

# Atradius Country Reports

Central, Eastern and South Eastern Europe –  
September 2015



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## Central, Eastern and South Eastern European economies: Atradius STAR Political Risk Rating\*:

<b>Czech Republic:</b>	<b>3 (Moderate-Low Risk) - Stable</b>
<b>Hungary:</b>	<b>5 (Moderate Risk) - Positive</b>
<b>Poland:</b>	<b>3 (Moderate-Low Risk) - Negative</b>
<b>Slovakia:</b>	<b>3 (Moderate-Low Risk) - Stable</b>
<b>Turkey:</b>	<b>5 (Moderate Risk) - Stable</b>

\* The STAR rating runs on a scale from 1 to 10, where 1 represents the lowest risk and 10 the highest risk.

The 10 rating steps are aggregated into five broad categories to facilitate their interpretation in terms of credit quality. Starting from the most benign part of the quality spectrum, these categories range from 'Low Risk', 'Moderate-Low Risk', 'Moderate Risk', 'Moderate-High Risk' to 'High Risk', with a separate grade reserved for 'Very High Risk.'

In addition to the 10-point scale, rating modifiers are associated with each scale step: 'Positive', 'Stable', and 'Negative'. These rating modifiers allow further granularity and differentiate more finely between countries in terms of risk.

For further information about the Atradius STAR rating, please [click here](#).

# Czech Republic

Main import sources (2014, % of total)	
Germany:	30.7 %
Poland:	8.6 %
Slovakia:	6.9 %
China:	6.4 %
The Netherlands:	5.8 %

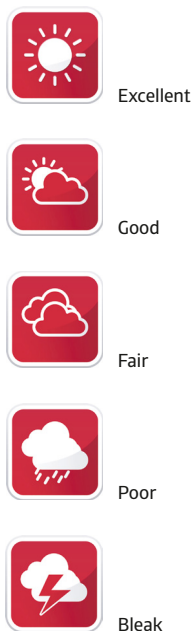
Main export markets (2014, % of total)	
Germany:	32.2 %
Slovakia:	8.4 %
Poland:	6.0 %
United Kingdom:	5.1 %
France:	5.1 %
















Key indicators	2012	2013	2014	2015*	2016*
Real GDP (y-on-y, % change)	-0.8	-0.5	2.0	3.0	3.1
Consumer price (y-on-y, % change)	3.3	1.4	0.4	0.5	1.8
Real private consumption (y-on-y, % change)	-1.4	0.7	1.5	2.6	2.8
Retail sales (y-on-y, % change)	-3.8	-1.1	5.7	4.3	2.0
Industrial production (y-on-y, % change)	-0.8	-0.1	5.0	5.2	4.8
Unemployment rate (%)	7.0	7.0	6.1	5.9	5.4
Real fixed investment (y-on-y, % change)	-3.1	-2.8	2.1	4.1	4.2
Export of goods and non-factor services (y-on-y, % change)	4.5	0.0	8.9	5.4	4.8
Current account/GDP (%)	-2.4	-1.4	0.6	0.6	-0.6
Fiscal balance (% of GDP)	-3.9	-1.2	-2.0	-2.2	-2.7

\* forecast Source: IHS

## Czech Republic industries performance outlook

September 2015



Agriculture	Automotive/Transport	Chemicals/Pharma	Construction	Construction Materials
				
Consumer Durables	Electronics/ICT	Financial Services	Food	Machines/Engineering
				
Metals	Paper	Services	Steel	Textiles
				

## Political situation

### Head of state:

President Milos Zeman  
 (since March 2013)

### Head of government:

Prime Minister Bohuslav Sobotka  
 (since January 2014)

### Population:

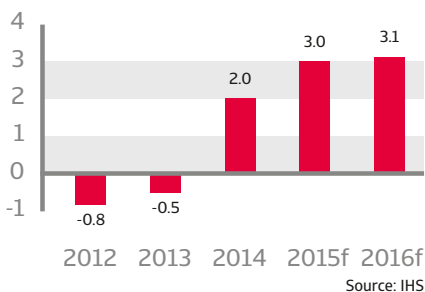
10.5 million

### Stable coalition government

Since January 2014 the Czech Republic is ruled by a centre left-coalition, holding 111 of the 200 seats in parliament. The coalition is led by the leftist Czech Social Democratic Party (CSSD), while the other two parties in the coalition are the centrist ANO 2011 and the Christian Democrats (KDU-CSL).

## Economic situation

### Real GDP growth (y-on-y, % change)



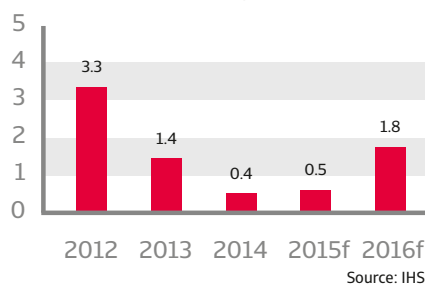
### The economic rebound gains momentum

The Czech economy suffered a contraction in 2012 and 2013, partly as the result of austerity measures, as tax increases and public sector cuts lessened the purchasing power and confidence of both households and businesses. At the same time, lower demand from EU trading partners hit exports. At more than 75 %, the Czech Republic's export-to-GDP ratio is one of the highest in the EU, making it especially vulnerable to foreign trade losses.

