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PANORAMA

TURKEY: END OF THE TULIP PERIOD?

COFACE ECONOMIC PUBLICATIONS

By Seltem IYIGUN, Coface MENA Economist

Turkey's economy experienced several shocks during 2015 and 2016. Heightened political uncertainties, regional tensions, the US rate hike process, the credit rating downgrade and domestic security issues, have all resulted in lower tourism revenues, a slowdown in consumer demand, lower appetite from foreign and domestic investors and weaker local currency.

These factors have contributed to a slow-down in capital inflows to Turkey – inflows on which the country is heavily reliant for its economic activity. Compounded by global risk aversion and local companies paying their debts in dollars, this environment has caused a sharp depreciation of the lira. This is threatening the payment behaviour of the corporate sector, as well as investment appetite and growth perspectives. Coface expects the Turkish economy to grow by 2.5% in 2016 and 2.7% in 2017.

It should be noted, however, that despite these domestic and external shocks over the last couple of years, the Turkish economy has remained resilient. Manufacturing production continues to edge up on an annual basis, mainly on the back of the economic recovery in Europe, Turkey's main trading partner. The measures that have been implemented to boost domestic demand are expected to have effects on consumption in the upcoming period. Thanks to its improving relations with neighbouring countries, tourism revenues should start to increase in the second half of 2017. Exports to the EU area are continuing to rise, partially compensating for exporters' falling profits. Higher public spending will also support economic activity, especially with the recent incentives package aimed at encouraging investments.

Most importantly, the implementation of structural reforms means that a path of sustainable growth in the medium term still looks promising for economy, all the more as the country benefits from a young popu-lation and large domestic market. Although economic growth has slowed, the economy has still been in continuous progression for the last 27 quarters.

After elaborating on this challenging outlook in the first section, the panorama will focus on the retail sector, as it is a good indicator of both domestic demand and the impact of currency risks for businesses. The study will then examine the automotive sector, where domestic sales are edging down, but exports remain fairly strong, on the back of the European recovery.

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QUOTES BY ECONOMISTS

1 LOWER GROWTH PERFORMANCE EXPECTED

SELTEM İYİGÜN

MENA REGION ECONOMIST
seltem.iyigun@coface.com

Lower growth despite more fiscal stimulius

Turkey's economy posted a growth rate of 2.2% in the January-September period of 2016 compared with the same period of a year earlier. In the third quarter, the economy contracted by 1.8%, the first year-on-year decline in economic growth since 2009. The main driver of the contraction was related to the decline by 3.2% in private consumption and by 0.6% in fixed investment. At that time, the growth of nearly 24% in public consumption expenditures avoided a deeper slump in GDP.

Greater political uncertainty resulting from two parliamentary elections in 2015, drying global liquidity due to the US Federal Reserve's rate hike process and the weaker Turkish lira, all contributed to dragging down growth. The perception of risk deteriorated further in 2016, due to heightened regional tensions, intensifying domestic security problems, the failed coup attempt on July 15th and the credit rating downgrade. Due to these negative domestic and external shocks and weaker confidence, GDP growth is expected to decline in 2016.

Between 2002 and 2011 Turkey benefitted from the cheap and abundant liquidity, provided to international financial markets by major central banks, in order to recover from the negative impacts of the 2008 global financial crisis. The country's development strategy was mainly based on cheap foreign borrowing, which was then used by households and businesses in the form of cheap credit.

In 2017, government spending is expected to be one of the key growth drivers. In the 2017-2019 medium term plan, the government has foreseen a wider budget deficit, which is a reflection of declining headline growth and some counter-cyclical fiscal spending over the past three years[1] . The country's low public deficit and debt levels (Turkey's EU-defined debt stock to GDP ratio stood at only 32.9% in 2015) means that it can use fiscal policy as a tool to mitigate economic slumps. To counter waning business sentiment, the government has announced a broad investment package whose objective is to improve the investment climate via a project-based approach. The new package, which entered into force in September 2016, includes support instruments (such as corporate tax exemption of up to 100% and investment support of up to 200%), income tax withholding support, customs duty exemption and free transfer of these immovable properties for projects etc[2].

Despite this negative growth momentum, the country has been able to maintain fiscal discipline. Public finances are solid, providing enough room to manoeuvre for the government to support the economy through higher spending. The EU-defined general government nominal debt stock is low, as Turkey has been meeting the Maastricht criteria for both of the indicators. Only 35% of the central government's debt stock is denominated in foreign currencies. This provides government finances with protection against fluctuations in foreign currency markets.

