

Turkey: an economic pearl on the Bosphorus

Almost unnoticed, the Turkish economy surged forward to close the gap on the EU27. Economic growth in the period 2002-2011 amounted to 5.3% while growth in the eurozone got stuck at 1.3%. Even this year, Turkish GDP growth will be 3.5 to 4%, while the eurozone economy will shrink by 0.4% and that of the Netherlands by almost 1%. By 2030, Turkey will have Europe's fifth largest economy. Dutch exporters underestimate the opportunities in Turkey.

Main observations

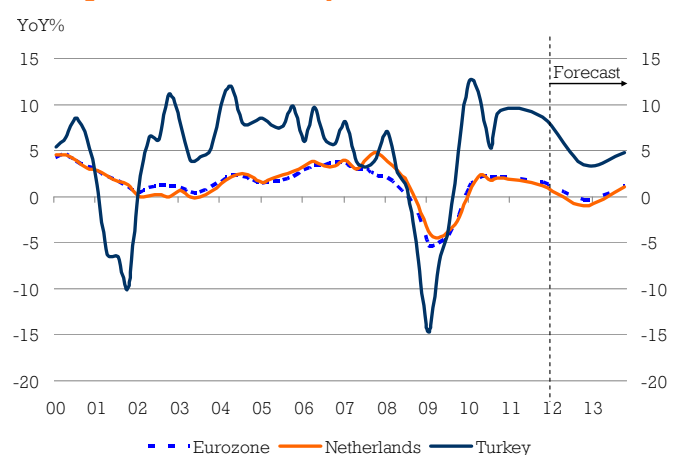
- Potential growth rate for the long term is 5.3% annually
- In 2030, Turkey will be the fifth largest economy in Europe
- Although the population is relatively young, a major growth area is in the population segment aged 30 years and above (currently a consumer market worth EUR 383 bln, rising to EUR 556 bln in 2020)
- Upgrading of production package is reflected in more high added-value production. Highest growth rates until 2020 in production of investment goods and intermediary products
- Turkey is becoming one of the important automotive production locations in Europe. While construction companies from Turkey are operating in many countries outside the country (the metro in Warsaw)
- Dutch exporters underestimate the opportunities in Turkey and are missing out on EUR 4.1bln potential exports until 2016
- Turkey is shifting its focus on exports towards fast-growing regions in the Middle East, North Africa (MENA) and Emerging Europe; the share of Western Europe is rapidly declining
- Dutch companies could team up with Turkish partners to access MENA, and increase our market share there
- Turkey is our hub to MENA

Basic facts Turkey

	2011
Nominal GDP (US\$bn)	772
Population	75 million
GDP per capita (US\$)	10,444
CPI (average %YoY)	6.5
Wage rates (%YoY, nominal)	14.9
GDP-composition by sector (%)	
Agriculture	10
Industry	29
Services	54
Exchange rate (TRY/USD) annual average	1.67
Exchange rate (TRY/EUR) annual average	2.32
Exports US\$bn	144
Imports US\$bn	233
Trade balance (US\$bn)	-89

Source: ING

Development GDP Turkey



Source: EcoWin, ING

Turkey's current ratings

	Rating	Outlook	Last action
Moody's	Ba2	Positive	5-Oct-10
S&P	BB	Positive	19-Feb-10
Fitch	BB+	Stable	24-Nov-11

Reasons for the success

- What are the main drivers of the economic success story?
- How could it all happen in the shadow of the growing problems within the eurozone?
- What are the challenges for the Turkish authorities?
- What are the opportunities for Dutch companies in Turkey?

Top position in Europe

As a result of its higher economic growth rate, the Turkish economy, as measured by GDP, now ranks at number 18 in the world, just after the Netherlands. In 2014, Turkey's GDP will exceed the Dutch GDP. Based on its demographic development, the high growth rate of investments and the improvements in productivity, the Turkish potential economic growth for coming years increased to 5.3%. By 2030, the Turkish economy will be larger than Spain and only just behind Italy, according to Goldman Sachs. The Netherlands will be ranked 7.

Figure 1: Ranking Turkish economy in Europe by size of GDP

2010		2030		Rank change
Rank	Country	Rank	Country	
1	Germany	1	Germany	--
2	France	2	France	--
3	United Kingdom	3	United Kingdom	--
4	Italy	4	Italy	--
5	Spain	5	Turkey	+2
6	Netherlands	6	Spain	-1
7	Turkey	7	Netherlands	-1

Source: Goldman Sachs

Main drivers of the success story

In 2000 and 2001, Turkish leadership took serious measures to reform the economy.