That said, growth returned in 2014, thanks to higher private consumption, rising investment and government spending. Due to robust domestic demand and benign economic conditions in the Eurozone, Czech GDP is expected to grow 3.0 % in 2015 and 3.1 % in 2016. Private consumption, industrial production and investment growth are expected to accelerate further in 2015, while exports continue to increase, as the country's international competitiveness has improved.

In order to improve the country's competitiveness and boost exports, in November 2013 the Central Bank intervened in the currency market by buying euros in order to weaken the Koruna against the Euro. Since then, it has repeatedly stated it will automatically intervene in order to keep the Koruna rate close to a currency ceiling level of 27 per euro, at least until mid-2016. As the economy has gained strength again and the Koruna showed an appreciating trend, in July 2015 the Central Bank intervened again in the foreign exchange market to keep the currency ceiling.

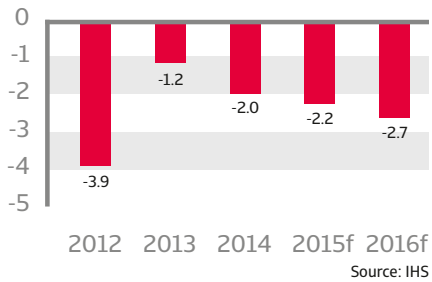
### Consumer price (y-on-y, % change)



A second objective of the Central Bank's interventions is to spur inflation, as the koruna depreciation makes imports more expensive. Since the end of 2012 - and as the effects of a VAT increase have faded - consumer prices have begun to drop, and despite a recent increasing trend, inflation is expected to reach only 0.5 % in 2015; still below the Central Bank's target of 2%. Finally inflation is expected to increase to 1.8 % in 2016.

The Czech Republic's unemployment rate reached 6.1 % in 2014 (down from 7.0 % in 2013) and is expected to decrease further in 2015 and 2016 with the economy gaining strength.

### Fiscal balance (% of GDP)



### Yearly budget deficit has dropped below 3 % of GDP since 2013

Government finances have improved in 2013 as the budget deficit decreased from 3.9 % of GDP in 2012 to just 1.2 %, putting it below the 3 % of GDP Maastricht threshold. Since then the budget deficit has remained below this threshold and is expected to do so in 2015 (2.2% of GDP) and 2016 (2.7 % of GDP). Government debt decreased in 2014, to 42.6 % of GDP from 45.0 % of GDP in 2013. It is expected to decrease further in 2015, to 41 % of GDP, which is low compared to other countries in the region. Government debt is forecast to remain on a low level in the coming years due to robust economic growth.

The improvement in public finances means that the Czech Republic would have no troubles adhering to the adoption criteria of the Euro. However, entering the Eurozone still remains a controversial issue in Czech politics, and it is not expected that the country will enter the Eurozone before 2018.

The current account is stable, and expected to reach another surplus of 0.6 % of GDP in 2015, followed by a 0.6 % of GDP deficit in 2016, as a buoyant domestic market will raise the level of imports. The level of foreign debt has increased significantly in recent years, to more than 55 % of GDP (from 42 % of GDP in 2007), but remains manageable.

# Hungary

Main import sources (2014, % of total)	
Germany:	25.4 %
Austria:	7.4 %
Russia:	7.0 %
China:	6.4 %
Slovakia:	5.5 %

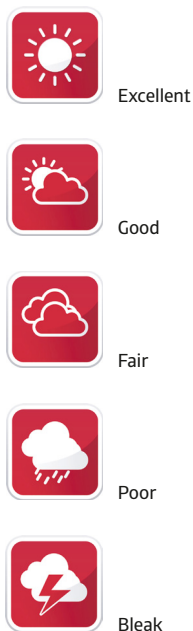
Main export markets (2014, % of total)	
Germany:	28.2 %
Austria:	5.6 %
Romania:	5.6 %
Slovakia:	5.0 %
Italy:	4.7 %
















Key indicators	2012	2013	2014	2015*	2016*
Real GDP (y-on-y, % change)	-1.5	1.7	3.5	3.0	2.4
Consumer price (y-on-y, % change)	5.7	1.7	-0.2	0.8	2.7
Real private consumption (y-on-y, % change)	-2.0	0.2	1.5	2.6	2.4
Retail sales (y-on-y, % change)	-1.3	1.5	5.2	2.4	0.5
Industrial production (y-on-y, % change)	-1.8	1.1	7.5	5.8	4.9
Unemployment rate (%)	11.0	10.1	7.7	7.2	7.1
Real fixed investment (y-on-y, % change)	-4.2	5.2	11.7	2.3	1.1
Export of goods and non-factor services (y-on-y, % change)	-1.5	5.9	8.7	7.7	5.1
Current account/GDP (%)	1.0	3.1	4.2	5.3	4.7
Fiscal balance (% of GDP)	-2.3	-2.4	-2.6	-2.7	-2.6
Foreign debt/GDP (%)	132.6	123.6	104.8	111.3	102.6

