging market assets amidst continued developed state monetary easing and ongoing declines in global bond yields. This limited the downside pressure on the lira following the coup and supported the subsequent recovery. Indeed, after declining throughout 2015, foreign ownership of Turkish government local debt surged higher in 2016 and demand does not appear to have been badly hit by political instability.

**Long-Term Outlook (six-to-24 months)**

Over a longer-term time horizon BMI expects the lira's trajectory to be characterized by continued depreciation and elevated volatility. This is due to a variety of factors including loose monetary policy, high inflation and wide external deficits. BMI forecasts an end-2017 exchange rate of TRY3.25/USD, with an average of TRY3.20/USD over the course of next year.

Persistently low real interest rates underpin BMI's view on the lira. The Central Bank of Turkey (CBRT) has cut interest rates five times in 2016 despite well-above target inflation, including in its first meeting after the failed coup, and BMI expects additional monetary easing in the coming quarters. This comes in the wake of sustained calls from the highest level of government for lower interest rates, and the consolidation of power underway following the attempted coup suggests that the independence of key institutions such as the central bank will come under increasing pressure. BMI expects the CBRT to keep rates as low as possible given the constraints placed on it by the market, which will encourage a steady depreciatory trend marked by bouts of both upside and downside volatility on the back of domestic developments and shifts in global risk appetite.

Dovish monetary policy will also encourage lira depreciation by keeping domestic inflation well above that of Turkey's most important trading partners. In turn, inflation will continue to erode the potential benefits for external competitiveness accrued from nominal currency depreciation, thus impeding a badly needed rebalancing of Turkey's external deficit. Since Q312, the lira has depreciated by 28.8% in nominal effective terms but just 9.0% in real effective terms according to data compiled by JP Morgan. Turkey's traditionally large current account deficit has narrowed alongside falling energy prices, but is forecast to remain around 5.0% in the coming years, one of the highest among emerging market peers. A continued rebound in energy prices over the coming year will raise import costs and hurt Turkey's terms of trade, another headwind for the lira.

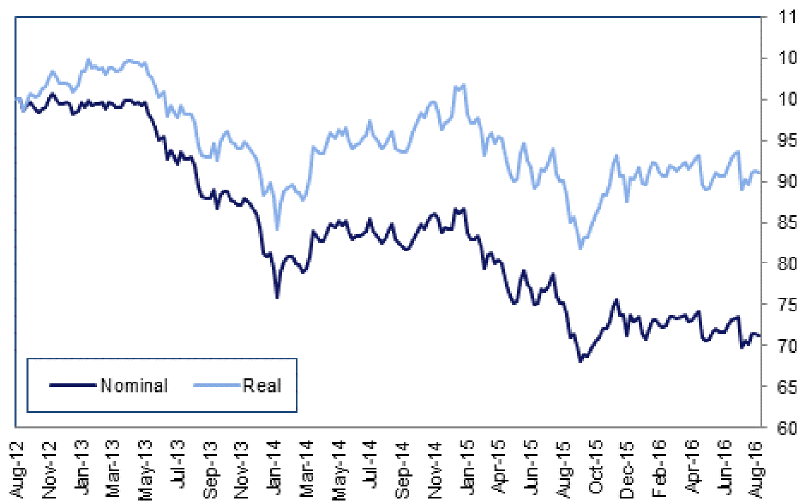
**Risks to Outlook**

In both the short and longer term, BMI sees the balance of risks as being tilted towards more depreciation than implied by BMI's forecasts. In addition to impeding sustainable appreciation, pursuing a very loose monetary policy while also running a large 'hot-money' financed current account will leave Turkey highly exposed to destabilizing bouts of capital flight during period of global risk aversion or domestic volatility. Giving rising long-term political risks following the failed coup, and the potential for the US Federal Reserve to hike interest rates more quickly than currently priced in by markets, there are many potential triggers for additional downside volatility in the lira.