1) Turkey Country Risk Report, Q4 2016, BMI
2) Turkey to grant new incentives for eligible investments on a project basis, Invest in Turkey, September 2016

The average maturity of borrowing has also lengthened. Turkey's treasury is currently able to borrow up to 15 years, on average, from international markets (compared with 7 years in 2002) and up to 70 months on average from domestic markets (compared with 9 months in 2002). **These improvements have allowed Turkey to increase investments in sectors such as education, healthcare and infrastructure** – all important pillars of the country's sustainable growth per-formance. Between 2003 and 2015, Turkey invested 253.3 billion lira in its infrastructure. These Improvements in infrastructure are bringing great advantages for trade, by cutting the time and costs of logistics and thus improving productivity.

Despite the slower growth rate, new job creation is continuing this year, following on from the creation of a further 688,000 posts in 2015. In the context of the higher labour participation rate and slowing economy, the unem-ployment rate stood at 11.3% in August 2016. Structural reforms and rising economic activity should help to further reduce unemployment over the upcoming period.

The government's commitment to reforms is an important factor in sup-porting sustainable growth. The reform plan that it has introduced is based on four pillars: investment incentives, research & development, the international labour force and costs savings. The government intends to provide 600 million lira to companies with investment plans and to offer some tax exemptions and reductions in 2017. The authorities also aim to grant 522 million lira to the tourism sector in 2017. In terms of ease of opening a business[3], following recent improvements, the number of procedures required has been cut from 8 to 3 and the number of days from 7.5 to 2.5. The government also supports design centers, small-scale R&D centers and technology development hubs (through supports for technological incentives and tax and duty exemptions). In order to encourage more domestic savings (the lack of which is creating the country's main structural weakness – its current account deficit), Turkey is transforming the voluntary private pension system into a mandatory private pension scheme. This implies the automatic participation of every wage-earner under 45 years of age being enrolled in a pension plan, to be determined by their employers. In the medium term, these structural reforms should reduce the manufacturing sector's dependence on imported imports and help to narrow the current account deficit.

The authorities have also implemented measures to help boost domestic demand. Credit card payment installment limits have been increased from 9 to 12 months (apart from some goods and services), credit card debts can be restructured to up to 72 months, the installment limit for consumer loans has been extended to 48 months and the minimum deposit rate for housing loans has been lowered from 25% to 20%. The impact of these measures should be seen as from the fourth quarter of 2016. Nevertheless, within the environment of slower economic activity and rising unemployment, the pace of growth in household debt could present an obstacle. In July 2016, the unemployment rate rose to 10.7%, its highest level since February. The household financial leverage ratio (financial liabilities to financial assets) stood at 48% as of March 2016, up from around 40% in 2010. Although the ratio still appears to be low, a further increase could restrain household borrowing capacity. As at the end of 1015, there were 58.2 million credit cards in use in Turkey[3] , while the total labour force stood at 30.9 million. The number of consumers who did not pay their consumer credit card debt declined by 5% in the first nine months of 2016 (compared with the same period a year earlier[4]). Nonetheless, according to the Federation of Consumers Association, total unpaid credit card debt stock stands at 260 billion lira (approximately $82 billion). The government's efforts to bring these consumers back into the economy, through debt restructuring, could have positive impacts on the consumption side.

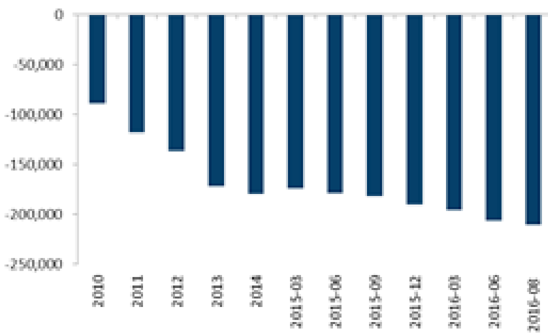
Currency risks and the persistent current account deficit are the main challenges

One of the biggest risks for Turkey's private sector could be its foreign currency exposure. The total amount of external debt that the private sector is required to pay within a year stands at $91 billion. With the current account deficit estimated to be hovering at around $30 billion, Turkey's total external financing needs have grown to nearly $120 billion. It should be noted that there has been a significant decline in the private sector's short-term external debt since the last quarter of 2014, when it reached $113.4 billion. This decline indicates that companies are reducing their short-term financing from overseas, to borrow with longer maturities, as their long-term external debt increased by $39 billion to reach $208 billion during the same period. This could be seen as a balancing move.