\* forecast Source: IHS

## Hungary industries performance outlook

September 2015



Agriculture	Automotive/ Transport	Chemicals/ Pharma	Construction	Construction Materials
				
Consumer Durables	Electronics/ICT	Financial Services	Food	Machines/ Engineering
				
Metals	Paper	Services	Steel	Textiles
				

## Political situation

### Head of state:

President Janos Ader  
 (since May 2012)

### Head of government:

Prime Minister Viktor Orbán  
 (since May 2010)

### Population:

9.8 million

### Troublesome relationship with the EU

In the April 2014 general elections the ruling conservative coalition of the Fidesz and KDNP parties prevailed, keeping its two-thirds majority in parliament for the time being (133 of 199 seats). However, in early 2015 the ruling coalition lost its two-thirds majority in a by-election.

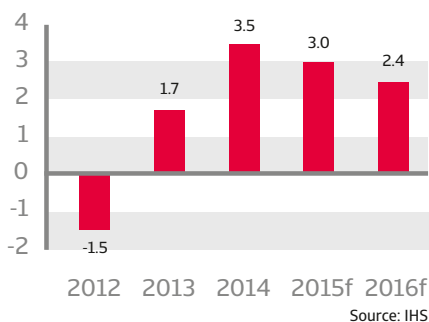
The Orbán administration has repeatedly taken actions that led to confrontations with the EU commission and its EU peers. Among them were a controversial media law and some constitutional amendments that were criticised by the EU commission as curbing the independence of the judiciary. Some of the original initiatives were later changed and diluted after the EU commission warned Budapest that those new laws would be incompatible with existing EU laws, and that it would resort to legal action unless changes were made.

The most recent controversial action by the Hungarian government was its decision to start building a fence on the border with Serbia and changing asylum laws to be able to deport migrants more easily.

Together with some unorthodox economic policy decisions like additional taxes on banks, the government's repeated confrontations with the EU have led to some uncertainty among its European peers and international investors about the reliability of Hungary as a political and economic partner.

## Economic situation

### Real GDP growth (y-on-y, % change)



### Slower growth expected in 2015 and 2016

Hungary's GDP growth accelerated to 3.5 % in 2014 after 1.7 % in 2013, as household demand grew, investment recorded a major year-on-year increase and both imports and exports increased further. At the same time the government had implemented some controversial measures to encourage economic growth, including a series of mandatory utility tariff cuts, and one-off taxes on specific sectors. Economic growth is expected to continue in 2015 and 2016, although at a slower pace: by 3.0 % and 2.4% respectively. The trade surplus is expected to decrease in the coming years as import growth is expected to outpace export growth.

Unemployment grew from a 2008 pre-credit crisis level of around 7.5 % to more than 10% in 2012, but since 2013 it has started to decrease, and is expected to decline further in 2015 to 7.2 %. However, so far the rising employment rate is largely a result of individuals registering for public works programs, while job creation in the private sector has remained weak.

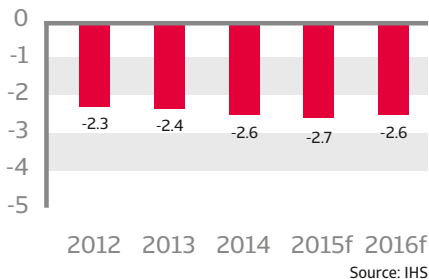
Between mid-2012 and mid-2015 the Central Bank of Hungary repeatedly (29 times) and decreased the benchmark interest rate, from 7% to 1.35 %. This has been part of its monetary easing policy in order to counter decelerating inflation and to spur economic growth. However, in July 2015 the Central Bank announced it will end the cycle of interest rates cuts and keep the current 1.35 % interest rate for a longer period.

After 0.2 % deflation in 2014 (mainly due to regulated household energy prices) consumer prices are expected to grow again, by 0.8 % in 2015 and 2.7 % in 2016.



As an additional measure to spur economic growth, the Central Bank has provided 1.5 trillion forint (EUR 4.8 billion) in interest-free loans to commercial lenders since 2013 to boost credit to small and medium-sized companies.

### Fiscal balance (% of GDP)



### Both government and external debt remain high

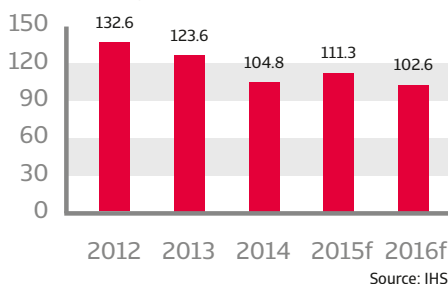
The government has proven committed to fiscal discipline so far. Hungary exited the EU's excessive-deficit procedure in 2013, and containing the budget deficit within 3 % of GDP is a top priority of the administration in order to avoid EU sanctions. However, since 2010 the government has been using unorthodox ways to balance the budget, most notably extraordinary taxes on banks and utilities. The budget deficit is forecast to remain below the 3 % threshold in 2015 (2.7 % of GDP) and 2016 (2.6 % of GDP).

