FT SPECIAL REPORT

Investing in Turkey

Tuesday November 29 2016

www.ft.com/reports | @ftreports

Inside

Cracks in a growth story start to show

The president is asking Turks to hand him more power in exchange for a bright economic future, writes *Mehul Srivastava*

Unrest: Business, especially in the Kurdish south-east (above), has been hit by a tumultuous year
Ilyas Akengin/AFP/Getty Images

Fund managers of the world, here is an interesting investment proposition: consider Turkey. Its president, Recep Tayyip Erdogan, wants to hold a referendum proposing to cut ties with its biggest trading partner, the EU.

He has sent troops into the quagmire of Syria's civil war and is itching to join a bigger fight in Mosul and Raqqa.

After a failed coup attempt in July, he has jailed his political opponents, shut down dozens of news outlets critical of his policies and isolated a large swath of his country in the Kurdish south-east, shutting off the internet for days and arresting local politicians.

He rules by decree, under a state of emergency, and has confiscated more than $10bn in assets in the past five months from the many companies run by people he considers disloyal, effectively making the Turkish state one of the nation's largest conglomerates. Foreign investment is down, the lira has fallen to record lows and the country's sovereign debt is rated junk by two out of the three major agencies.

So unnerving is the current state of affairs that a single, unsourced and probably false article in the pro-government newspaper, Sabah, caused a nosedive in shares of the listed units of the region's largest food manufacturer, Yildiz Holding. The newspaper hinted at links between an unnamed high-profile company and the exiled Islamic cleric Fethullah Gulen, whom the government accuses of orchestrating the coup attempt. The next day, traders drove down shares in Yildiz, the maker of Godiva and the UK's United Biscuits.

But all this chaos is temporary, say those who remain confident about Turkey's fundamental economic strength, and with growth of about 3 per cent this year, the argument is hard to dismiss.

The country's investment climate is "clouded, yes, that's the right word", says Ilhami Koc, chairman of the Turkish Capital Markets Association, an industry group. "Fundamentally, the promise of this country is still there, but it is clouded in the eyes of investors because of terrorism, and then this [attempted] coup."

Investor confidence will return, Mr Koc says. "If there is a good settlement in that region [Syria and Iraq], then this part of the world could be a centre of investment," he says.

That, in essence, is the promise Mr Erdogan is making to his nation: in a country rocked by instability, the solution is for the people to hand him more powers, to make him, constitutionally, the most powerful leader the country has known. If Turks assent quickly enough, via a referendum expected to take place by spring 2017, he promises to restore peace and stability to the nation, and with peace will come the return of long-term economic prosperity. New bridges will soar, he says. Railway tunnels will burrow, highways will criss-cross the country, investors will realise anew the potential of a young middle class and the malls will be full again.

> As one economic journalist tweeted last week: 'Resist the crisis, continue shopping'

As one economic journalist, Abdurrahman Dilipak, tweeted last week to his half-a-million followers: "Resist the crisis, continue shopping."

Continued on page 3

Ankara seeks to lift confidence after a turbulent year

Economy

Investors are betting on the fundamentals to deliver returns, writes *Jonathan Wheatley*

Nihat Zeybekci, minister of the economy — Orhan Cicek/Getty Images

On a recent trip to Britain, Nihat Zeybekci, Turkey's minister of the economy, was asked what he thought of the UK turning its back on the EU through its June 23 referendum to leave the bloc.

"I don't see it that way," Mr Zeybekci replied. "I think you could rather say that the EU failed to retain the UK as a member. From the EU point of view, of course, it is a loss, but are we concerned? No, on the contrary. We see it as an opportunity."

Some might say the minister's words showed an advanced ability to look on the bright side. Turkish officials are already working on a "new generation" free-trade agreement with the UK to be concluded simultaneously with Britain's departure from the EU. It would be "one of the most comprehensive" trade deals Turkey has signed.

Others might argue his response was typical of a country where events that would bring other economies to a standstill can apparently be shrugged off.

This year alone Turkey has suffered at least three serious terrorist attacks, a change of prime ministers, spats with Germany and the EU, a failed coup, the closure of dozens of media outlets, the seizure of hundreds of private companies, arrests of opposition politicians and the continuing spillover from conflicts across its borders.

"It is natural for people to ask questions about these things," says Mahmut Unlu, chairman and chief executive of Unlu & Co, a financial advisory firm. "But throughout the whole geopolitical situation, the government has been committed to business. Turkey's macro fundamentals have not been affected. Everything else maybe, but not the macro."

Turkey's economy has consistently grown at 6, 7 or 8 per cent a year for much of the past two decades. Even with slower growth of about 3 per cent this year, it is one of the few middle-income economies in the world showing that kind of performance. While its monetary policies have often mystified and infuriated analysts and investors, the government's fiscal discipline has been beyond reproach: its budget deficit, averaging about 1.5 per cent of GDP for the past six years, would be the envy of most western European countries.

Investors continue to be attracted by Turkey's demographic advantage: 80m people, with an average age of 29 and an apparently unstoppable propensity to consume.

This alone, for many, is good reason to look beyond the political turmoil. "From a business perspective, it is part of the country's DNA to be a bit unpredictable sometimes," says Roberto Pedretti, chief executive for central and eastern Europe and Turkey at Nielsen, the consumer research company. "The beauty of this country is that if you look at it in the long run, rather than quarter by quarter, the result is always good."

It may not be what investors are used to, Mr Pedretti says, but that is only to be expected. "Turkey has a velocity that we do not see in many European countries," he says. "Poland is definitely a more stable and less risky environment than Turkey, but the growth opportunities in Turkey are greater."

> 'The beauty of this country is if you look at the long run, the result is always good'

As investors know only too well, however, past performance is no guide to future returns. Many are wondering whether, this time, the uncertainty will cause more lasting damage.