Another positive development comes from the fact that net foreign currency exposure has declined since the end of 2013, when the former chairman of the U.S. Federal Reseve announced the bank's less accomodative monetary policy strategy. This resulted in a weakening of emerging currencies, including the lira. Companies have opted to reduce their currency exposures, due to the heightened volatility of the local currency (particularly against the dollar and the euro).

3) Annual Report, 2015 The Interbank Card Center (BKM)
4) The Banks Association Of Turkey Risk Center

Chart 1: Net Foreign Exchange Position of Non-Financial companies (Million USD)

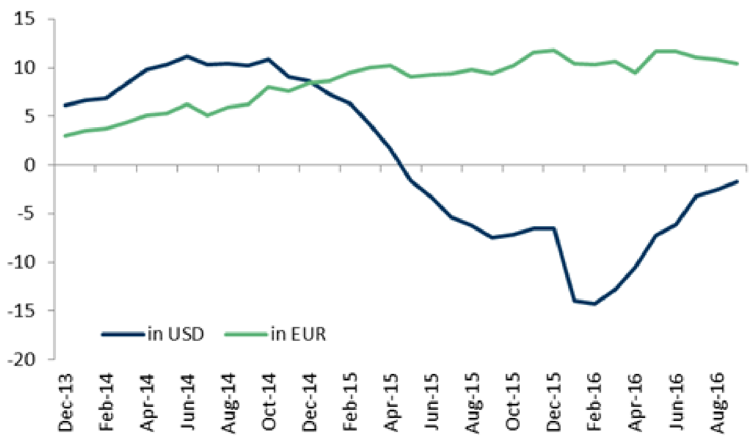


Source: CBRT

The weakening of the lira is hindering the development of private consumption, the economy's main growth driver. This is being compounded by other factors such as tensions on the Syrian border, higher loan interest rates and rising inflation, which are motivating consumers to delay purchases. This slowdown has been occuring since the start of 2016. Imports of consumer goods declined by an average of 3.8% during the first three quarters of 2016 (compared with the same period in 2015). Auto sales remained almost flat during the first ten months of the year compared to the previous year. During the first nine months of 2016, first-time housing sales rose by only 2.7% compared to the same period in 2015 (when they increased by 10.4%). Consumer loans, in nominal terms, also decelerated (registering 6% growth in the third quarter of 2016, compared to nearly 15% in the first quarter of 2015). Lower domestic spending is hampering the growth performance of companies. This lacklustre consumption is mainly due to the deterioration of economic sentiment, with higher inflation reducing purchasing power. According to Turkey's Central Bank model, a 10% depreciation of the Turkish lira against the euro/dollar basket pushes inflation up by 1.8 percentage points after two years. The pass-through impact of the depreciation shock to inflation is seen within a year[5]. It would therefore be fair to expect that inflation will reach nearly 9% by the end of first half of 2017 (up from the current 7%), on the back of the lira's 15% depreciation against the euro/dollar currency basket seen since September 2016. A further depreciation of the lira would particularly impact durable consumer sectors, which are highly sensitive to these currency fluctations.

The sharp depreciation of the lira has not, so far this year, helped Turkish exports to pick up. During the January-September period, exports fell by 2.7% compared to the same period in 2015. The deterioration is mainly due to the decline in global trade volumes, turmoil in Turkey's key export markets such as Iraq and Syria and tensions with some of its neighbouring countries. Compounded by these developments, the lira's depreciation of around 18% versus the US dollar since the start of 2016 has not significantly improved the competiveness of Turkish goods. As of October 2016, the CPI-based real exhange rate of the Turkish lira stood at 98.51 - far removed from the threshold of 120 that the central bank considers as an overvaluation. Nevertheless, in terms of volume, exports rose by 3.4% on average from January-September 2016 compared to a year ago. This clearly illustrates the flexibility of Turkish exporters and their ability to quickly diversify in terms of products and export markets. This flexibility will be one of the economy's greatest advantages in 2017. The fact that the value of Turkish exports to the EU, in euros, is continuing to increase, confirms this advantage.