However, Hungary still has a very high level of public debt. In 2011, the public debt to GDP ratio peaked above 82 %, and has decreased only moderately since then, to 76.9 % of GDP in 2014. The forecast for Hungary's public debt reduction remains pessimistic, partially due to a deal the government struck with Russia in early 2014 for the funding of a nuclear power plant in Hungary. A EUR 10 billion interstate credit agreement with Russia to finance this project will be a large burden for public finances for decades, decreasing the chances for significant public debt reduction.

Hungary's major weakness is its high level of external debt. After peaking at 155 % of GDP in 2009, Hungary has at least brought its foreign debt level down to 105 % of GDP in 2014, which nevertheless remains very high. A large share of it is foreign currency-denominated, which exacerbates the problem, as a weak forint hurts many Hungarian households and businesses whose loans are denominated in foreign currencies. Therefore Hungary remains highly vulnerable to international investors sentiment and currency volatility.

The government has started to take measures to reduce Hungary's dependence on foreign financing such as exchanging foreign currency-denominated debt for Forint-denominated debt. But while the lower external exposure may improve Hungary's risk profile on international financial markets, such a policy could increase the risk of a decrease foreign lending and private investment.

### Foreign debt (% of GDP)



Since 2011, the Forint has further weakened against the euro as a result of the monetary easing policies by the Central Bank as well as uncertainty over Hungary's economic policies and public finances. The Forint strengthened in early 2014 despite the continued monetary easing, because of improved international market sentiment and better domestic economic conditions, but nevertheless it has remained volatile since then.

Hungary's current account balance has moved into surplus since 2010, up to 4.2 % of GDP in 2014. Prior to the 2008 credit crisis, Hungary had large current account deficits, but this has improved significantly since 2009 due to decreasing imports and a quick recovery in exports. The current account is expected to remain in surplus in 2015 and 2016.

# Poland

Main import sources (2014, % of total)	
Germany:	27.5 %
Russia:	10.6 %
China:	6.5 %
The Netherlands:	5.7 %
Italy:	5.4 %






Main export markets (2014, % of total)	
Germany:	26.3 %
United Kingdom:	6.4 %
Czech Republic:	6.4 %
France:	5.7 %
Italy:	4.5 %
















Key indicators	2012	2013	2014	2015*	2016*
Real GDP (y-on-y, % change)	1.8	1.7	3.4	3.5	3.8
Consumer price (y-on-y, % change)	3.7	0.9	-0.1	0.0	1.6
Real private consumption (y-on-y, % change)	0.9	1.2	3.0	3.0	1.8
Retail sales (y-on-y, % change)	2.3	1.6	3.3	3.0	4.3
Industrial production (y-on-y, % change)	1.2	2.3	3.4	5.4	6.4
Unemployment rate (%)	10.1	10.3	9.0	7.9	7.4
Real fixed investment (y-on-y, % change)	-1.7	0.9	9.5	5.2	5.0
Export of goods and non-factor services (y-on-y, % change)	4.3	5.0	5.3	5.4	5.1
Current account/GDP (%)	-3.7	-1.3	-1.3	-1.1	-2.0
Fiscal balance (% of GDP)	-1.9	-2.5	-1.7	-2.8	-2.4

\* forecast Source: IHS

## Poland industries performance outlook

September 2015

-  Excellent
-  Good
-  Fair
-  Poor
-  Bleak

Agriculture	Automotive/ Transport	Chemicals/ Pharma	Construction	Construction Materials
				
Consumer Durables	Electronics/ICT	Financial Services	Food	Machines/ Engineering
				
Metals	Paper	Services	Steel	Textiles
				

## Political situation

### Head of state:

President Andrzej Duda  
 (since August 2015)

### Head of government:

Prime Minister Ewa Kopacz  
 (since September 2014)

### Population:

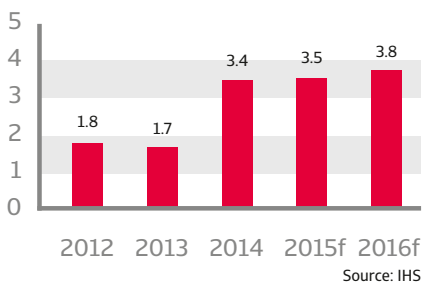
38 million

### Next general elections to be held in October 2015

The current political situation is stable. A coalition between the Christian-democratic Civic Platform (PO) and the agrarian, farmer-oriented Polish People's Party (PSL) has been in power since the October 2011 general elections, with a slight parliamentary majority. The next parliamentary election is due to be held 25 October 2015. Currently the conservative Law and Justice party PiS is leading the polls. In the May 2015 presidential elections the PiS candidate, Andrzej Duda, won against the incumbent Bronislaw Komorowski from PO.