1. A floating exchange rate system was introduced after the crisis of 2001.
2. Inflation targeting became part of the government's policies to trim down inflation pressure.
3. Reforms in the fiscal policy were introduced to maintain a high primary surplus to lower the government debt in percentage of GDP.
4. Banking sector reforms and recapitalisation were applied, along with establishment of a strong regulatory authority.

Reforms introduced in 1980 to liberalise trade and the domestic economic economy filtered through.

This is supported by a sizeable young population of 75 million, often well educated, and a strategic location at the border of Europe and Asia. Turkey benefits from membership in a customs union with the EU since 1996, which makes it a very attractive platform for export-oriented manufacturers. There is relatively a low cost base and a well trained workforce.

This time it's different

More than a decade ago Turkey was known to be a high-risk country. Huge swings in economic growth and inflation, government deficit and rapidly increasing debt and current account deficits all created serious external debt problems. As a consequence there have often been episodes of large Turkish lira devaluations, interest rates remaining high for a long time.

It took the Turkish government many years to convince financial markets this time it's different. GDP growth was running at 5.3% in 2002-2011 compared with only 3% in the 90s. Government deficit fell to 2% of GDP while public debt fell from 78% in to 39% in 2011. Strong capital inflows during stabilization period in 2000s supported FX reserve accumulation, while falling inflation pulled interest rates down too. Since three years Turkey is building down its reliance on multilateral support. The last IMF programme ended in May 2008 and Turkey will be paying back all its debt to IMF by mid 2013. In other words, currently Turkey has no IMF programme in place nor an official support plan from the EU. External financing needs of the private sector are covered by loans from private sector lenders. This created a high dependency on foreign private lenders and a risk. Certainly in times where foreign private lenders are limited in their lending activities. The international risk shift from emerging markets to the advanced economies helped to improve Turkey's image on the financial markets.

Twin problems

The Turkish economy shows a substantial deficit on its external trade. This year, imports will exceed exports by USD 72 billion. This is already less than last year. But still 9% of GDP, which is high by international standards. A large part of the deficit is financed by external borrowing from private sources. Income generated by exports of goods and services is used to pay interest and amortisation on the external debt. Turkey needs 50% of those receivables on its trade annually to service its external debt. This is high and a drag on the country's long-term development. A higher growth rate of Turkish exports and a reduced growth rate of imports is necessary to reduce the trade deficit and to reduce the burden of the external debt. Structurally high import dependency of production and a low private savings ratio account for a large current account deficit. The recent comments of the officials to improve the pension system could help to increase the domestic savings and indirectly reduce the trade deficit and its reliance on external borrowing.

Main attractions to participate in the catching-up process are:

1. Rapidly developing local market.
2. Attractive production location for Turkish domestic market and regional markets.
3. Turkey as a hub.

Rapidly developing local market

The large population of 75 million puts it in the top 20 in the world. After Russia and Germany, Turkey has the third largest population in the region. The population is expected to continue growing over the next four decades, achieving its maximum size of 90 million in 2050, after which it will gently decline. Although the growing population is still young, it is aging. Within the next 20 years Turks older than 65 will comprise more than 10% of the total population. This is mainly due to decreasing birth rates and improvements in health care.

Figure 2: Consumer segmentation: 2010-2020

	2010	2020	% Growth
Total in thousands	72,473	79,502	9.7
Babies/Infants (0-2 years)	4.9 %	4.1 %	-7.4
Children (3-8 years)	10.0 %	8.3 %	-9.2
'Tweenagers' (9-12 years)	7.3 %	5.9 %	-11.7
Teens (13-19 years)	12.1 %	11.0 %	-0.3
People in their twenties	17.6 %	16.2 %	1.0
People in their thirties	15.8 %	16.1 %	11.9
Middle-aged Adults (40-64 years)	25.1 %	29.6 %	29.0
Older Population (65+ years)	7.2 %	8.8 %	35.3

Source: National statistical office, Euromonitor International, ING

Growth in prosperity in the country and the shift towards more middle-aged consumers increases private consumption and causes a shift in the consumption pattern. The wealthiest among the age groups, the middle-aged adults, rose to 17.7 million. They spend more money on personal goods, services, hobby products, health and luxury products. This type of expenditure will increase further. Consumer expenditure on education is growing rapidly due to the increased demand by teens and people in their twenties. Students are key consumers at cafes and bars. They are also consumers of the latest fashion and electronic gadgets. The 30+ generation is mainly focused on home ownership, their children's education and home entertainment products. The shift in population distribution and the increasing spending power is reflected in the forecast of private consumption by expenditure. There still is a huge and fast-growing demand for housing, transport, health goods, medical services, alcoholic beverages and tobacco.