Chart 2: Turkey's exports to the EU-28 (yoy, %)



Source: TSI, Coface calculations

Sectors such as textiles, plastics, iron & steel and motor vehicles - where Turkish manufacturers have expertise and the capacity to repond quickly to demand from European customers - have registered significant upsurges in exports to the EU-28. This is also related to higher demand from Europe, due to its economic recovery. The expected increase in exports to Europe in 2017 should also support Turkey's economic performance.

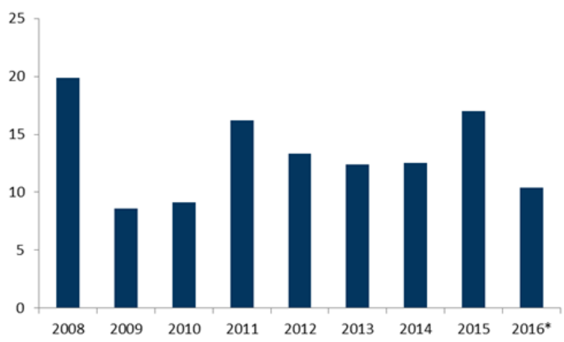
On the import side, lower energy prices have narrowed the current account deficit to 3.7% of GDP in 2015. Between January and September 2016, total imports declined by 0.7% compared to the same period in 2015. This drop was mainly due to the decline in global energy prices. Turkey's economy is heavily dependent on energy imports and therefore benefitted from the drop in prices. The country's energy import bill dropped by 34% during the first nine months of 2016 compared to a year earlier,

5) A Bayesian Approach to Analyzing Inflation Dynamics in Turkey, Inflation Report 2006-I, Inflation Developments, Box 3.2, CBRT down to $19.5 billionThe recent recovery in energy prices and the pace of growth in Turkey's domestic demand could be the key drivers of the external gap during 2017.

Falling tourism revenues also had a negative effect on the overall deficit. The tourism sector has suffered from a series of high profile terrorist attacks, the deterioration of relations with Russia (after the downing of a Russian jet by Turkey in 2015), a failed coup attempt and the disinclination of domestic consumers towards extreme spending (in the wake of higher political and regional uncertainties). During the first nine months of 2016, tourism revenues plunged by 30% and tourist arrivals by 26% compared to the previous year. Russian tourists represent Turkey's second largest group in terms of international arrivals (after Germany). From January to September 2016, the number of Russian tourists to Turkey tumbled by 84% compared to the same period in 2015. The outlook has, however, improved, following Turkey and Russia's rapprochment since the failed coup attempt. In August 2016, the Russian government lifted their ban on charter flights to Turkey and this has reopened Turkey to Russian tourists. The lifting of these restrictions should lead to a 30% increase in demand for tourism to Turkey, according to Russia's Transportation Ministry[6]. Nevertheless, this should only contribute to a slow recovery in the tourism sector, as the security environment is still considered as potentially volatile by international visitors. Narrowing tourism revenues, coupled with the progessively decreasing impact of oil prices, could slow the narrowing process of the current account deficit

The higher perception of risk could also be hampering the financing of the current account deficit. The deficit is mainly financed through short term capital inflows. This situation leaves the country vulnerable to sudden shocks to capital inflows in cases of risk aversion in international financial markets. This could also represent continued risks for long term capital inflows, due to heightened political and economic uncertainty.

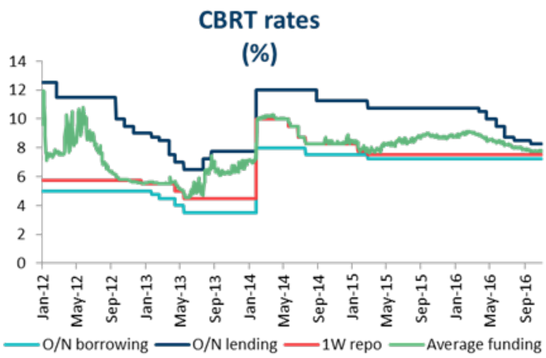
Chart 3: FDI in Turkey (USD billion)



Source: Undersecretarial of Treasury

Developments in the current account deficit, monetary policy and inflation are decisive factors in Turkey's currency risk. In October 2016, the annual rise in headline consumer prices stood at 7.2%, while core inflation fell from 7.7% to 7% (an 18 month low). These figures suggest that headline inflation is likely to remain close to the central bank's recently revised year-end inflation target of 7.5%. Concerned by the plunging lira, Turkey's central bank raised its benchmark interest rate by 50 basis points, to 8%, and its overnight lending rate to 8.5% (up from 8.25% in November). This cautious stance in monetary policy could limit further depreciation of the domestic currency - unless there is further deterioration in risk aversion globally, or towards Turkey.