## Economic situation

### Real GDP growth (y-on-y, % change)

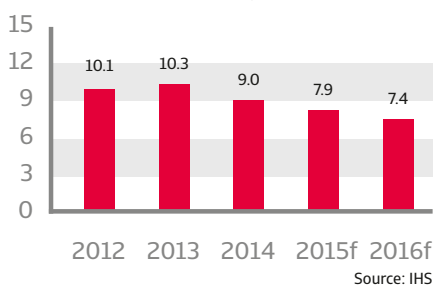


### Economic growth above Eurozone average

In recent years Poland's economy grew at a substantially faster rate than the Eurozone, and is expected to do so in the coming two years. In 2014 Polish GDP increased 3.4 %, mainly driven by private consumption and investment. The agriculture and food sectors have been particularly hit by Russia's embargo on EU food imports, as before the ban Poland annually exported fruit and vegetables worth between USD 1-2 billion to Russia. That said, the Polish economy is expected to benefit from low energy prices and the rebound in the Eurozone, with GDP expected to grow 3.5 % in 2015, based on robust domestic demand and increasing exports. In 2016 the economy is expected to grow 3.8 %.

Since 2013 consumer price inflation has been low, below the National Bank of Poland (the Central Bank) target of 2.5 %, and even turned negative since July 2014. Deflation is driven by the domestic impact of the plunge in oil prices and Russia's ban on food imports, which has created excess supply of food products domestically. This has led the National Bank of Poland to lower the benchmark interest rate to 1.5 %. Consumer prices are expected to remain unchanged in 2015 and to increase 1.6 % in 2016.

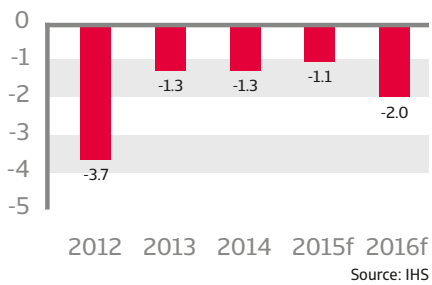
### Unemployment rate (y-on-y, % change)



The unemployment rate, although below the Eurozone average, remained high in 2014, at 9.0 %. That said, a labour office reform and new forms of aid for employment purposes, implemented in May 2014, led to a decrease compared to 2013 (10.3 %). Demand for new jobs is growing and is highest in the industrial production and the education segments. Unemployment is expected to decrease further, to 7.9 % in 2015.

Since 2007 Poland's government debt has increased, and in 2013 it peaked at 57 % of GDP. But it decreased to 50.1 % of GDP in 2014, primarily due to a pension reform (which however is only a short-term solution to reduce government debt). The fiscal deficit has been below the 3 % Maastricht threshold since 2009 and is forecast to remain so in 2015 and 2016, but is expected to increase in 2015, as military spending is likely to be increased further as a reaction to Russia's intervention in Ukraine.

### Current account (% of GDP)



Poland's foreign debt level increased from 42 % of GDP in 2004 to more than 70 % in 2014. While this is a very high level, it is still in line with most Central and Eastern European countries. The current account deficit has returned to a more moderate level of 1.4 % of GDP in 2013 and 1.3 % of GDP in 2014. This decrease has been mainly due to exports outperforming imports. The current account deficit is expected to decrease to 1.1% of GDP in 2015, but to increase again in 2016 (to 2 % of GDP) due to higher domestic demand boosting imports.

During the 2008/2009 credit crisis, the Polish currency depreciated sharply against the euro. However, since then the exchange rate has been relatively stable, and there is currently no reason to expect any major currency fluctuation. Overall, Poland enjoys solid investment grade ratings and the government can borrow at reasonably good rates on the financial markets. Yields have been decreasing due to strong foreign demand for Polish external debt and monetary loosening by the European Central Bank (ECB). Poland has robust economic fundamentals that should protect it in case of adverse investor sentiment.

# Slovakia

Main import sources (2014, % of total)	
Germany:	19.9 %
Czech Republic:	17.6 %
Austria:	9.7 %
Russia:	8.2 %
Hungary:	6.5 %

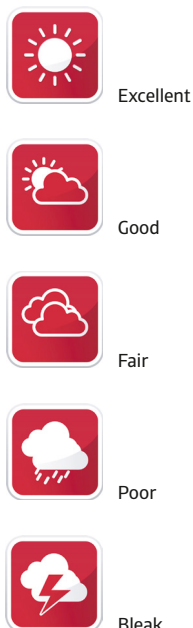
Main export markets (2014, % of total)	
Germany:	22.1 %
Czech Republic:	12.9 %
Poland:	8.4 %
Hungary:	6.3 %
Austria:	6.2 %
