Atilla Yesilada, co-founder of Istanbul Analytics, a consultancy, says foreign executives are increasingly nervous. He was called to one western embassy recently to answer questions from potential investors.

"The most frequent question was, 'How do we know the government won't attack our assets?'" he says.

"I think that is an undue concern, but with more than 500 companies taken over without due process, people wonder. A country at our stage of development needs a good judiciary and good standards of governance and they are not providing that."

The problem, in Mr Yesilada's view, is not that the government does not grasp the importance of business. With no oil and few other natural resources beyond tourism — an industry that has been hit by terrorist attacks — the economy depends on investment for growth.

Mr Unlu insists that investors have not been put off. He says that anecdotal evidence suggests foreign direct investment has picked up over the past month or two. "There was a three or four-month hiatus and that will lead to a fall in FDI this year," he says. "But there will be no lasting fall in investment."

The government has been alive to the risks of post-coup turmoil, moving quickly after the attempt to pump liquidity into the banking system and draw up and send to parliament a series of pro-business reforms.

"The government is trying to instil confidence in investors and they are very diligent . . . meeting companies at home and abroad and passing new legislation on a daily basis," Mr Yesilada says.

"But they don't understand there is no political certainty. They think what they are doing is good for the people and for security and they don't understand why it isn't attracting investment."

Investors are still betting on progress in the long term

Private equity Favourable demographics suggest a rosier future is possible, reports *Jonathan Wheatley*

Measured by fundraising and investment, Turkey has pretty much fallen off the private equity map in 2016.

According to the Emerging Markets Private Equity Association (EMPEA), no new PE investment funds were raised in Turkey in the first half of the year and just $3m was invested in four deals. That compares with $104m invested in 19 deals last year and a recent peak of $569m in 28 deals in 2011.

Anthony Stalker, partner and chief investment officer at ADM Capital Europe, admits that investment has been slowing and fundraising has been difficult. Investors, he says, have been put off by the violent and destabilising events that have dominated headlines in Turkey and Europe. With elections looming in France and Germany, where regional migration is set to be a big issue, news coverage casting Turkey in a poor light is unlikely to improve.

"The geopolitical news couldn't have been much worse and the headlines are not going to get any better," Mr Stalker says. "That puts people off." The fact that the lira has lost about 45 per cent of its value against the dollar since 2012 only adds to investors' fears, he says.

But, Mr Stalker says, PE investors should focus on the opportunities driven by Turkey's long-term growth story rather than the recent turbulence.

"We have been in Turkey since 2005 and there has been dramatic change, especially in the small to mid-cap sector," he says. "This is a thriving business community that offers real growth."

As well as having a young population and strong domestic demand, Turkey is emerging as a genuine manufacturing base for Europe, he says. He cites ADM Capital Europe's investment in Cevher Dokum, a maker of aluminium castings for the automotive industry.

ADM and its partner had been due to sell their stake to Nemak, a Mexican auto parts maker, on July 17 — two days after the coup attempt. "All parties, wisely, decided to step back and see how things played out," he says. Five weeks later, the parties agreed to go ahead. The deal was completed this month.

"This is a classic case of a company taking a long-term strategic view and it illustrates my main point," says Mr Stalker. "To invest in Turkey, you need to take a view that, over the next five to 10 years, very favourable demographics will continue to support positive growth in domestic demand as well as building a manufacturing hub for Europe."

Selcuk Yorgancioglu, a partner in Istanbul at the Abraaj Group, an emerging market PE firm, goes further, saying business in Turkey goes on almost unaffected by geopolitical turmoil.

He says Abraaj closed its latest investment fund, having raised $526m, one week after July's coup attempt (and therefore outside EMPEA's figures for the first half).

It has made two investments out of the fund in the past two years — a 25 per cent stake in ecommerce company Hepsiburada and a 10 per cent stake in Fibabanka, a bank. Abraaj now plans to make five more investments with the more than $300m remaining.

'The issue is confidence. If we can find something that will lift all these dark clouds, we will have a chance'

Short view: currency exchange boards in Istanbul — Chris McGrath/Getty Images

All Abraaj's previous investments in Turkey, from 2008 onwards, were sold by 2013. "Good businesses can be exited at all times," Mr Yorgancioglu says. "But right now we have nothing to sell. That's not a question of luck but of prudence."

Meanwhile, he says, Abraaj's investments are beating expectations. Hepsiburada's revenues, he says, will grow by 110 per cent in lira terms this year — "whatever the depreciation, [that is] still big growth in dollar terms".

But not everyone is as positive. Ozgur Altug, economist at BGC Partners in Istanbul, says some private equity deals are still going through, as Turkey's economic slowdown leads some businesses to look for buyers.

Sellers of business assets in Turkey do not often drop their prices at times of difficulty, he says, but they may now find they need cash, or a partner, to see them through difficult times.

"The opportunities for private equity are there," he says. "People see the slowdown and say, 'That's my opportunity.'"

Despite the upbeat tone from PE investors, there is no escaping the EMPEA numbers and their clear portrayal of an investment environment that, isolated examples apart, is at a near standstill.

For the economy as a whole, private sector investment declined by 1.2 per cent in the first half of this year, according to the central bank, after growing at double digit rates for much of the past 20 years.

Public sector investment is still growing quickly — at 4.5 per cent in the first half — but that is not enough to offset the slowdown in the private sector.

"The issue is confidence," says Mr Altug. "If we can find something that will lift all these dark clouds hanging over Turkey we will have a chance. But the headlines every day, about the presidential system, the death penalty, the cross-border situation, the purges, the arrests — all this affects people's willingness to invest."

FDI
Investment falters as tensions mount

Turkey's appeal as a destination for foreign direct investment has been put to the test in recent months by a host of geopolitical challenges, security threats and internal tensions.