| BMI TURKEY CURRENCY FORECAST | | | |
|---|---|---|---|
| | **Spot** | **2016** | **2017** |
| **TRY/USD, ave** | **2.93** | **2.96** | **3.20** |
| **TRY/EUR, ave** | **3.31** | **3.17** | **3.36** |
| **One-Week Repo Rate, %** | **7.50** | **7.50** | **7.00** |
| ***Updated August 25; Source: Bloomberg, BMI*** | | | |

**Inflation Eroding Competitiveness Gains**

**Turkey-Nominal and Real Effective Exchange Rate, Rebased To August 2012 = 100**




*Source: JP Morgan, Bloomberg*

**Holding Support after Failed Coup Attempt**

**Turkey - Exchange Rate, TRY/USD**


*Source: Bloomberg, BMI*

## Operational Risk

Progress towards EU convergence reforms and infrastructure investment programmes has so far helped bolster Turkey's Operational Risk profile. The convergence process has now stalled as the government and population have become increasingly disenchanted with EU membership, but the overall outlook remains cautiously optimistic. The government remains committed to privatization, an open trade and investment policy, and continued economic reforms. Turkey's Operational Risk profile is subject to downside risks over the long term, with key flash points being the deteriorating security situation both domestically and in the region, deteriorating relations with the West, and the steady erosion of checks and balances and institutional independence under President Recep Tayyip Erdogan.

| SWOT ANALYSIS | |
|---|---|
| | |
| **Strengths** | • **Turkey offers one of the largest and youngest labour markets in Europe.**<br>• **Turkey's maritime trade network is the best-connected in the region, with the country benefitting from strong links to international shipping routes.**<br>• **There are 19 free trade zones, in which investors benefit from a number of tax incentives.**<br>• **Turkish security forces have received extensive training by US counter-terrorism experts. As a result, Turkish security services have highly developed counterterrorism capabilities. Foreign workers and businesses benefit from a relatively safe operating environment.** |
| **Weaknesses** | • **Severance pay packages in Turkey are the most expensive in the region.**<br>• **Road-based supply chains face long delays due to traffic congestion, particularly in the city of Istanbul.**<br>• **Turkey has the highest profit tax in the region, which decreases profit margins.**<br>• **Turkey is exposed to the Syrian civil war and the expansion of the Islamic State (IS) in Iraq, especially in the southern border regions.** |
| **Opportunities** | • **Specialized secondary schools have the potential to provide pupils with dedicated knowledge before attending university.**<br>• **Investment in railway and road infrastructure will alleviate congestion and improve cross-border trade links.**<br>• **The e-commerce sector is set to benefit from expanding internet penetration rates.**<br>• **Turkey's long-standing membership of NATO reduces the probability of the country being victim to external attack.** |
| **Threats** | • **The informal labour market is likely to continue negatively impacting the efficiency of the formal sector.**<br>• **Mismanagement of the country's vast water reserves means that water availability is likely to become a pressing issue.**<br>• **Concerns over the impact of cyber crime are increasing, and there is no specific legislation to address it at present.**<br>• **The independence of key institutions such as the judiciary and various regulatory bodies from political influence is increasingly under threat.** |

**Operational Risk Snapshot - Turkey - Q4 2016**

***BMI View:*** *Turkey's once promising operating environment is being slowly undermined, reducing its appeal as an investment destination. Policies pursued by the government, under the direction of President Recep Tayyip Erdoğan, have increased political polarization and sparked social unrest, led to crackdowns on media freedoms, undermined the independence of the judiciary and caused a return to conflict with Kurdish separatists. The civil war in neighbouring Syria has exerted a considerable influence over Turkish policymaking and gradually dragged the country into greater involvement, leading to an uptick in terrorist attacks, a huge influx of refugees and fractious relations with international powers also involved in the conflict. Though Turkey continues to offer considerable investment potential, particularly due to its large labour force and open trade policies, investor sentiment towards the country will remain dampened over the medium term. As a result, Turkey underperforms in the overall BMI Operational Risk Index, ranked in the middle of the pack regionally in 15th place out of 31 countries in Emerging Europe, with a score of 56.4 out of 100.*

**Crime and Security (48.0/100):** Turkey's security situation is under considerable pressure, as the army is involved in a conflict against the Kurds in the south-eastern regions near the borders with Iraq and Iran and the country faces a high Islamic terrorist threat. This increases crime and security risks in the country as attacks have increasingly occurred in major cities and against civilian targets. Consequently, Turkey performs poorly with regards to criminal and terrorist group capabilities. Turkey's strong military machine slightly mitigates risks of violence and interstate conflict.