Key indicators	2012	2013	2014	2015*	2016*
Real GDP (y-on-y, % change)	1.6	1.4	2.4	2.8	3.5
Consumer price (y-on-y, % change)	3.7	1.5	0.0	0.1	1.9
Real private consumption (y-on-y, % change)	-0.4	-0.8	2.2	2.6	2.8
Retail sales (y-on-y, % change)	-1.4	0.4	3.5	2.3	2.1
Industrial production (y-on-y, % change)	8.0	5.2	3.7	5.0	6.3
Unemployment rate (%)	14.0	14.2	13.2	11.7	10.9
Real fixed investment (y-on-y, % change)	-9.3	-2.6	5.7	4.0	4.3
Export of goods and non-factor services (y-on-y, % change)	9.3	5.2	4.6	4.9	5.3
Current account/GDP (%)	1.8	2.3	0.1	1.0	1.2
Fiscal balance (% of GDP)	-4.2	-2.6	-2.9	-2.4	-1.6

\* forecast Source: IHS

## Slovakia industries performance outlook

September 2015



Agriculture	Automotive/ Transport	Chemicals/ Pharma	Construction	Construction Materials
				
Consumer Durables	Electronics/ICT	Financial Services	Food	Machines/ Engineering
				
Metals	Paper	Services	Steel	Textiles
				

## Political situation

### Head of state:

President Andrej Kiska  
 (since June 2014)

### Head of government:

Prime Minister Robert Fico  
 (since April 2012)

### Population:

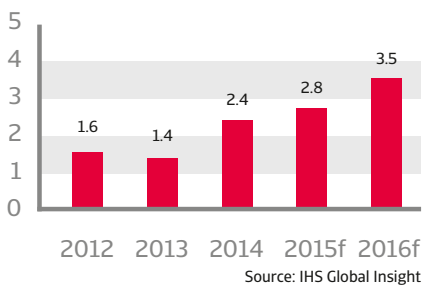
5.4 million

### Smer-SD party rules with absolute majority

Since April 2012 Slovakia is ruled by the social-democratic Smer-SD party, which gained 83 of the 150 seats in parliament in the March 2012 elections. Next general elections are due to be held in 2016.

## Economic situation

### Real GDP growth (y-on-y, % change)



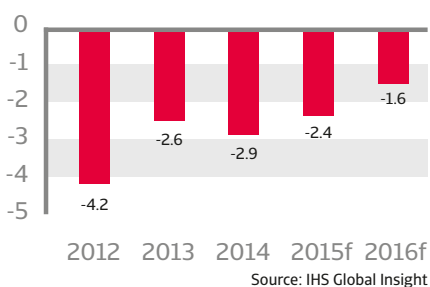
### Broad-based economic growth forecast in 2015 and 2016

The Slovakian economy grew 2.4 % in 2014, driven by consumer spending and business investment, government consumption and net exports. Growth is expected to accelerate further in 2015 and 2016, by 2.8 % and 3.5 % respectively, driven by continued robust domestic demand and increasing exports to the Eurozone. Private consumption is forecast to continue to be one of the primary drivers of the economic expansion.

The labour market shows strong improvement, with the unemployment rate expected to decrease from 14.2 % in 2013 to 11.7 % in 2015 and 10.9% in 2016, mainly due to improving domestic economic conditions. This jobless rate would then be on par with the Eurozone unemployment rate.

Slovakia's external economic position is solid. Exports and imports are well balanced and both growing. The current account surplus decreased to 0.1 % of GDP in 2014, but is expected to stabilise and remain positive in the coming years. At the same time the level of Slovakia's foreign debt is low.

### Fiscal balance (% of GDP)



Government finances are stable with the budget deficit being kept below 3 % of GDP since 2013. The budget deficit is expected to decrease to 2.4 % in 2015 and 1.6 % in 2016. Long term government bond yields have decreased rapidly over the past three years, reducing debt servicing costs for the government. Therefore the government debt level is expected to stabilise at 57 % of GDP in 2015, before starting to decrease in the coming years.

# Turkey

Main import sources (2014, % of total)	
Russia:	10.4 %
China:	10.3 %
Germany:	9.2 %
USA:	5.3 %
Italy:	5.0 %


























Main export markets (2014, % of total)	
Germany:	9.6 %
Iraq:	6.9 %
United Kingdom:	6.3 %
Italy:	4.5 %
France:	4.1 %

Key indicators	2012	2013	2014	2015*	2016*
Real GDP growth (y-on-y, % change)	2.1	4.2	2.9	3.0	3.3
Consumer price (y-on-y, % change)	8.9	7.5	8.9	7.5	6.6
Real private consumption (y-on-y, % change)	0.3	5.3	1.7	3.2	3.3
Real exports of goods & non-factor services (y-on-y, % change)	16.3	-0.2	6.8	1.9	4.9
Fiscal balance (% of GDP)	-1.7	-1.3	-1.5	-1.5	-1.9
Current account/GDP (%)	-6.2	-7.9	-5.7	-5.7	-5.2
Foreign debt/GDP (%)	48	51	54	61	64
Foreign debt/export of goods and services (%)	181	198	192	196	196
Short-term debt/international reserves (%)	103	117	122	130	135
International reserves (in months of merchandise imports)	5.1	5.3	5.4	5.4	5.1