Figure 3: Expenditure by category 2010-2020 (in volume and %)

	2010 (€ bn)	CAGR 2010-2020
Food and non-alcoholic beverages	82,2	0,8
Alcoholic beverages and tobacco	15,8	6,8
Clothing and footwear	15,4	-3,1
Housing	89,3	5,9
Household goods and services	25,5	2,8
Health goods and medical services	16,1	6,2
Transport	48,6	5,2
Communications	21,0	3,4
Leisure and recreation	14,3	-2,2
Education	5,5	6,0
Hotels and catering	25,0	4,1
Misc goods and services	24,8	3,1
Total	383,5	3,8

Source: National statistical office, OECD, Eurostat, Euromonitor International, ING

Local production for local and regional consumption

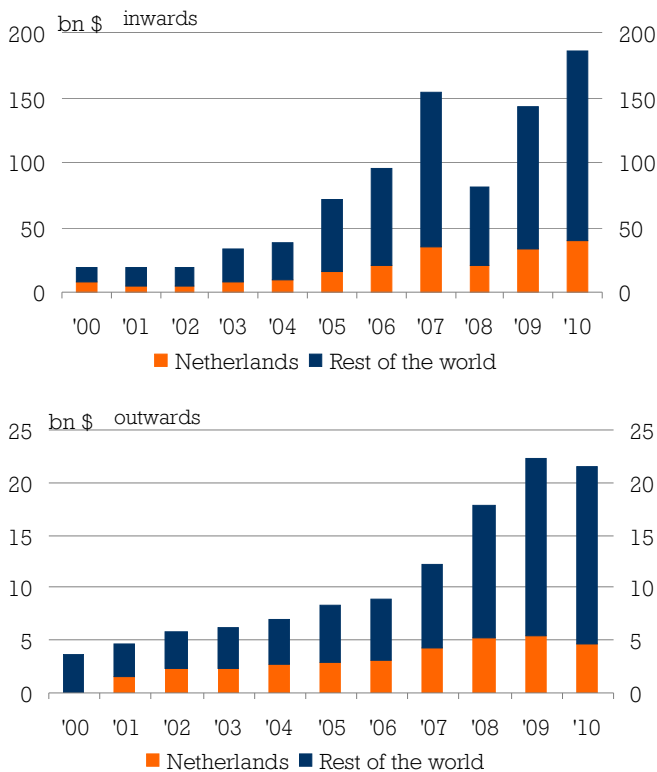
Stimulation of Turkish exports and substitution of Turkish imports with local production is an important focal point of the government plan to solve the twin problem. Compared with other European countries the Turkish external sector is relatively small. High growth rates of domestic consumption and production trigger a huge inflow of imports. This increases the trade deficit rapidly since exports cannot keep up with import growth. There are however ample opportunities to improve the export profile as well as opportunities to stimulate local production substituting intermediate goods imports. The Turkish economy is dominated by the services sector (54% of GDP). Trade, finance, transport, tourism and logistical services are important sectors for many years and flourishing in the current climate. The government supports the growth of the higher added value production within the manufacturing sector in a process to upgrade the economy and the export profile. Part of the stimulation policy is the attraction of foreign companies to bring in new technologies. In addition the government sees the need for improved productivity in the agricultural sector. Improvements in infrastructure and business-friendly government initiatives have been quite successful. The entrance of foreign companies helped to make the automotive industry in Turkey an important one in Europe. Shipbuilding is an officially prioritized sector that flourishes in Turkey. The production of consumer electronics has also expanded rapidly. Turkey is the largest producer of TV screens in Europe. Its construction companies are active worldwide, and Turkey is known to have the second largest construction industry in the world. For example, a Turkish

company is building the metro in Warsaw. The rapid growth rate of the economy during the last 10 years triggered a lot of oil imports. Reduction of the dependency on oil and gas imports is an important government policy item. Energy imports weigh heavily on the trade balance. New discoveries of oil reserves on Turkish territory give hope for a future reduction of the country's dependency on oil imports. Reducing oil imports and increasing energy efficiency are spearheads of the government's policy.