**Labour Market (53.2/100):** The challenges posed to businesses seeking to recruit from Turkey's labour market are hindering the country's appeal as a location for investment. Businesses face recruitment difficulties despite the advantages of a large and highly urbanized labour force, with many workers seeking formal employment, due to educational shortcomings, a lack of vocational training and rigid labour regulations. While low labour costs had previously offset these risks, rising wages are undermining the country's competitiveness even for low-skilled and labour-intensive businesses.

**Logistics (62.1/100):** Turkey's strong transport infrastructure offers a variety of shipping and freight options to logisticians and reduces the risks of congestion or delay in moving goods around the country. Increasing rail and shipping connectivity looks set to improve these factors further as Turkey seeks to capitalize on its location at the hub of three major continents. This is facilitated by smooth bureaucratic mechanisms easing the transition of goods across Turkey's border. The largest risks in Turkey's logistical set-up come from the cost of utilities, as the country relies on imports to meet many of its demands and economic pressure limits its ability to subsidies necessities.

**Trade and Investment (62.3/100):** A diverse economy and open trade and investment policies, supplemented by generous investment incentives, are the main draws for foreign investors considering entering the Turkish market. A developed and well integrated financial industry is also beneficial for securing credit. Nevertheless, investor confidence in the Turkish market has plummeted in recent years as the government's uncertain and polarizing policies have sparked social unrest, a resumption of the conflict with Kurdish separatists and erosion of the rule of law.

In addition, Turkey's exposure to the Syrian conflict has increased the risk of terrorist attacks and sent relations with Russia to new lows. These factors have resulted in a significant dampening of investor sentiment towards Turkey.

### Labour Costs

***BMI View:*** *Rising wage costs mean that Turkey is losing competitiveness as a location for low-wage, labour-intensive enterprises. Despite an abundance of low-skilled labour, a significant minimum wage increase in 2016 has pushed up labour costs and will hinder the expansion of formal employment. In addition, rigid labour regulations restrict freedom with regard to hiring and firing practices and undermine productivity. Although trade unions are not prevalent or well organized, the consequent lack of established avenues for negotiation and absence of worker protections complicates labour-employer relations and raises the risk of workplace accidents. As a result, Turkey scores a low 38.9 out of 100 for the Labour Costs pillar of BMI's Labour Market Risk Index, ranking 24th out of 31 Emerging Europe countries.*

### Cost and Flexibility of Labour

The significant increase in the minimum wage introduced as of 2016 has raised employment costs for businesses, particularly in low-wage industries, through both higher wage costs and increased social security contributions. The elevated minimum wage has eroded the country's competitiveness as a location for labour-intensive and export-led industries, with the ratio of wage costs to productivity per worker consequently declining. In addition, this move will hinder the further integration of workers into formal employment, as it provides a disincentive for businesses to register staff and enroll them in social security. This carriers further risks, however, particularly for multinationals reliant on Turkish suppliers, which must ensure that their partners adhere to employment regulations in order to avoid reputational damage. As a result of these considerations, Turkey receives a low score of 26.0 out of 100 for Costs of Employment, placing it bottom of the pack in Emerging Europe.

The flexibility of hiring and firing practices in Turkey is hindered by rigid employment regulations. In particular, redundancy provisions mandate that long-serving employees must be awarded extremely generous severance pay packages, making it difficult to lay off unproductive workers, hindering the hiring of new staff and causing high levels of turnover among younger people, who are cheaper to make redundant. This is somewhat offset by the limited presence of trade unions, which reduce the incidence of organized labour disputes, and few onerous mandatory worker benefits. Consequently, Turkey receives a modest score of 51.9 out of 100, ranking it in the middle of the pack regionally, in 15th place out of 31 Emerging Europe states.