\* forecast Sources: EIU, IHS, IMF

## Turkey industries performance outlook

September 2015

	Agriculture	Automotive/ Transport	Chemicals/ Pharma	Construction	Construction Materials
Excellent					
Good					
Fair					
Poor					
Bleak					
	Consumer Durables	Electronics/ICT	Financial Services	Food	Machines/ Engineering
	Metals	Paper	Services	Steel	Textiles

## Political situation

### Head of state:

President Recep Tayyip Erdogan  
(since August 2014)

### Head of government:

Prime Minister Ahmet Davutoğlu  
(since August 2014)

### Nature of regime:

Republican parliamentary democracy and secular state. The armed forces' political influence has been curbed.

### Population:

77.7 million

### June 2015 general elections result in a setback for the ruling AKP

The general elections in June 2015 delivered a setback for the religiously conservative Justice and Development Party (AKP), which reached 41 % of the vote, but lost its absolute majority. It also failed to reach a two-thirds majority in parliament: the threshold for constitutional amendments and changes. A change of the constitution would be necessary to increase the powers of the presidency, which is the aim of incumbent President Erdogan.

So far serious coalition talks between the AKP and other parties have not taken place, leaving the current administration in power as a caretaker government. Due to the political gridlock snap elections are due to be held in November 2015.

What some see as Erdogan pressing his own pro-Islamic ideology has increasingly annoyed a growing section of the population, especially in the cities. The protests sparked in Istanbul in the summer of 2013 were a reflection of this growing discontent and, while Erdogan prevailed in the first direct presidential elections held in August 2014, he gained just 52 % of the votes. Increasing actions to curb the independence of the judiciary and political interference in the media have raised domestic and international concerns.

### Heightened conflict in the region affects Turkish security

After the outbreak of the civil war in Syria Turkey has taken a clear anti-Assad stance and firmly supports the opposition forces. Since 2014, geopolitical risks have significantly increased due to the rapid gains of the jihadi group Islamic State (IS) in neighbouring Iraq (Turkey's second largest export market) and Syria. Consequently, the security situation has deteriorated in the south eastern part of the country due to a massive inflow of refugees from Syria and fighting close to the border. The ambivalence of Turkey to the US-led coalition against IS raised tensions with the US and the EU, as Turkey refused to support Kurdish anti-IS forces and to seriously stem the constant flow of IS recruits across its borders to Syria. This policy was motivated by the fear that the political and military clout of the Kurdistan Workers' Party (PKK) would increase as a consequence of the on-going conflict in Syria.

However, after an IS-led suicide bomb attack in a Turkish border town in July 2015 and due to the increasing security cooperation between the US and Kurdish forces, Ankara made a policy shift by actively participating in the international anti-IS alliance. Ankara has started air strikes against IS targets in Syria and permits the US Air Force to use a Turkish NATO-airfield for its sorties against IS. However, at the same time Turkish forces started to attack PKK targets in Northern Iraq, ending a two-year ceasefire and de facto terminating informal peace talks with the Kurdistan Workers' Party. This has already led to retaliatory attacks by the PKK on Turkish security forces.

The lack of a government with a stable majority in parliament, Turkey's direct involvement in the war against IS and the new escalation of the conflict with the PKK has increased political risks, and this could result in economic repercussions, e.g. by negatively influencing international investors' sentiment.

***Political risks have increased, which could result in economic repercussions.***



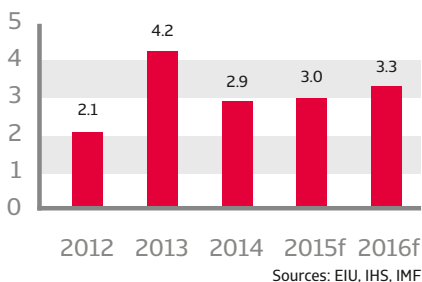
## Economic situation

### Structural weaknesses have re-emerged

In the last decade, Turkey has made impressive economic progress. With political stability since 2002, when the AKP came to power, the country has experienced GDP growth exceeding the European average, while real per capita income has increased markedly. A fast growing population of more than 75 million and rising prosperity have turned Turkey into one of the most prominent of emerging markets.

However, since 2013 Turkey's structural economic weaknesses have resurfaced: among them its stubbornly high inflation, large gross external financing needs, heavy reliance on volatile portfolio capital inflows and relatively weak international liquidity – coupled with increasing political risks. The Turkish currency depreciated sharply in 2013 when investors withdrew money from those emerging markets deemed most vulnerable to the eventual withdrawal of US monetary stimulus. As a result, Turkey faced widening current account deficits and a plunging currency. Since then Turkey has remained one of the most exposed emerging economies to a US Federal Reserve interest rate increase and to shifts in international investors' sentiment.