This summer's failed coup attempt and subsequent crackdown against the perceived enemies of President Recep Tayyip Erdogan has only added to a mounting sense of instability.

The country's temptingly large domestic market, low costs and convenient location straddling Europe and Asia, have made it historically attractive to foreign investors. It has won more than $232bn in total FDI since 2003, compared with $68bn for the whole of neighbouring south-east Europe, according to data from Unctad, the UN's trade and development arm.

But headline inflows to Turkey have ebbed in the first nine months of 2016, according to Turkey's central bank, which reported $7.1bn between January and September this year, compared with $13.3bn over the same period in 2015.

This decline, though steep, is not unique to Turkey. Unctad expects a 15 to 20 per cent global decline in FDI in 2016. "We do not expect any repercussions in Turkey's FDI flow [as a result of the coup]," says Ismail Ersahin, deputy executive director of the Istanbul-based World Association of Investment Promotion Agencies (WAIPA). "Quite the opposite. We expect FDI figures to gain momentum in the last quarter of 2016."

Deputy Prime Minister Mehmet Simsek expressed a sanguine view at a WAIPA event in Istanbul in October: "Headline-wise, clearly the news story remains a mixed picture to negative," he said. "Of course there will be economic fallout, and that is already reflected in our medium-term economic forecasts. [But the fallout] is likely to be limited and shortlived."

Multinational companies making greenfield investments — classified as on-the-ground investments involving the creation of a physical facility with new local headcount in a foreign country, or the significant expansion of existing facilities — have shown some patience with Turkey's troubles.

After a dip in 2014, the number of greenfield projects announced or launched in Turkey and the total

Deputy PM Mehmet Simsek

estimated capital investment in those projects rebounded in 2015, according to fDi Markets, an FT data service. There were 157 greenfield projects in 2015 totalling $6.1bn, compared with 108 worth $5.6bn in 2014.

As of the end of October, fDi Markets has tracked 89 projects worth $3.6bn that have been announced or launched this year. Seventeen of those announcements came after July's coup attempt and among them was the US-based food and beverage giant PepsiCo, which last month announced plans to open a new $120m food production facility in the eastern city of Manisa, employing 350 people initially and more than 500 by 2022.

Henry Loewendahl, the Turkey-based chief executive of FDI consultancy Wavteq, expects that foreign investment related to the tourism and real estate sectors in Turkey will continue to fall until long-term security has been restored.

The continuation of Turkey's EU integration process is another important precondition. Many companies use Turkey as an export platform for the EU, taking advantage of its customs union with the bloc.

The non-binding vote by the European Parliament last week, calling for the freeze of accession talks, has put that process under threat.

"The vote will increase the political risk premium of investing," Mr Loewendahl says. "Given Turkey is such an important market for EU business, we don't see significant risks to the customs union, but if accession negotiations are formally frozen, export-oriented FDI may shift to central and eastern Europe and other countries like Morocco."

Courtney Fingar

Bankers fret as Erdogan increases pressure to keep voters spending

Banks

The president is lambasting lenders for sitting on capital, write *Mehul Srivastava* and *Jonathan Wheatley*

Turkey's economy is youthful, growing, modern and diverse. But above all, it survives on leverage, engorged with the foreign debt that flows through its corporate sector.

By contrast, Turkey's banks are less exposed to dollar debt: only 15 per cent of their funding comes from borrowing, from local and foreign banks. A healthy 53 per cent comes from customer deposits according to the banking regulator, compared with an average for European banks of 45 per cent, according to the European Central Bank.

But this does not mean Turkish banks are immune from the country's economic downturn. Analysts say non-performing loans, officially at 3.3 per cent, are, in reality, probably running at 6 per cent or higher and they report significant political pressure on banks not to foreclose on non-paying customers.

In private conversations, Turkish bankers fret. At a time when they should be reining in lending, they are lambasted by President Recep Tayyip Erdogan for betraying the country by sitting on capital. When they should be protecting their bottom lines, they are being forced to drop lending rates to keep the voters spending. When the lira has proved to be the economy's biggest weakness, the government has put pressure on the central bank not to tighten policy to protect the currency.

"We are looking at a tough year," says one senior banker, who did not want to be named. "If we're not careful, we're looking at a hard landing."

Bankers talk of corporate customers struggling to find collateral, with the chairman of one medium-sized company allegedly offering the deeds of a summer house in France, and another offering cash recently brought back to Turkey under a tax amnesty.

"It is alarming how deep into their pockets they have to search to keep loans alive," one banker said.

The banks' disclosed figures may show a measure of strength against a barrage of domestic and external challenges. But the question is, how real is that strength, and how long can it last?

Serra Akcaoglu, chief executive of Citibank in Turkey and chair of Amcham Turkey, the US chamber of commerce, says it was the consolidation of the sector in the early 2000s — from which emerged about 50 banks with strong financials — that has given the economy its resilience. But this year's turmoil has put that resilience to a severe test and cracks are beginning to show in the sector's confidence.

The latest edition of a quarterly survey by the central bank, for example, points to a tightening of credit conditions among banks lending to the corporate sector. The same survey found that demand for loans among consumers, while holding in some sectors, has collapsed or turned out to be much weaker than banks expected in others.

53% Turkish banks' funding from customer deposits

45% European banks' funding from customer deposits

Consumer demand is falling

Separate monthly data from the central bank show the annual rate of credit expansion to the private sector falling sharply this year, from nearly 20 per cent at the end of 2015, to just 8 per cent in September.

Burcu Unuvar, of the department of economics at Ankara's Bilkent University, says the data highlight a structural weakness in Turkey's economy: its lack of savings. The country's saving rate, at the equivalent of just 16 per cent of GDP, is low by international standards. That means Turkish households and companies must borrow — either from lenders at home or abroad — to consume and invest. "The level of debt is not the problem," she says. "The issue is the lack of savings. You can't bet forever on people's willingness to borrow and spend."