Foreign participation and internalisation

Many foreign companies established themselves over the years in Turkey to profit from the rapidly growing domestic market and the regional role Turkey plays. See graph on inward foreign direct investments. Although still moderate the stock of FDI outflow supports the view that Turkish companies are spreading their wings outside the country as well.

Figure 4: Stock of FDI inwards and outwards



Source: OECD, ING

The Netherlands plays an important role in bringing FDI into Turkey. This is partly due to investments by Dutch companies but primarily because FDI's are often routed via the Netherlands.

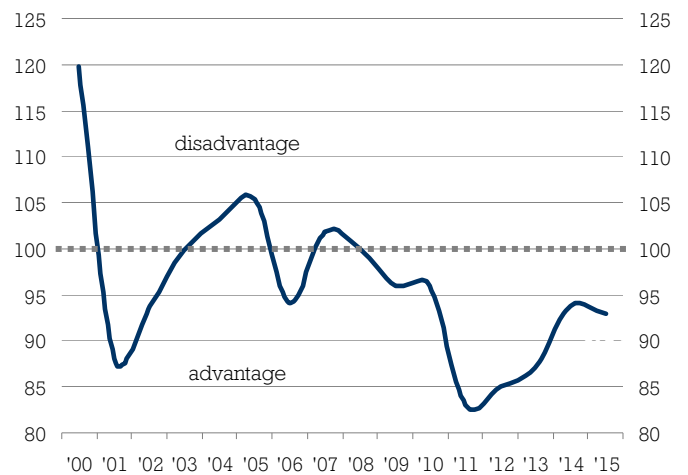
Wage costs a differentiating factor

One of Turkey's important assets is its working age population; currently 53 million, it will increase to 61 million at its

peak in 2040. After 2025 the working age population will remain unchanged. Net migration is expected to fall to zero after 2025.

Although wage costs showed a steep climbing pattern during the last 10 years, the development of the wage costs compared with Turkey's major competitor countries shows a favourable development. The weakening of the currency for many years and the improvement of labour productivity helped to keep up the country's competitive advantage (index below 100). Apart from the development of the wage costs, it's the level of wages that is still much lower than in competitor countries.

Figure 5: Relative unit labour costs (2008 = 100)



Source: Oxford Economics, ING

Upgrading production profile continues

Stimulated by the government a gradual upgrading of the production profile is on its way. Next decade agriculture, forestry & fishing and extraction will lose part of their share of GDP. Growth rates will be below the expected overall growth rate of 5.3%. The agricultural sector is particularly suffering from a lack of improvement in productivity. The government is currently looking into this. The top performer will be the construction sector. Huge domestic projects combined with construction work outside Turkey make this sector the top performer. In the manufacturing industry the production of intermediate goods will outperform other industrial sectors. More traditional sectors within this category, like chemicals, basic metals and non metallic minerals, profit from the high growth rate of the production of the other growing industrial sectors. Behind intermediate products, the production of investment goods is growing the most rapidly. Both categories will grow more rapidly than GDP growth. Growth in this sector illustrates the upgrading of Turkish local production capacity. Within the consumer goods category the production of durables shows one of the highest growth rates, though small compared with the size of Turkish GDP, at only 1.2% of GDP.

At the same time it illustrates Turkey's efforts to increase the domestic production in order to substitute imports and stimulate exports. The main service sectors are the financial and trade sector, transport and logistical services plus advisory services and housing rental services. Those service sectors will stay important in percentage of GDP also in future years. In the financial sector changes in the pension schemes will generate more business for the bank/insurance sector. Trade and logistical services will show a further increase in their activities in order to meet the requirements of continued expansion of international trade flows.

Figure 6: Development by sector of industry, '10-'20

	2010	Avg. ann % change 2011-2020
Total GDP, Bn TRY (prices 2005)	756.28	5.3%
Shares in % of total production		
Agriculture, forestry & fisheries	8.2%	3.5%
Industrial production	21.0%	5.5%
Extraction	1.2%	3.4%
Manufacturing	17.9%	5.6%
Consumer goods non durables	5.3%	4.0%
Consumer goods durables	1.2%	5.4%
Intermediate goods	8.7%	8.3%
Investment goods	2.7%	5.9%
Utilities	2.0%	5.5%
Construction	4.3%	8.1%
Services	66.5%	5.3%
	100.0%	

Source: Oxford Economics, ING

Room for improvement

Although much has been achieved, there is still room for improvement in Turkey's business environment.