Chart 4: CBRT policy rates



Source: CBRT

Looking ahead, trends in capital inflows will be key. The Institute of In-ternational Finance (IIF) forecasts that net capital outflows from emerging countries will stand at $206 billion in 2017 - a notable decline from the net capital outflows of $373 billion anticipated for 2016[7] . This situation can be seen in Turkey. Between January and September 2016, non-resident capital flows to Turkey fell by 12% to $26.9 billion, down from $30.6 billion in the same period of 2015. This was a major factor leading to a 16% depreciation in the Turkish lira against the euro-dollar basket - although part of this decline was related to external factors such as the US Federal Reserve's rate hike process, the US presidential election, Brexit and regional tensions.

Another source of concern is Turkey's private sector external debt stock. Although the total debt stock appears high, the non-financial private sector's share of short-term external debt stands at $38.2 billion (below 5% of GDP). As of September 2016, the private sector's roll ratio for its long-term external debt stood at 169%, on a 12-month cumulative basis. This situation suggests that the majority of private companies are able to meet their external liabilities.

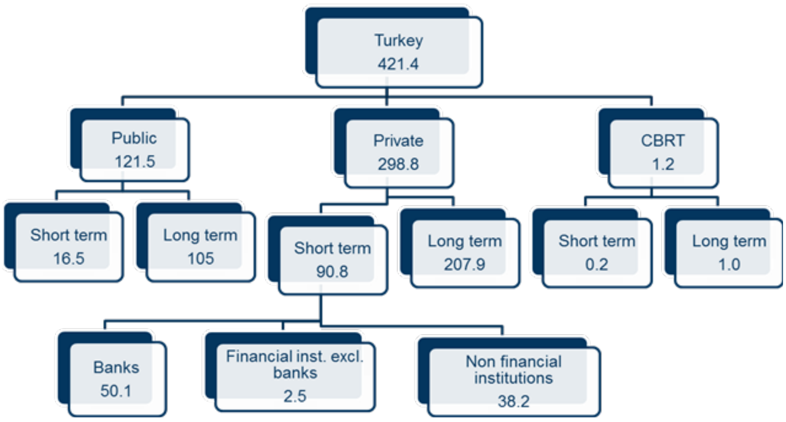
6) Russia Fully Lifts Turkey Travel Ban Imposed Following Syria Imbroglio, August 2016, Forbes
7) November 2016 Capital Flows to Emerging Markets, IIF

Nevertheless, it is important to underline the fact that, since the start of 2016, net acquisitions of foreign assets by Turkish residents have declined to $2 billion, down from $22.3 billion in the same period of 2015. This reaction to the lira's depreciation has, so far, helped to smooth the impact of higher borrowing costs and the weaker currency.

Turkey remains attractive for foreign investors, as can be seen by the capital inflows into Turkey since the start of 2016 (even though at a slower pace than in 2015). In 2009, when the economy contracted by 4.8% due to the global crisis, total foreign capital inflows into Turkey shrank by 95%. Although the current situation is far away from this scenario, the rate of foreign capital inflows into Turkey in 2017 will be very important for its economic performance. The country is still attracting foreign funds, although the sustainability of these capital inflows will depend on the business environment and developments in global financial markets.

International investors could also be attracted by Turkish bond yields of near to 11%, especially in the current global environment where yields are close to zero. This could represent a source of financing for the external deficit over the upcoming period and a chance to limit further depreciation of the lira.

Chart 5: Turkey's external debt stock (Q2 2016, billion USD)



Source: Undersecretariat of Treasury

2 SECTOR RISK

This section focuses on the retail and automotive sectors in Turkey, which are good indicators of the country's economic trends. Risks are currently escalating for retail businesses, mainly due to slowing domestic demand, costs and the lessening impact of currency weakening on the business environment. As concerns the automotive sector, even if the same risks apply to the domestic market, exports remain fairly strong and are helping manufacturers and component producers to somewhat compensate for lower profits.