With economic growth slowing this year, Ms Unuvar says, people fear losing their jobs and do not want to get further into debt. Falling demand for credit, she says, combined with a reluctance on the part of banks to lend, has created a dangerous mix. "We have lost the engine of growth," she says.

Yet banks now face new demands for funding from an unexpected source.

On November 21, the government began auctioning some 600 companies seized from those accused of helping to fund Fethullah Gulen, the exiled cleric whom Mr Erdogan blames for an attempted coup in July. Lining up to buy those assets — valued at about $10bn — are relatively small companies, their major qualification being loyalty to Mr Erdogan. They, too, will hope for favourable treatment from Turkey's banks.

A strong banking system alone cannot secure financial stability

COMMENT

Inan Demir

Investors have good reason to be concerned about aspects of the Turkish economy these days.

The list of domestic challenges is long: political tensions are running high at home and internationally, while the current account deficit is widening again — despite a sharp slowdown in economic activity that may, in the third quarter of 2016, lead to the first negative GDP growth figures in seven years.

With a large external financing requirement and dollar-dominated external debt structure, Turkey is particularly vulnerable to the higher US yields and stronger dollar expected under a Trump presidency.

These global and domestic challenges have all taken their toll on the Turkish markets, with the currency bearing the brunt of the pressure. The lira has depreciated by around 15 per cent against the dollar since the beginning of the year making it the third worst-performing emerging market currency after the Mexican and Argentine pesos.

But the fact that Turkey is not performing even worse than it is right now is thanks to two factors.

First, the government's fiscal stance has been conservative. As a result of continuing fiscal discipline, the public debt-to-GDP ratio has fallen almost continuously since Turkey's 2001 economic crisis. It now stands at just 33 per cent, nearly half the 60 per cent upper limit mandated by the Maastricht treaty for EU member states. Even with the predicted loosening of fiscal policy in 2017, the budget deficit is expected to widen to only around 2 per cent of GDP, according to the government's medium-term program projections.

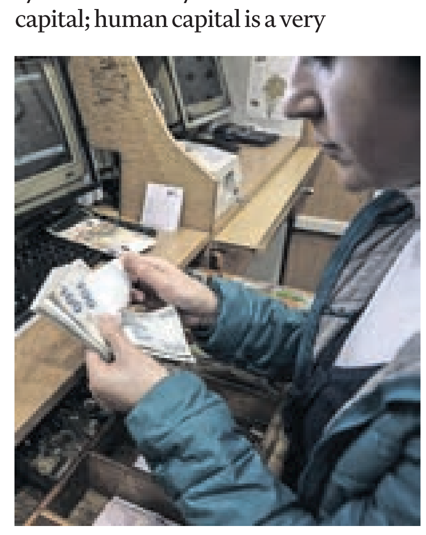
The second factor has been the strength of the Turkish banking system. This was not always the case: during the 2001 crisis, the banks were the weak link that propagated shocks across the economy. But Turkish bankers have taken the lessons from that crisis to heart. Gone are the days of large short-FX positions and the business model of relying on wholesale funding from abroad to lend to the government. In fact, Turkish banks' net FX exposure as of September this year is practically zero.

Instead, Turkish banks now engage in the very traditional practice of collecting deposits and lending to companies and households, staying away from fancy but risky products. They have been doing a good job of managing asset quality: the non-performing loans ratio of the banking system stands at 3.3 per cent — Italy's ratio is 17.5 per cent, according to IMF financial soundness indicators.

'Banks do not operate in a vacuum. Their access to foreign capital is affected by perceptions of Turkey'

Turkish banks also have ample protection against a deterioration in asset quality; the capital adequacy ratio is 16 per cent — double the minimum set by the Basel Accord — implying that the banks retain substantial buffers to absorb shocks.

But the strength of the banking system is not only about financial capital; human capital is a very important part of the story.



The lira fell to historic lows last week

According to the Turkish banks' association, 85 per cent of people working in banks have university or postgraduate degrees. Not only that, but, in a country where only 26 per cent of non-farm workers are women, the banking sector has a female employee ratio of 51 per cent.

This well-capitalised system is now an important pillar underpinning the stability of the wider economy. But banks do not operate in a vacuum and their access to foreign capital is very much affected by the rest of the world's perception of Turkey.

They now face specific pressures: a government push to accelerate credit growth via lower loan rates could erode net interest margins. This could hinder capital generation and future loan growth — precisely the opposite of what Ankara is trying to achieve.

Although banks may not be running short foreign currency positions themselves, their clients are, and the banks are therefore indirectly exposed to the FX risk. The short foreign currency position that the corporate sector runs has so far not led to significant asset quality problems for the banks. But this is no guarantee that quality will remain unaffected if the depreciation continues.

Even though the banks' capital cushions are strong, the stabilisation of the currency would be a welcome relief from future asset quality concerns. But that would require Mr Erdogan's government to change its stance on interest rate hikes.

The Turkish banking system may be strong, but its strength is not sufficient to safeguard overall macroeconomic stability. Banks will do what they can to support economic activity, but they will also need all the support that they can get from the government to ensure their margins are not unduly eroded and the financial health of their clients is not compromised by the continuous depreciation of the currency.

If the banking system cannot get that support, this bright spot will fade too.

The writer is senior emerging markets economist covering Turkey at Nomura

Security fears stifle businesses in the south-east

Insurgency The collapse of President Erdogan's Kurdish peace process has put investors off an unstable region, reports *Laura Pitel*

Life has begun to creep back into Sur district, the ancient heart of the city of Diyarbakir in Kurdish-majority south-east Turkey. Throughout last winter its basalt walls echoed with the sound of gunfire as state security forces battled youths linked to the Kurdistan Workers' party (PKK), a militia fighting for greater autonomy and more rights for Turkish Kurds. In March this year, the violence abated and curfews began to be lifted street by street.