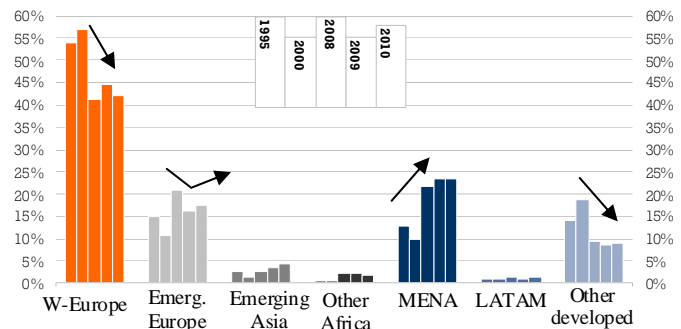
- Continued infrastructure improvement is required.
- Improvement in the World Bank ease of doing business ranking. Turkey is currently ranked number 71 of a total of 181 countries. This ranking is due to various costly and time consuming procedures and documents. Enforcing contracts in Turkey is a slow and expensive process, another hurdle to doing business.
- In general there is a need to increase trust in the judicial system.
- Dependency on external financing needs to be addressed.

Turkey's export profile and role as regional hub

The shift in the Turkish production profile is reflected in its changing export profile by commodity and destinations. Turkish export destinations changed rapidly in 2000 Western

Europe accounted for 57% of Turkish exports in 2010 this was reduced to 45%. The reduction of the EU share was compensated by an increase of the share of exports to countries in the Middle East and North Africa (MENA) region and Emerging Europe. MENA accounted in 2000 for 10% and in 2010 for 23% of total exports.

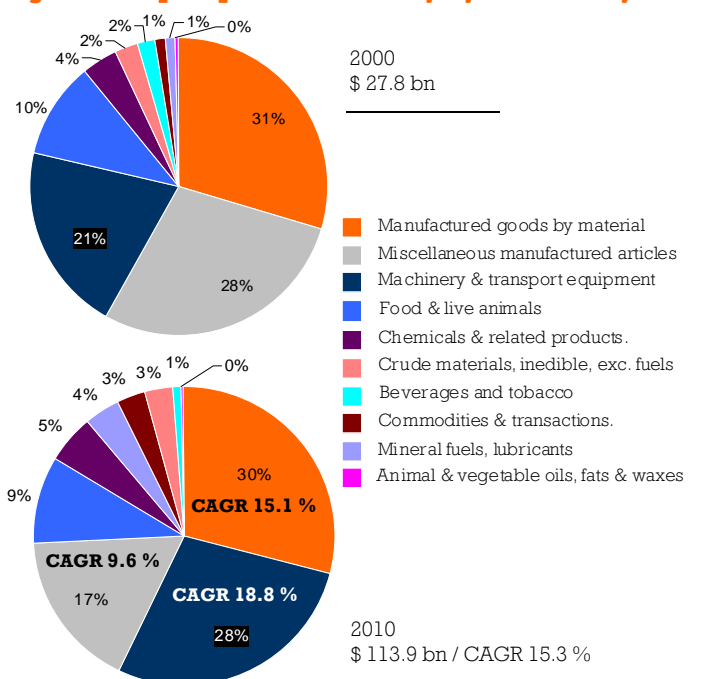
Figure 7: Focus on fast growing regions



Source: UNCTAD, ING

The MENA region is a fast growing border region. Main destinations within MENA are: Iraq, United Arab Emirates, Iran and Egypt. Unrest in some of the MENA countries temporarily reduces export growth to these regions. Nevertheless it remains a fast growing area which, in general, Turkey has excellent access to. As soon as things settle in the region Turkey's exports will profit from the recovery phase.

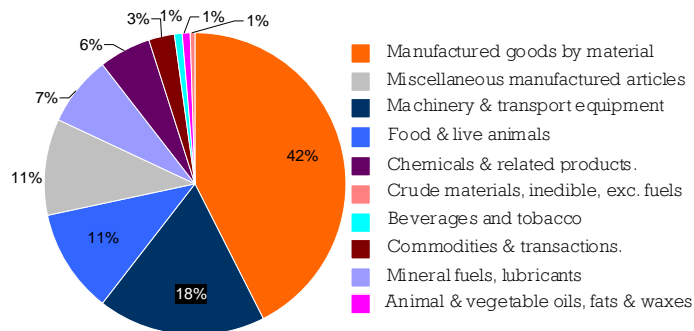
Figure 8: Export profile of Turkey by commodity



Source: UNCTAD, ING

The shift in Turkey's export package production profile is illustrated by the increased share of machinery and transport equipment (21% share in 2000 and 28% in 2010). The automotive industry and the TV screen industry are well-known examples. The entrance of foreign companies in Turkey establishing local production facilities will help to continue the upgrading of Turkey's production and export package. The trend in offshoring to Asia seems to be interrupted. Offshoring to countries closer to Europe, such as Turkey and also Poland, seems to be profiting from the break in this trend. The more traditional manufactured goods by material (like textile) clearly outnumber the other export sectors with destination MENA.