Retail: Constrained by lower consumer confidence and higher costs

Turkey's retail sector plays a key role in its economic growth In fact, Turkey's retail sector has been benefitting from solid economic growth for a decade, bolstered by its large population of close to 80 million and rising per capita income. The median age of inhabitants stands at 31 - indicating that youth constitutes an important share

SECTOR RISK ASSESSMENT

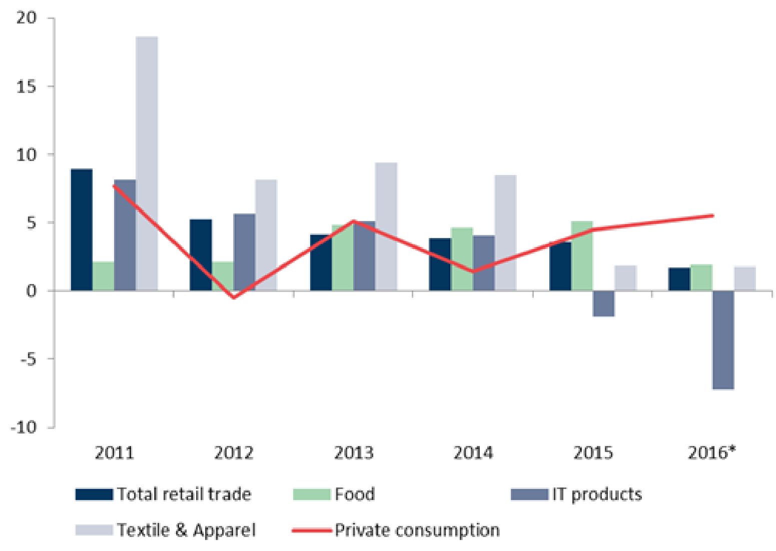
Sectors	Turkey
Agrofood	High risk
Automotive	Middle risk
Chemicals	High risk
Construction	Very high risk
Energy	High risk
ICT	Middle risk
Metals	Very high risk
Paper-Wood	Middle risk
Pharmaceuticals	Weak risk
Retail	High risk
Textile-clothing	High risk
Transportation	Middle risk

Weak risk · Middle risk · High risk · Very high risk of the total population. This somewhat explains consumers' willingness to spend and their quest for higher value products and more sophisticated service suppliers. At 75%, the country's urbanisation rate is high. This makes it easier for retailers to serve a large part of the population. The government's investments in infrastructure have also had a very positive impact on profits, as they have helped to reduce logistical costs for retailers.

Despite this, growing political tensions, terrorist attacks, the weakening of the lira and rising inflation are all weighing heavily on the retail sector's performance. These factors have caused a slowdown in domestic demand - a trend that is expected to continue in 2017. Annual growth in private consumption is expected to moderate to 2.8% in 2017, down from 4% in 2016[8] and this will weigh on retail sales. Total growth for the retail sector decelerated to 1.7% during the first nine months of 2016, down from 3.5% a year earlier.

Sparser access to credit is continuing, due to higher interest rates, while dampened consumer confidence is also dragging down retail sales. The plunge in tourism revenues, related to security issues and deteriorating relations with some neighbouring countries, is also darkening the perspectives for the retail sector.

Chart 6: Change in retail trade and components (yoy, %)



Source: Turkish Statistics Institute, IIF
*Indicates change in January-September 2016 compared with the same period a year earlier

As Turkish households spend around 24% of their budget on food, it remains the largest retail sub-sector. After reaching 141.9 billion lira (nearly $52 billion) in 2015, household spending on food is expected to rise to 155.6 billion lira in 2016 and 169.8 billion lira in 2017. Although this spending appears to be increasing in nominal terms, its pace of growth is declining on an annual basis. Whilst food spending is less vulnerable to economic crises, as it is vital need, consumers do tend to reduce their spending on high-end food products during periods of high inflation and eco-nomic uncertainty. On the other hand, sales of clothing and footwear are forecast to grow quickly, even though they only account for 7.4% of total household spending.

Spending on clothing and footwear is expected to reach 40 billion lira in 2016 and 43.5 billion lira in 2017. This market is extremely diversified, offering a large range of choices for consumers. With changing life styles and an important share of female clients who closely monitor international fashion trends, the demand for these products is expected to continue. Nevertheless, the pace of growth is forecast to be lower than in previous periods, due to the slowdown in the economy and the negative impact of high inflation on purchasing power.