Now, some shops have raised their shutters. Cafés in the striped stone market square of Hasan Pasa Han are serving breakfast again. Street vendors have resumed trundling their wooden carts piled with walnuts and powdered oblongs of Turkish delight.

But the end of the recent clashes — the latest in an insurgency that has been fought on and off in the region since 1984 — has not dissipated the gloom hanging over Diyarbakir's business community. Fighting continues in the mountains near the border with Iraq and police and military targets in cities are being struck by retaliatory bombings by the PKK.

Alican Ebedinoglu, head of Diyarbakir's Union of Traders and Artisans, says that before the collapse in July 2015 of a two-year ceasefire there was a sense of optimism and momentum in Diyarbakir province. "But it all went downhill," he says. "Now we are experiencing the worst economic period in Diyarbakir."

The south-eastern region has long been the country's poorest. Education levels here are lower than the national average and the economy is dominated by agriculture. In the 1990s, hundreds of thousands of south-eastern Kurds fled to urban centres after being forced from their villages — many as part of a state effort to cut off support for the PKK, who are deemed a terrorist organisation by Turkey, the EU and the US. Millions more left in search of opportunities in western Turkey or Europe.

"As far back as I can remember incentives [have been needed] to get businesses to go to the south-east, and mandatory service to get public servants to work there," says Nigar Goksel, Turkey director of the International Crisis Group. "The region hasn't benefited from the economic momentum of the country, proportionately."

This lack of economic opportunity is one of many factors that have fuelled local sympathy for the PKK. For decades, bouts of violence have deterred both foreign and Turkish investors and

'After the ceasefire ended, it was all downhill. Now we are experiencing the worst economic period'

damped the region's growth prospects.

After coming to power in 2002, President Recep Tayyip Erdogan's Justice and Development party (AKP) gave greater recognition to the nation's estimated 16m Kurds and, in 2013, reached an unprecedented ceasefire with the PKK. The AKP government channelled money to the region, improving transport infrastructure, energy production and health services.

But while the south-east has subsequently grown in prosperity, it still lags behind the rest of the country: GDP per capita for Diyarbakir province and neighbouring Sanliurfa province grew by about 80 per cent between 2004 and 2011 (the latest figures available) to around $4,000, according to the Turkish Statistical Institute. Over the same period, the countrywide average rose from around $5,000 to $9,000.

The government blames the PKK, arguing the group has deliberately thwarted state investment projects by destroying machinery and threatening companies that invest in the south-east. Ankara's opponents accuse it of a half-hearted commitment and of focusing its money on building defence infrastructure, rather than on projects to create and sustain jobs.

In recent years, growth has been undermined by wars in neighbouring Syria and Iraq, two of the most important export destinations for the Turkish provinces that border those countries.

After the collapse of the ceasefire last

Left behind: Life is beginning to creep back into Diyarbakir after months of violence
Ilyas Akengin/AFP/Getty Images

summer, fighting erupted in south-eastern city centres for the first time, where rearmed PKK-linked youths declared "autonomous zones". The violence displaced an estimated 350,000 civilians.

Mr Ebedinoglu says that 1,000 businesses have closed in the Sur district of Diyarbakir since last summer and 5,000 people have lost their jobs. Four out of five hotel beds are empty, he says, and businesses fighting to stay afloat are struggling to obtain credit.

Since July's thwarted coup attempt, the government has sacked thousands of Kurdish teachers, closed media outlets and detained MPs from the largest Kurdish opposition party, accusing them of supporting the PKK. Internet services were shut down in a bid to stifle protests, hitting local business.

Meanwhile, Ankara says the state and the private sectors will plough 10bn lira (around $3bn) into rebuilding and reviving the city of Diyarbakir and other south-eastern cities devastated by the fighting. Early this year, then prime minister Ahmet Davutoglu announced a plan to reconstruct Sur like the Spanish city of Toledo. "Everyone will want to come and appreciate its architectural texture," he said.

But the reconstruction plan — which involves bulldozing areas untouched by the fighting — is controversial. Locals fear being forced from their homes into the suburbs, in what they see as an attempt at demographic engineering to weaken PKK support. The government denies this, but the lack of clarity is hampering those trying to get back on their feet.

Cahit Pekkolay, a local businessman, owns a portfolio of commercial property that now stands empty. "There is a lot of uncertainty," he says.

Ugras Ulku, senior economist at the Institute of International Finance in Washington, says that, in the long term, the region's economy needs to shift towards services and manufacturing. But he is not optimistic. "Such a shift could only be possible if more investment could be channelled to develop the essential physical infrastructure in the south-east," he says. "That requires a substantial improvement in the security situation in the region."

Cracks in a growth story start to show

Continued from page 1

His tone might have been tongue in cheek, but it was not a bad argument, said a senior London-based financier on a recent trip to Istanbul. Investors did not care if Mr Erdogan was autocratic, majoritarian or even if he eventually became a dictator, he said. What they did care about was stability.

"What you're seeing right now is a period of chaotic transition," he said, asking to remain anonymous. "Pushing, pulling, advancing, retreating — my clients don't like that. They want [to say], 'Be done with all this, and give us a call when you have become what you want to become'."

The transformation has been messy. After the failed coup attempt, Mr Erdogan assumed emergency powers within a week, granting him unquestioned authority, in a rehearsal of the role he is seeking permanently.

In theory, with an incapacitated constitutional court (following the dismissal of two of its members), hardly any independent media to criticise him and few opposition leaders brave enough to challenge him, Mr Erdogan's transition to an executive presidency ought to have been smooth.

Instead, while he began preparing the country for the referendum, the president had other battles to fight: the removal of the Kurdish politicians he accuses of fronting for terrorists, the exile, firing and imprisonment of those suspected of loyalty to Mr Gulen and the taming and seduction of a nationalist opposition leadership, whose support he needs for the referendum to secure parliamentary approval.