Figure 9: Products and countries to MENA 2010



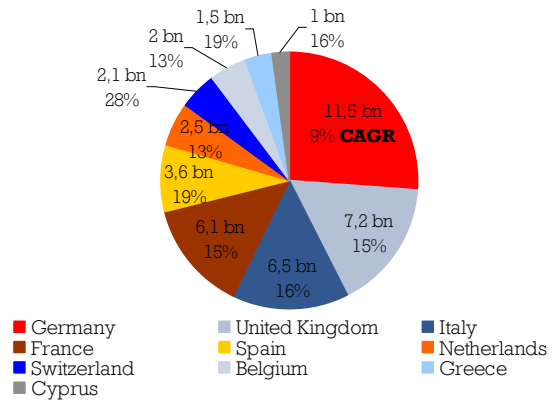
MENA countries	Bil. \$	% share	MENA countries	Bil. \$	% share
Iraq	6.0	23%	Lebanon	0.5	2%
United Arab Emirates	3.3	13%	Jordan	0.4	2%
Iran	3.0	12%	Kuwait	0.3	2%
Egypt	2.2	9%	Yemen	0.2	1%
Saudi Arabia	2.2	8%	Sudan	0.1	1%
Libya	1.9	7%	Bahrain	0.1	1%
Syria	1.8	7%	Qatar	0.1	1%
Algeria	1.5	6%	Oman	0.1	0%
Tunisia	0.7	3%	Mauritania	0.03	0%
Morocco	0.6	2%	Djibouti	0.03	3%

Source: UNCTAD, ING

Unrest in the MENA region had a negative impact on export growth to this region. Almost 50% of the major destinations in the MENA region are currently impacted by the unrest. Turkey has good access to most of the countries in the region. It is highly likely Turkey will profit from a strong recovery once peace is restored in the region.

Germany is the most important partner for Turkish exports to Western Europe as well as for Turkish imports. The German role in Turkish imports is directly linked to its huge imports of machinery and transport equipment.

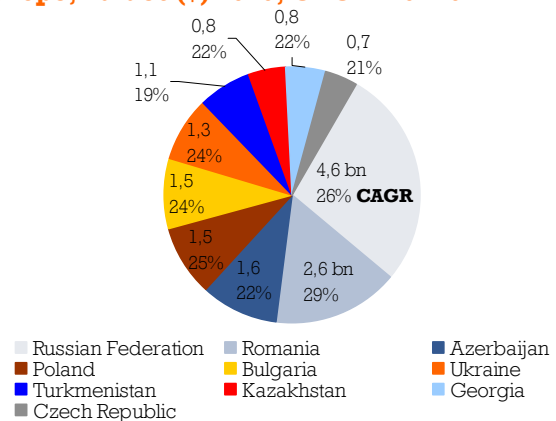
Figure 10: Top 10 export partners within Western Europe, values (\$) 2010, CAGR '10-'20



Source: UNCTAD, ING calculations

The importance of Russia for Turkish imports and exports can be explained by the inflow of oil in the country. Russian oil and natural gas wealth created increased demand for Turkish products, including both traditional Turkish exports and higher added-value products. After Russia, Romania is the most important partner for Turkish exports.

Figure 11: Top 10 export partners within Emerging Europe, values (\$) 2010, CAGR '10-'20