Consumer electronics remains the most vulnerable subsector within retail, as these goods are not perceived as vital needs by consumers. Moreover, being mainly imported, their prices are highly sensitive to the lira's depreciation. In 2017, households are forecast to spend 7.61 billion lira on audio visual equipment, cameras and computers, compared to 6.9 billion lira in 2016. Again, despite the increase in nominal terms, the pace of growth in spending fell to an annual increase of 10.9% in 2017, versus 15.9% in 2016.

The biggest challenge for retailers is their low level of profitability, typically caused by high operational costs. The largest of these is related to inventory costs. Between 2013 and 2015, the cost of merchandise rose from 65.5% of net sales to 67.3%. Another factor dragging on profitability is the structural weakness of return on equity. The ratio of return on equity fell from 25.9% in 2013, to 18.4% in 2015. This led to the majority of retailers being dependent on loans to finance their businesses - but with the US Federal Reserve's rate hiking process, the financial conditions being imposed on Turkey are tightening. Interest rates on commercial loans denominated in Turkish lira rose from around 10% in 2013, to nearly 14% in 2016. This clearly increases the debt burden on companies. Those who opted to use commercial loans denominated in euros and/or in dollars have suffered heavily from the sharp depreciation of

8) Turkey Full Economic Database, September 2016, IIF the lira (which has plunged 92% against the dollar and 55% against the euro since 2013).

The lira's sharp devaluation is weighing heavily on rental costs, as rents in shopping malls or in central locations of big cities are usually denominated in euros or dollars. According to a statement from Turkey's BMD, the cost of rents in shopping malls has increased by 15% in 1.5 months due to the lira's depreciation[9] . **High indebtedness is also impacting the short-term financial health of retailers.** Their working capital declined from 2.7 billion lira in 2013, to 2.3 billion lira in 2015, mainly due to the sharp increase in short-term liabilities. This indicates a limited capacity to roll short-term debts which could fragilise their financial structure.

In addition to these factors are market saturation and fiercer competition (with additional services and discounts offered to customers), which are also trimming profit margins. Retail discounts rose to 5.6% of net sales in 2015, up from 4.9% in 2013. This trend appears to have continued in 2016, with a large share of retailers reporting a decline in profits.
The rise of 30% in minimum wages since the start of 2016 has additionally hit retailers, as they mainly rely on lower-paid employees. This increase has also applied to employer social security contributions and the costs of some of the services they outsource (such as security and catering). This situation has had the hardest impact on the profit margins of companies that do not have the possibility to pass these wage hikes on to final consumers.

Challenging environment in the short-term, but oppor-tunities for the long-term

Although the retail sector offers significant opportunities in the long term, it faces tough challenges in the short term. Its financial structure, which is dependent on borrowing to finance business activities, makes the sector vulnerable to any further depreciations in the lira (as this would put pressure on the central bank to increase its rates, which would in turn lead to a rise in interest rates on all type of loans). On the other hand, recent statements from the authorities on the possibility of provisional arrangements concerning retail rents denominated in foreign currencies, could be positive news (as they would protect retailers from further negative impacts of a weaker lira, even on a temporary basis). In summary, the lira's depreciation, the impact of high inflation on purchasing power and political uncertainties will all continue to drag on the retail sector's performance.

The decline in tourist arrivals represents another issue for Turkish retailers. According to some reports, around 5% of the sector's total turnover comes from visitor spending. In 2017, improved relations with neighbouring countries could help retailers to partially compensate for previous falls in sale volumes.

In the longer term, the retail sector should benefit strongly from the country's high urbanisation, its good infrastructure (which supports new sale channels such as online sales), the youthful population and rising per capita income. These factors are expected to support the retail sector's steady growth performance. Further urban expansion around the big cities should also help retailers to gain access to new customers.

Turkish retailers also benefit from the country's geo-graphical location, with its proximity to Western Europe and the Gulf countries. Although total tourist arrivals declined in 2016, arrivals from the GCC countries rose by 28.6% in the January-October 2016 period, compared to the previous year. The attraction of wealthy tourists to the country is allowing retailers to generate sales, especially in the medium to high range segments.

Automotive: slight decrease in domestic market but supportive external conditions

In 2016, Turkey's automotive sector saw a decline in do-mestic sales compared to the previous year. In the first ten months of the year, total sales declined by 3% compared to the same period in 2015. This fall has mainly resulted from the slow-down in economic activity, which dragged down sales in the commercial subcategory by 12.3% in the January to October 2016 period, on an annual basis.