The considerable minimum wage increase implemented in January 2016 will elevate overall labour costs for businesses, particularly those employing large, low-skilled labour forces, although it will also result in upward pressure on wages for workers earning higher salaries. The average minimum wage for a worker in a first-time position as a supermarket cashier stood at USD571.40 in 2016, the third highest figure regionally, which indicates the impact that this increase will have on employers. The average monthly wage across all sectors of the economy in 2010 (latest available data) was even higher than this, at USD1,283, more than double the mandatory monthly minimum wage in 2016. Although the consequent increase in household incomes will provide a boost to private consumption, there will be negative consequences for businesses and the economy over the medium term. One major concern is the loss of competitiveness in export-led industries due to higher labour costs, with the ratio of minimum wage to value added per worker falling to the fourth lowest regionally. This will lead businesses to seek investment opportunities in other countries where labour costs are less of a drag on profit margins.

Employment costs will also be raised as businesses will be required to pay more towards social security contributions levied on workers' salaries. The rate of mandatory social security contributions currently stands at 20.5%, to which is added an unemployment insurance contribution of 2%, which is average regionally but uncompetitive on a global comparison. This highlights another concern surrounding the minimum wage increase, which is that will hinder the integration of more workers into the formal labour market by deterring businesses from adhering to labour regulations and ensuring that staff are enrolled in social security programmes. This will be a concern for companies reliant on Turkish suppliers, particularly textiles manufacturers, which will have to increase inspections and audits - to ensure that labour standards are being adhered to, and to mitigate the risk of reputational damage by association with firms which are flouting regulations.

Another pressing risk to labour market flexibility in Turkey is the rigid regulations surrounding redundancy practices. On average, employees are entitled to 23.1 weeks of salary following their dismissal, which is the most generous severance pay package in the region by some margin (Lithuania is second with 15.9 weeks). As a result, employers in Turkey are often unable to hire-and-fire employees in response to market forces, which dampens the competitiveness of the country's labour market and acts as a deterrent to investment. Inflexible redundancy regulations are particularly detrimental for younger workers, as larger severance payments are required for laying off long-term employees, at 43.3 weeks' salary for workers with over 10 years' tenure. This discourages dismissal of older workers and hinders hiring of younger, more productive staff, while also leading to higher turnover and less vocational training for younger workers. Consequently, these practices are highly restrictive and costly for businesses, undermining productivity and the ease of hiring and firing.

The Turkish Constitution affirms the right for employees to form labour unions, engage in collective bargaining and conduct strikes in the event of a dispute. However, there are strict procedures for the declaration of a strike in the private and state enterprise sectors. In fact, strikes are illegal in numerous industries: for example, in the production of coal for water, electricity, gas and coal power plants and in banking and public notaries. Moreover, politically motivated strikes, solidarity strikes, occupation of work premises, labour go-slows and other forms of obstruction are prohibited. In addition, only an estimated 9% of the workforce is unionized. This limited trade union influence means that disruptions to production are few, although the International Labour Organization (ILO) states that the manufacturing sector is the most frequently affected, with 17 strikes in 2013. Due to the high number of non-unionized workers, the effective ratio of the workforce covered by a collective bargaining agreement may be as low as 3%, making industrial relations comparatively straightforward for employers. This increases the freedom with which businesses may act with regard to hiring and firing practices and setting wages.