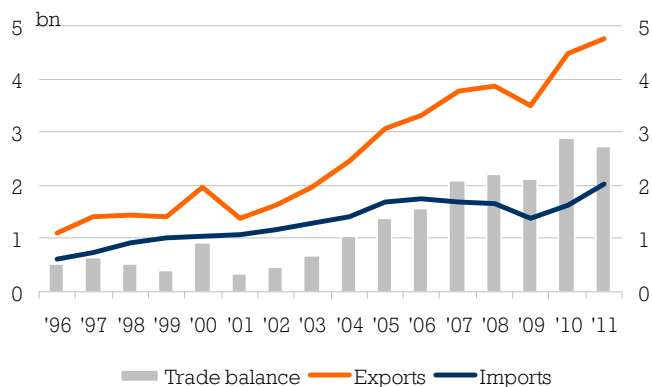
Source: UNCTAD, ING calculations

The Turkish Dutch trade balance

The trade balance between Turkey and the Netherlands shows, since 2001, an ever growing deficit for Turkey. In 2011 there seems to be a break in this trend. Dutch exports to Turkey are dominated by transport and machinery equipment, consumer electronics, chemicals and agrifood products. The share of crude material exports increased substantially. Data from CBS shows a remarkable reduction in the share of higher added-value products in the Dutch export package. Turkish exports to the Netherlands are highly dependent on more traditional sectors like textile products,

which are typically lower added-value products. Despite this, the share of higher added-value products is increasing. The export packages of Turkey and the Netherlands are developing in contrary directions. This can partially be explained by the upgrading of the Turkish production profile, with more high added-value products for the local and export market. It is too early to forecast a structural reduction of the Dutch surplus in its trade with Turkey. The upgrading of the Turkish production structure will ultimately have an impact on the Dutch trade surplus.

Figure 12: Dutch Turkish trade balance



Dutch exports exist of 4 flows to Turkey.

- Domestically produced exports.(€ 2.8bn)
- Re-exports.(€ 2bn)
- Indirect Dutch exports via the world to Turkey.(€ 0.9bn)
- Indirect Dutch exports via Turkey to the world.(- € 0.3bn)

With the help of ING's own Dutch trade model, the analyses of Dutch exports to Turkey was translated into the development of exports by sector of industry. The biggest flows to Turkey are domestically produced exports (EUR 2.8 bln). The major part is exported by the chemical industry. Products from the technological manufacturing industry and the agrifood industry are the next most important sectors. Wholesale trade and business services are the most important service sectors exporting to Turkey. In addition to the domestically produced exports a lot of exports are imported to the Netherlands and exported again, with limited additional activities added to these products. This is called re-exports. Thanks to the Netherlands' location (Rotterdam harbour, Schiphol airport) re-exports is an important part of Dutch total exports. Of all Dutch exports to Turkey in 2010, 40% was re-exports.

In total, 2010 indirect Dutch exports via Turkey to other parts of the world amounted to EUR 0.3 bln, see box at the last page, more than 50% is exported back to Western Europe. The share of indirect Dutch exports via Turkey to MENA is negligible. It is also possible that Dutch products, exported to for instance Germany and Belgium, end up in products with final

destination Turkey. This total of Dutch exports to Turkey via other countries in the world amounts to EUR.0.9 bln. Almost 30% of Dutch exports via the world to Turkey go via Germany and 16% via Belgium. Adding up the 4 export flows gives a total export figure of EUR 5.4 bln.

Figure 13: Dutch exports by sector 2010 (mln €) and CAGR 2010-2015

	2010	CAGR 2010-2016
Agriculture and food industry	338	7.0%
Oil and gas, minerals industry	345	6.8%
Chemical industry	667	5.5%
Manufacturing industry (by material)	271	14.4%
Technological manufacturing industry	486	13.2%
Utilities	24	6.8%
Construction	11	5.7%
Wholesale trade	239	8.9%
Retail trade	111	8.9%
Transport and logistics	47	5.7%
Financial services	5	5.6%
Business services	210	5.7%
Public and health services	82	5.9%
Total domestic exports	2837	8.7%
Re-exports	1949	3.2%
Total exports	4785	6.6%
Services	455	6.5%
Goods	2382	9.1%