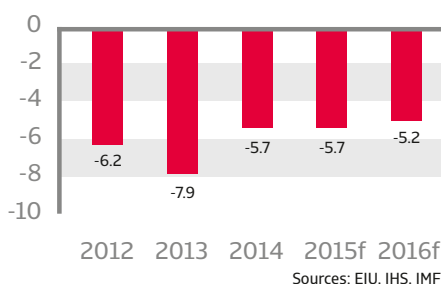
### Real GDP growth (y-on-y, % change)



### Slowdown of growth expected in 2015

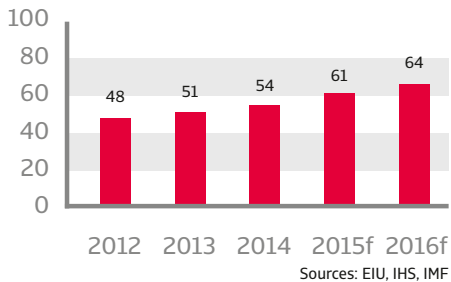
In 2014 the Turkish economy lost steam due to lower export growth as well as decreasing private consumption and investment, both constrained by higher lending rates and a depreciating currency that made imports more expensive. GDP growth slowed to 2.9 %, and is expected to increase at the same rate in 2015. Being a large oil importer, the Turkish economy should profit from lower oil prices, which should help to boost private demand, lower inflation and narrow its persistently large current account deficit - a result of a combination of low savings and high investment. But due to the strong Lira depreciation, inflation is expected to remain high in 2015, at around 7 %, while the current account deficit is expected to remain at the same level as in 2014 (5.7 % of GDP) and to decrease modestly to 5.2 % of GDP in 2016.

### Current account (% of GDP)



Increasing foreign debt and substantial capital imports (foreign direct investment and portfolio capital) are needed to cover the current account deficits. However, since much of those deficits is financed from volatile short-term portfolio investment, this makes the economy very vulnerable to any negative shake-ups in financial markets, which could trigger a massive capital withdrawal and could also lead to more fluctuations in the Lira exchange rate.

### Foreign debt (% of GDP)

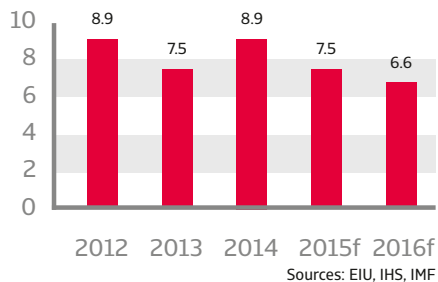


### Rising credit risk in the corporate sector

Credit risk in the corporate sector is rising, as Turkish businesses' foreign-currency borrowing is high and still increasing. According to the IMF, Turkey's total external financing needs amount to around USD 200 billion a year, while foreign debt of banks and the corporate sector increased from around 5 % of GDP in 2008 to 18 % of GDP in 2013. The on-going depreciation trend of the Turkish Lira makes such loans more expensive to service, and the expected increase in interest rates by the US Federal Reserve later this year is likely to drive investment away from emerging markets like Turkey.

That said, Turkey's solvency remains reasonable for the time being. Only a massive lira depreciation by about 30 % in real terms would seriously threaten Turkey's external debt sustainability, and this is not expected within the next 12 months.

### Consumer price (y-on-y, % change)



### Economic policy: increased concerns due to political pressure on the central bank

Turkey's public finances are sound, with small deficits of around 1.5 % - 2.0 % of GDP expected in 2015 and 2016. Public sector debt remains moderate at around 35 % of GDP.

However, there is growing concern about the direction of economic policy, mainly due to the Central Bank's decision to cut interest rates ahead of the June 2015 general election by a cumulative 75 basis points to 7.5%. This happened despite above-target inflation and on-going currency depreciation (another interest rate cut under similar circumstances took place in the run-up to the August 2014 presidential elections). This has raised doubts about the independence of the central bank, as the Turkish government had repeatedly voiced its desire for low borrowing costs to spur growth. It seems that the Central Bank has again bowed to political pressure.

The future earnings capacity of the Turkish economy is constrained by macro-economic imbalances related to high credit growth, high inflation and a large external deficit, coupled with structural issues related to its low savings rate and weaknesses in competitiveness, limiting FDI inflow.

The investment climate is also hampered by a weak judicial system and an inflexible labour market. Moves to privatise state banks and the power sector are also proceeding too slowly. Without structural reforms to raise savings, reduce dependency on energy imports and improve the investment climate, Turkey's potential growth rate will decrease to 3 % - 3.5 % per annum. However, no major structural reforms are expected in the current political situation.

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**Atradius N.V.**  
David Ricardostraat 1- 1066 JS Amsterdam  
Postbus 8982 - 1006 JD Amsterdam  
The Netherlands  
Phone: +31 20 553 9111  
[info@atradius.com](mailto:info@atradius.com)  
[www.atradius.com](http://www.atradius.com)