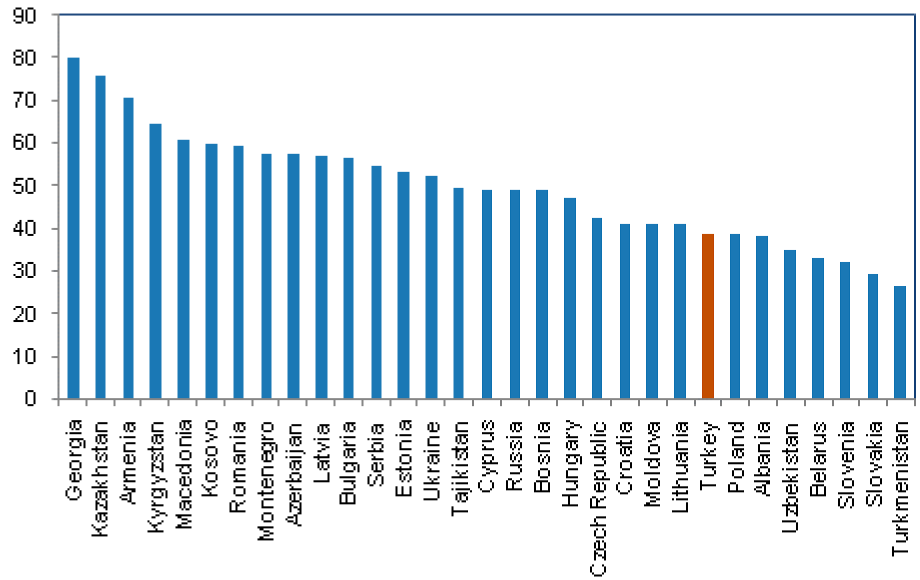
The absence of an active trade union movement can also be detrimental to businesses, however, as labour disputes become more difficult to resolve due to the lack of recognized worker representatives with which to negotiate. Wildcard strikes called with little notice or organization can also be more common. In addition, the lack of worker's unions also means that there has been limited pressure on the government to enforce safe working conditions. Turkey has seen numerous workplace accidents in recent years, notably the Soma mine disaster in May 2014, in which 301 workers lost their lives. The lack of provisions for worker safety exposes companies to risks from reputational damage if accidents occur, and means that companies must take care to comply with international safety standards.

On the positive side, the regulations governing working hours in Turkey do not pose significant restrictions on businesses. The maximum number of working hours per week is 45 and the maximum per day is 11. Employees who have worked 45 hours in one week are entitled to a continuous two-day weekend break. Businesses are permitted to initiate a 50-hour work week for up to two months per year in the event of a seasonal increase in production, but outside of this period, overtime work carries a premium of 50% of hourly pay. Paid annual leave entitlements are moderate on a regional comparison, with workers allowed 18 paid days off per year on average. However, BMI highlights that paid public holidays are not included in this allowance, which bring the total paid days off in Turkey to 30.

| TURKEY - LABOUR REGULATIONS GOVERNING FLEXIBILITY OF WORKFORCE | |
|---|---|
| **Contracts** | |
| **Fixed-term contracts prohibited for permanent tasks?** | **Yes** |
| **Maximum length of a single fixed contract (months)** | **No Limit** |
| **Working Week and Absences** | |
| **Maximum working days per week** | **6** |
| **Premium for overtime work (% of hourly pay)** | **50** |
| **Paid annual leave (average for workers with 1, 5 and 10 years of tenure, in working days)** | **18** |
| **Paid or unpaid maternity leave mandated by law?** | **Yes** |
| **Minimum length of maternity leave (calendar days)** | **112** |
| **Redundancy** | |
| **Dismissal due to redundancy allowed by law?** | **Yes** |
| **Notice period for redundancy dismissal (average for workers with 1, 5 and 10 years of tenure, in salary weeks)** | **6.7** |
| **Severance pay for redundancy dismissal (average for workers with 1, 5 and 10 years of tenure, in salary weeks)** | **23.1** |
| ***Source: World Bank 'Doing Business'*** | |