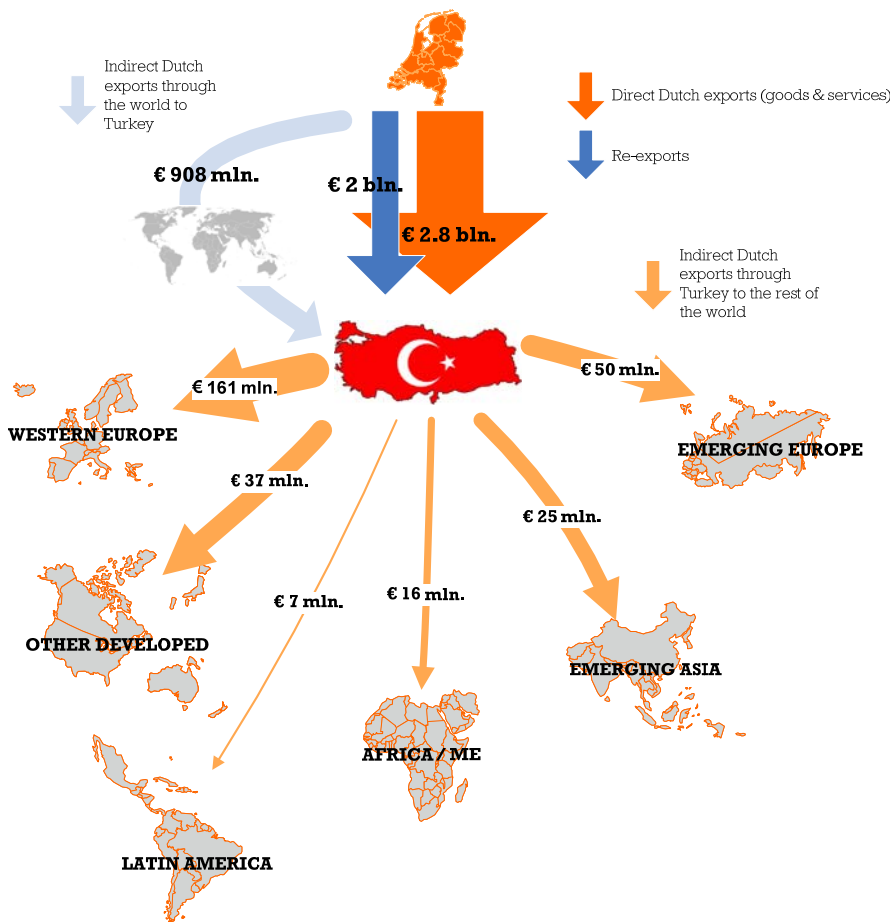
Source: Eurostat, Oxford Economics, ING calculations

Dutch exporters underestimate opportunities in Turkey

Dutch exports to Turkey only amount to 0.9% of total Dutch exports. If Dutch export growth to Turkey continues as forecasted (6.6% in value on annual basis) the share will be 1% in 2016. In total Turkish imports our share will decrease. To keep our market share in Turkish imports Dutch exports need to double their base growth rate (at least 13% on annual basis). Based on the 13% annual growth rate of Turkish imports Dutch domestic exports should amount to EUR 6 bln instead of EUR 4.7 bln in 2016. Otherwise Dutch exporters are missing out on EUR 4.1 bln exports until 2016.

Box 1 Indirect exports and the hub function of Turkey

Exports are not only used to satisfy final demand in the importing country, but can also be used as an intermediary product in the destination country's production process. Dutch components are included in Turkish products. It is also possible that Dutch products are re-exported via Turkey to other countries. The analysis does however not cover the Turkish re-exports. From Turkey, products, including the Dutch component, are exported to other countries. This implies that exports to Turkey are not only driven by Turkish final demand, but also by final demand of many other countries. We refer to this as indirect exports through Turkey to the rest of the world.



Source: ING, VU (updated)

Disclaimer

The information in this report reflects the personal views of the analyst(s) and no part of the compensation of the analyst(s) was, is or will be related, directly or indirectly, to the inclusion of specific recommendations or views in this report. The analysts that contributed to this publication comply with all the requirements laid down by their national supervisors for the performance of their duties. This publication has been prepared on behalf of ING Bank N.V., established in Amsterdam, solely for the information of its clients. ING Bank N.V. is part of ING Groep N.V. This publication is not investment advice or an offer or solicitation for the purchase or sale of any financial instrument. This publication is purely informative and may not be regarded as advice. ING Bank N.V. secures its information from sources it regards as reliable and has taken all reasonable care to ensure that the information on which it based its view in this report are not untrue or misleading at the time of publication. ING Bank N.V. makes no representation that the information used by it is accurate or complete. The information in this report is subject to change without notice. Neither ING Bank N.V. nor any of its directors or employees accepts any liability for any direct or consequential loss arising from any use of this publication or its contents or mistakes in the printing and setting of this publication. Copyright and database rights protection exist in this publication. Information in this publication may be used as long as the source is mentioned. In the Netherlands ING Bank N.V. is registered with and supervised by De Nederlandsche Bank and the Financial Markets Authority.

**To find out more, visit
ING.nl/kennis or call**

Rob Rühl

Head of Business Economics
+ 31 20 56 39508

Mohammed Nassiri

Research Assistant
+ 31 20 56 34444