Passenger car sales rose by 1% for the same period, de-spite several negative factors (such as the weaker currency, political uncertainties, high inflation and unemployment) damp-ening consumers' confidence and pushing them to delay pur-chases.

Production volumes during the first ten months climbed to 1,179 thousands units - the highest ever level. Although there was a fall in commercial vehicle sales, the demand for passenger cars supported automotive production.

Despite the slight contraction in domestic markets, Turkish car manufacturers benefitted from the recovery in Europe. In the first nine months of 2016, automotive demand rose by 8.4% from a year earlier for EU-28 and EFTA

9) Shopping Malls can not find solution for rent, Nov. 30, 2016, Sozcu daily newspaper countries[10]. In the months from January to October 2016, Turkish automotive exports rose by 10.8% compared to the same period in 2015. During this time, exports to Germany rose by 16.9%, to Italy by 11.4% and to France by 10.3%. The continued recovery in the European economy is also expected to support automotive sales and production volumes in 2017. It is important to underline the fact that, despite recent struggles, Turkey is still the world's 15th largest producer in the automotive sector and the 5th largest in Europe.

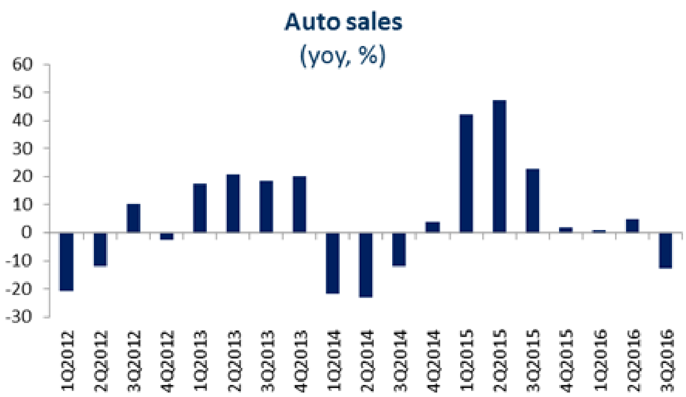
In 2017, the main challenges for the automotive sector will be related to new regulations and fluctuations in the lira. The recent depreciation in the lira could add upwards pressures on prices in the coming period, given that the import ratio in the domestic car market stood at 76% in the January-October period. On the regulatory side, in late November, Turkey introduced an increase in the special consumption tax rate for higher priced vehicles. The new rate takes into consideration price ranges and engine cylinder volumes. This is expected to weigh on luxury car sales by increasing final purchase prices.

Coupled with the rising financial liabilities of consumers and the private sector, this new tax could restrain sales. Car producers and equipment manufacturers may seek to compensate for the possible decline in domestic sales by ex-ploring new opportunities in the European market - as the Euro-pean recovery is expected to remain supportive in terms of growth in demand from Turkish exporters in 2017. Furthermore, the weaker lira provides exporters with a competitive advantage, making Turkish exports cheaper in euro terms. On the other hand, the fact that the automotive sector's dependence on imported components stands at over 50%, could reduce some gains.

The removal of international sanctions on Iran could also provide producers with an unpenetrated market. Turkey's automotive sector remains highly export-oriented, with 71% of its vehicle output destined for export in 2015. Iran's demand for vehicles is expected to grow by an annual average of 12.6% between 2016-2020[11], offering Turkish automotive producers good opportunities for sales and investments. The removal of sanctions would allow them to tap freely into the Iranian market - a market they were previously unable to profit from, as many of Turkey's automotive producers are under the control or ownership of US and European-based companies (which were held back by sanctions on Iran).

The US Federal Reserve's rate hike process will be an important driver of monetary policies in emerging markets, including Turkey. Further depreciation of the lira could push Turkey's central bank to deliver more rate rises, which would in turn increase interest rates on auto loans (which declined from 14% on average between August 2015 and August 2016, to 13.6% in mid-November 2016). On the other hand, the lackluster appetite for investment, lower business confidence and trend for companies to cut extra spending (including renewals of car fleets) could also weigh on commercial vehicle sales in 2017.

Chart 7: Turkey total vehicle sales



Source: Automotive Distributors' Association (ODD

10) European Automotive Market, October 2016, Automotive Distriubutors' Association
11) Turkey Automotive Report, Q4 2016, BMI

COFACE SA
1, place Costes et Bellonte
CS 20003
92276 Bois-Colombes
France
www.coface.com

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