## Inflexible Regulations and Wage Increases Undermining Competitiveness

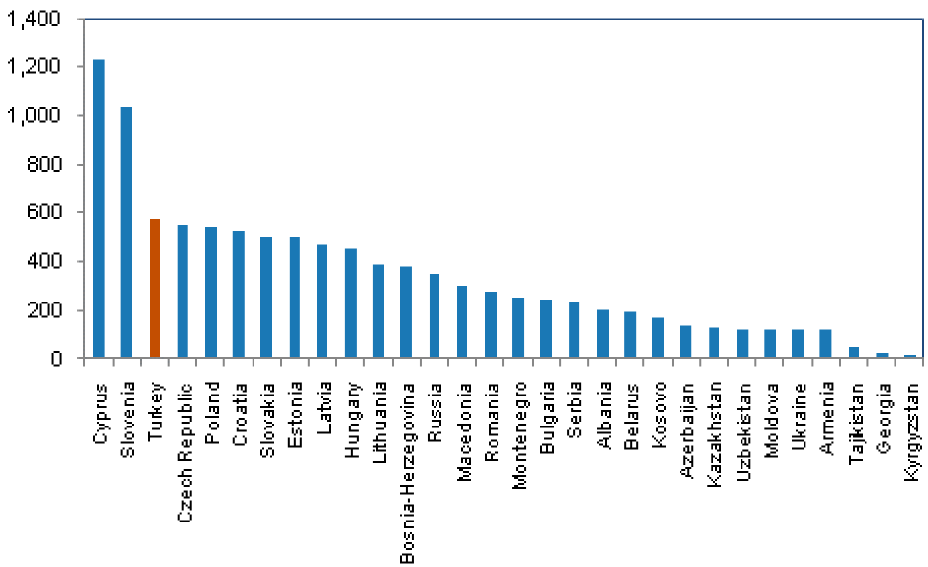
**Emerging Europe - Labour Costs**




*100 = Lowest risk; 0 = highest risk. Source: BMI Labour Market Risk Index*

## Minimum Wage Hike Reduces Competitiveness

**Emerging Europe - Minimum Wages (USD/month), 2016**




*Note: As applicable to the worker assumed in the case study. Source: World Bank 'Doing Business'*

**Market Size and Utilities Availability**

Turkey's utilities network is relatively reliable in comparison to Middle Eastern countries. Although the price of electricity and fuel is above average, this does not add substantially to operational costs for businesses. However, Turkey's lack of domestic hydrocarbons deposits and declining water resources expose its supply of electricity, fuel and water to significant geopolitical risks. This heightens the threat of shortages disrupting business activity over the medium term. Turkey is therefore ranked low in the Emerging Europe region for Market Size and Utilities, in 28th place out of 31 states, with a score of 46.0 out of 100.

The lack of domestic natural resources available for exploitation to supply its large market means that Turkey is one of the world's largest net energy importers. The country is highly reliant on imports of oil and gas in order to generate electricity and provide fuel for vehicles, which increases prices for consumers. Of greater concern, however, is the risk of disruption to the supply chains of these vital commodities due to instability in neighbouring states or source countries, including Ukraine and Iraq. Turkey's attempt to position itself as a regional energy transit hub may mitigate these risks over the longer term, but the threat of shortages remains pertinent as of 2015. These factors result in a low score of 32.2 out of 100 for Electricity and Fuel, which places the country 30th out of 31 states in Emerging Europe. On the positive side, electricity grid coverage is good, especially in comparison to neighbouring Middle Eastern states.

Businesses in Turkey face similar risks with regard to the water supply, which is a contentious issue regionally due to the scarcity of freshwater and the fact that several countries rely on the same supply. In addition, over-extraction and climate change have resulted in water shortages and droughts which have had a severe impact on agriculture and other water-intensive industries. In addition, although Turkey offers widespread access to internet services for both businesses and consumers, boosting the potential for e-commerce, download speeds remain sluggish on a regional comparison, which will deter investment in high-tech industries. Nevertheless, Turkey receives a higher score for Telecommunications and Water, at 59.8 out of 100, which places it 19th regionally.