These moves have resulted in global concern that has driven the lira lower than at any time in its history.

In addition, Mr Erdogan is acting just as the world starts to prepare for the end of the seemingly limitless liquidity that has propped up emerging markets for years.

After Donald Trump's victory in the US presidential election, given the long-anticipated prospect of a US interest rate rise, the Turkish lira appeared among the least safe assets they could hold. Instead, foreign investors have sought the safety of the yen and gold.

The retreat of that global flood of money has exposed in Turkey what economists Barry Eichengreen and Ricardo Hausmann have called an "original sin", or the tendency of countries to borrow from abroad what they cannot get at home.

For Turkey, the penance could be particularly grim. In S&P Global's Original Sin Index, which calculates the degree to which 15 of the world's largest emerging economies finance their public and private sectors in domestic currency, Turkey lies near the bottom, above only Indonesia, Hungary and Argentina.

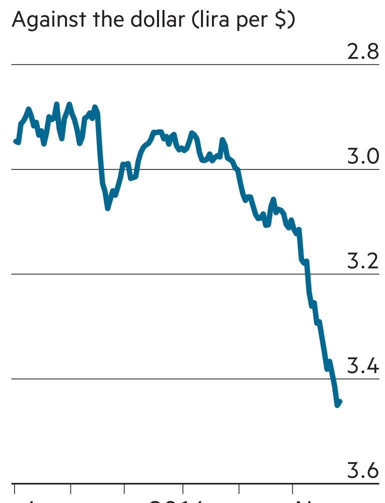
One saving grace is deeply liquid foreign currency spot markets. Oddly

'Now we are seeing pushing, pulling, advancing, retreating — my clients don't like that'

enough, in a country where a scarcity of dollars could one day tip over into a balance of payments crisis, ATMs in Turkey will pay out dollar bills and banks offer accounts in dollars, euros and other foreign currencies, turning citizens into amateur currency day traders, trying to outrun the lira's decline.

Turkey is certainly alone among emerging markets in granting its citizens such unrestricted access to foreign currency. In the days after the coup

Turkish lira
Against the dollar (lira per $)



Source: Thomson Reuters Datastream

attempt, as the lira sank to what were then historic lows, Turks sold $12bn of their holdings to buy local currency, arresting the lira's slide temporarily.

The lira has continued to fall since then, exposing companies to the dangers of their dollar-denominated loans.

JPMorgan Chase thinks the rout is not over yet. Its analysts forecast that as Mr Erdogan pursues his executive presidency — and as Turkey's structural flaws are increasingly exposed in a less liquid global environment — the lira could fall to 3.50 per dollar before the year's end and 3.65 by the end of 2017.

Mr Erdogan is well aware of this. Last Wednesday, he presided over a meeting of the economic co-ordination board, in place of his handpicked prime minister, and, on a day the lira continued its slide, lambasted the central bank for not taking real interest rates to zero.

The following day, the central bank defied him, raising its benchmark rate for the first time since 2014. The relief for the lira was temporary: after the European Parliament voted to suspend Turkey's membership talks the same day, the currency fell to a fresh low.

This is the pattern investors can expect to keep seeing in Turkey: a contest between one of the weakest of currencies and the strongest of leaders.

Contributors

Mehul Srivastava
Turkey correspondent

Jonathan Wheatley
Emerging markets writer

Laura Pitel
Freelance journalist

Courtney Fingar
Head of content, fDi Intelligence

Cordelia Jenkins
Commissioning editor

Steven Bird
Designer

Michael Crabtree
Picture editor

All FT Reports are available at: ft.com/reports

Follow us on Twitter at: @ftreports

For advertising details, contact:
Ekin Ilyasoglu , +90 212 273 1027
ekinilyasoglu@logaritma.com.tr or your usual FT representative.

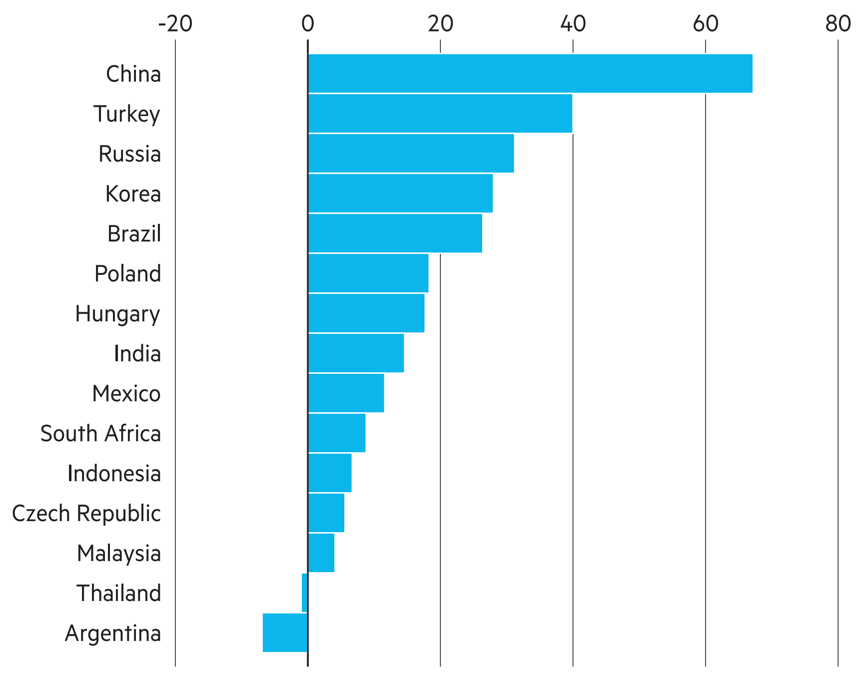
All editorial content in this supplement is produced by the FT. Our advertisers have no influence over or prior sight of the articles or online material.