**Electricity**

The electricity generation sector in Turkey is exposed to a number of risks, which include declining water resources, terrorist attacks on infrastructure and dependence on potentially unreliable gas imports. Shortages have led to blackouts in recent years, which disrupt business activity, while costs are higher than the regional average. More stable supplies of fuel for electricity generation are expected to be secured over the medium term, as Turkey bids to become a major energy hub, which should mitigate the risk of power shortages to some extent.

Natural gas is the major source of electricity generation in Turkey, with BMI's Power team estimating the fuel to have accounted for 42% of total production in 2014, followed by coal and hydropower, generating roughly a quarter each. Although sources for power generation are well diversified, theoretically reducing the risk of shortfalls in supply, reliance on hydropower and imported gas does pose risks to electricity production. The recent resumption of the Hamitabat natural gas plant project seeks to increase Turkey's domestic production capacities, while April 2015 also saw construction begin for Turkey's first nuclear power plant. This will decrease Turkey's significant reliance on imported natural gas, but not until the projects are completed in several years time.

Dry gas and liquefied natural gas is imported mainly from Russia, Iran, Azerbaijan, Algeria and Norway. Import sources are quite well diversified, which minimizes the risk of disruption to the fuel supply chain. However, natural gas infrastructure has been a target for terrorist attacks, which leaves Turkey exposed to disruptions to the supply. Shortages of gas supplies have, in the past, led to inadequate resources for electricity generation, which results in power outages, disrupted business activity and increased reliance on expensive private generators. In addition to these risks to electricity generation, there is also a lack of efficiency in transmission and distribution networks, which increases losses and the risk of blackouts. These risks are not mitigated by low electricity costs, as tariffs stand at USD0.13 per kilowatt hour (kWh) in 2015, the fifth-highest costs in the region. This increases business overheads, particularly for energy-intensive industries, although costs are not particularly prohibitive on a global comparison, matching the worldwide average.

On the positive side, the electricity network in Turkey covers almost the entire population, at about 99.9%, which means energy-intensive businesses will not be restricted with regard to location. In addition, it takes 70 days on average for new business premises to get connected to the electricity grid, which is faster than the OECD average of 89 days. This is beneficial, as delays for investors opening new businesses will be reduced. A boost to electricity generation will be provided by the Tanap pipeline, which is being developed between Turkey and Azerbaijan. This will supply the country with a more stable source of gas, reducing its reliance on Russia and Iran. The pipeline is expected to come online in 2018 and the foundation is expected to be laid in 2015.

**Water**

The availability of water resources for household, industrial and agricultural consumption is becoming a major issue in Turkey. The country benefits from a large network of river systems which can be tapped for water extraction. However, these rivers are also utilized by downstream countries, which suffer from water shortages and droughts, while dam building and increased consumption take place in Turkey. As a result, tension over water resources in the region is high and Turkey may be forced to look to alternative sources of water extraction, such as desalination, in order to prevent widespread shortages.

The water sector in Turkey is badly mismanaged, with high losses resulting from ageing infrastructure and poor maintenance also contributing to a lack of available water resources. There are high levels of industrial pollution, which is exacerbated due to the fact that nearly a quarter of the rural population is not connected to wastewater treatment plants. This largely negates the benefits of widespread access to improved drinking water, which is available to 99.7% of the population, as the quality of water is poor and rationing may become necessary in order to prevent shortages. Businesses should be aware that, over the medium term, water rationing may require them to provide bottled water for employees, adding to operating costs.

## Major Forecast Changes

- BMI revised down their 2017 real GDP growth forecast from 3.3% to 3.0%.

## Key Risks

- The major risk to Turkey's macroeconomic trajectory in the coming years stems from its large external financing requirement. Turkey's large current account deficit and dearth of foreign direct investment inflows leaves the country vulnerable to external shocks and a major outflow of foreign capital, which becomes more likely as the US Federal Reserve commences a tightening cycle. As such, BMI believes risks to growth are weighted primarily to the downside.

- Geopolitical conflict and rising incidence of terrorist attacks within Turkish borders have weighed on external trade and tourism inflows, and may escalate in the coming year, dampening further the growth outlook.