Companies loaded with foreign debt fear rate rises

Debt High levels of borrowing are unsustainable, write *Jonathan Wheatley* and *Mehul Srivastava*

Turkey's corporate debt bulge: second only to China's

Percentage point change in non-financial sector corporate debt to GDP (2005-2015)



Source: Institute of International Finance

When Donald Trump won the US presidency, investors immediately expressed their views of what the impact might be on Turkey: the lira plunged, losing 7 per cent of its value against the dollar in the space of 10 days.

What spooked investors most was not the threat of protectionism that has roiled other emerging markets, but the effect an expected rise in US interest rates, under a Trump presidency, will have on a country that is so heavily dependent on foreign finance.

At the heart of the problem is corporate debt. Over the past decade, Turkish companies have run up foreign currency debt at a pace second only to that of their peers in China.

According to Turkey's central bank, Turkish companies had foreign currency liabilities of about $210bn at the end of September, the latest month for which data are available. "The problem is, it keeps getting worse," says Atilla Yesilada of Istanbul Analytics, a consultancy. "They are stuck on a treadmill."

The "rollover ratio" for Turkey's corporate sector was more than 160 per cent in the first nine months of this year, according to central bank data. In other words, for every $100 due, companies borrowed those $100 again and added another $60. "They don't have a choice. If they don't keep borrowing they will go into bankruptcy," says Mr Yesilada.

It is easy to see how tightening global credit conditions could quickly become catastrophic for companies in that position. But two factors suggest that a crisis can be avoided, at least for a while.

One is that the net foreign exchange liabilities recorded by the central bank may be overstated. Ozgur Altug, chief economist at BGC Partners in Istanbul, estimates that Turkish companies have about $150bn salted away overseas in undeclared deposits and have been bringing some of this back into the country. Such transfers would show up as borrowing from overseas — perhaps accounting for about 20 per cent of the new debt, Mr Altug suggests.

The other mitigating factor is that the share of foreign debts maturing in 12 months or less is close to zero — at just $5m in September, according to the central bank. Many banks, though, are known to date loans at just a few days over a year to avoid the short-term label, so this may be largely a false assurance. However the debt is measured, says Mr Altug, this "doesn't mean [currency weakness] won't hit their income statements. There will definitely be an impact."

The difficulty for investors is to gauge the damage likely to be caused by currency weakness and falling corporate earnings and when, or indeed if, it will become critical.

The challenge for Turkish companies is how to generate enough foreign currency to meet their repayments. There are three ways of doing that: as exporters, as members of the tourism industry, or as participants in the domestic economy who can make enough lira to buy the foreign exchange they need.

All three sources of income are under stress. Exports, which were growing at 10 to 15 per cent a year for most of this century, have collapsed over the past two years. Exporters also face an additional currency mismatch: about 60 per cent of their foreign debts are denominated in dollars, while the dollar share of export receipts is only 40 per cent, according to Inan Demir of Nomura.

"In the Trumpflation world, Turkey will be in the unenviable position of generating export revenues in other currencies and trying to service dollar-denominated debt," he says.

Revenues from tourism have also collapsed. As Moody's Investors Service noted when it downgraded the country to junk in September, income from tourism fell by nearly 30 per cent in the first half of this year from a year earlier, largely as a result of terrorist attacks and of sanctions imposed by Russia last year after Turkey shot down a Russian military jet.

Moody's noted: "While the removal of Russian sanctions is likely to provide some support to the [tourism] sector, full normalisation will be delayed as long as political and security risks remain elevated."

As for those indebted companies relying on the domestic market, growth is not running quickly enough. The economy will grow by about 3 per cent this year, far short of the rates Turkey has achieved this century and of the growth needed to meet foreign obligations.

Some analysts warn that the money borrowed overseas by Turkish companies has not been put to the best use. Had enough of it gone into investment to boost productivity, things would be different. But too much, critics say, has gone into Turkey's money markets, where interest rates are much higher than the rates borrowers pay on overseas markets.

Michael Harris, an analyst at Renaissance Capital, says most companies should be able to adjust to rising financing costs by raising prices or cutting costs, for instance, in headcount.

But there are limits: "If the lira keeps weakening, the recessionary cost cuts will intensify, giving more reason to worry," he says.

Watch the risk, not the fundamentals

Portfolio investment

Experienced investors are proving hard to scare, reports *Jonathan Wheatley*

Businesses investing in Turkey's real economy often say that the trick is to look past the turmoil of geopolitics and focus on the potential of the country's young, consumption-driven market.

But investors in the stock market seem to say the opposite: never mind the fundamentals, watch the political risk, is the apparent message.

Despite a steady and impressive rise in earnings per share (in contrast to an almost mirror-image fall in EPS for emerging markets as a whole over the past five years) Turkish stocks have consistently underperformed their peers. They currently trade at a 35 per cent discount to the benchmark MSCI Emerging Market equities index.

"Turkey is probably the emerging market with the highest rate of earnings growth and yet the market is derating [falling in price]," says Emre Akcakmak, portfolio adviser at East Capital, an emerging and frontier market asset manager. "This tells us a lot. There is a lot of political risk premium."

East Capital is a long-term investor in Turkish equities and Mr Akcakmak has been looking for bargains in the aftermath of July's failed coup attempt. Valuations were already so low they did not have much further to fall and buying opportunities have been limited.

The fact that prices did not fall further after the coup attempt underlines the resilience of asset prices to shocks. This supports the view that most foreign investors in Turkish portfolio assets are experienced Turkey hands who have been watching the market for years and are hard to scare.

In spite of the turbulent events of this year, foreign investors have shown some appetite for Turkish risk. Central bank data show $4.3bn flowing into Turkish portfolio assets this year, with $1.6bn going to equities and $2.7bn to debt securities. This compares with combined inflows of less than $1.6bn for the whole of 2015.

Serra Akcaoglu, chief executive of Citibank in Turkey, says this is evidence of confidence in the market. "Turkey does give positive interest rates," she says.

But others say foreign investors have been driven to Turkey, and its fellow emerging markets, by the dearth of returns available elsewhere.

"The starting point has to be global liquidity conditions," says Inan Demir of Nomura in London. "If global conditions weaken, Turkey underperforms in both absolute and relative terms."

Indeed, as asset managers piled into safer assets — loading up on the yen and gold — they sold nearly $1bn in Turkish securities in the week of the US election, according to the central bank.

Years of loose monetary policy at western central banks have been supportive for emerging market assets. The spread this year of zero and negative yields offered by European and other government bonds has driven some investors to take risks they would previously have avoided.

> Despite a rise in earnings per share, Turkish stocks have underperformed their peers consistently

But with US interest rates expected to rise — especially if president-elect Donald Trumpreflates the US economy — flows to EM assets could well go into reverse. This would be particularly damaging for EM fixed income assets, which have ridden on a global fixed income rally many believe is ending.

Added to this are Turkey's own political and economic risks. Despite last week's modest interest rate rise from the central bank, short-term rates for fixed income investors are close to zero, says Mr Demir.

"It is hard to argue that this is adequate reward for the risks investors are taking," he says.

Could Trump trample growth in an emerging economy?

COMMENT

Daron Acemoglu and Murat Ucer

Much of Europe is mourning a US presidential election that has catapulted real-estate mogul Donald Trump into position as possibly the world's most powerful person.

In contrast, Ankara is rejoicing: President Recep Tayyip Erdogan and his government have made it clear that they welcome the result — not only because they think Mr Trump is likely to upset US power structures, but also because his rival, Hillary Clinton, had declared her intention of arming Syrian Kurds, seen as a hostile force by the government.

Mrs Clinton was also alleged to have received campaign contributions from the network of the exiled cleric Fethullah Gulen, accused by Mr Erdogan of orchestrating the failed coup attempt in July.

Ankara's glee is misplaced, however, mainly because the implications of a Trump presidency are likely to be dire for the Turkish economy. Turkey has achieved average annual growth rates of about 3 to 3.5 per cent since the onset of the global financial crisis in 2007, but its growth has been low quality in at least three senses.

First, in contrast to a period between 2002 and 2006, when productivity growth was at 6 per cent per annum, there has been almost none since. This implies that there have been no improvements in how technology is being used or in how labour and physical capital are being allocated.

Second, the growth has been fuelled not by investment but by consumption, fed by an unsustainable rise in private credit, which has increased from around 30 per cent of GDP before 2007 to almost 80 per cent now. Such rapid credit growth in emerging economies is often the harbinger of a looming economic crisis.

Finally, economic institutions have been weakened since 2007. A range of institutional reforms — such as increasing transparency in government, limiting corruption, empowering independent agencies, and introducing a rule-based decision-making framework — have been all but reversed. Instead, public perceptions of corruption have risen and political meddling in economic affairs has become commonplace.

Despite its low quality, however, Turkish growth has been resilient. One reason for this stands above all else: the abundant global liquidity that has been created in part by ultra-low world interest rates courtesy of the US Federal Reserve and, to a lesser extent, the European Central Bank.

But these conditions seem likely to change under President Trump. Two pillars of his economic policy are expected to be massive tax cuts and infrastructure spending, which the markets have already begun pricing in.

> 'Ankara's glee is misplaced. The implications of a Trump presidency are likely to be dire'

This re-run of Reaganomics will increase US fiscal deficits and debt and may push up US inflation — developments unlikely to leave the Fed with any other option than raising the federal funds rate relatively quickly. As interest rates increase, the global or dollar liquidity glut will dry up.

Emerging economies in general, and Turkey in particular, have little time to adjust to such a shift in the global environment. Time is running out for the Turkish economy for other reasons too. Economic growth had begun to slow even before the coup attempt, increasing uncertainty for foreign investors.

The latest indicators suggest the economy has contracted in the third quarter of 2016, probably leaving Turkey with meagre growth of about 1 per cent year on year — the lowest level in almost a decade. Meanwhile, the unemployment rate has risen by 1.5 percentage points to 11.4 per cent over the past four months.

Turkey shares another trait with some of its fellow emerging economies: it has a limited capacity for enacting countercyclical policy to combat a sharp slowdown. The weakness of the lira (which has lost some 15 per cent in a matter of weeks); the Turkish central bank's aggressive rate cutting since March (with the exception of the modest increases of last week); a large external financing requirement amounting to almost 30 per cent of GDP, due to the stubbornly high current account deficit and short-term debt obligations; and limited central bank reserves leave little room for action on monetary policy.

On the fiscal side, Turkey has some breathing space, thanks to relatively low government debt-to-GDP ratios (around 35 per cent) and moderate headline deficits (around 1.5 to 2 per cent), but the underlying situation is a lot weaker than it first appears, with primary expenditure growth visibly outpacing tax revenue growth.

It is not too late to change course. Growth in the aftermath of Turkey's economic crisis in 2001 showed how even modest attempts towards a more inclusive economy can spearhead rapid and relatively high-quality growth. Nothing precludes a re-run of that experience — except Turkish politics.

An economic revamp requires hard political choices — restarting the process of economic reforms, reversing the control of the government over the judiciary and economic agencies, and starting a rapprochement with Europe and the US. This is a tall order, but one that is urgently needed if Turkey is to withstand the wild and unpredictable winds of a new Trumpian world.

Daron Acemoglu is the Elizabeth and James Killian professor of economics at the Massachusetts Institute of Technology; Murat Ucer is Turkey adviser at GlobalSource Partners.

Trump Towers in Istanbul