After a decade of well-implemented reforms and high growth rates, the Turkish economy seems to be struggling to maintain the same growth performance. Coface expects a growth rate of 3.5% this year - still a solid rate, yet below the potential growth rate estimated at 5% and lower than some of the country’s peers.

The recovery in the US economy and the Federal Reserve exit strategy have pushed the global economy into a new era. Emerging countries face new challenges due to less available liquidity and structural vulnerabilities. Over the period ahead, the high volatility of the Turkish lira, the recovering but still-fragile growth in Europe and geopolitical risks weighing on the top export markets, are considered as the main challenges for the Turkish economy. Coupled with the general elections in June 2015, these factors are leading to a slowdown in household consumption and investment expenditure.

The textile and clothing sectors are among the most impacted by the developments in the global economy. Regional tensions are also weighing on the export performance of Turkish textile and clothing companies. Coface has increased the textile sector risk assessment to high risk level from medium risk, mainly due to the restrictive impact of the euro’s strengthening on export revenues, increasing import and production costs, the fragile recovery in the core market of Europe, losses recorded in Ukraine and Russia and finally deterioration in companies’ payment performance. The clothing sector currently stands at medium risk level, but is being closely monitored.

The pharmaceutical sector remains solid, despite heavy regulations and lower profit margins. Coface evaluates the risk level of this sector as low. The sector is benefiting from the greater access of Turkish citizens to healthcare services, higher per capita income and higher pharmaceutical expenditure per capita. Although the reference pricing system puts pressure on prices, which in turn restrains investments in new technologies, the sector still has the strong foundations necessary for steady financial performance. Payment collection is steady, as no delays have been detected in State payments.

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HOUSEHOLD CONSUMPTION CONTINUES BUT FOR HOW LONG?

The Turkish economy recorded a growth rate of 2.9% in 2014, below the government-end-2014 forecast of 3.3%. Household expenditure contributed 0.9 percentage points (pp) to the growth rate during the period, declining from 3.4 pp in 2013. As household consumption accounts for around 63% of total output, this decline in pace pushed down the country’s growth rate from the 4.2% achieved in 2013.

The main reasons behind this slower momentum in household expenditure were the macroprudential tools implemented by the Turkish banking watchdog (BDDK) at the beginning of 2014, in order to curb domestic demand and narrow the current account deficit. These tools limited the number of installments for some goods and imposed higher down payments for auto loans. As a result, the pace of growth of consumer loans declined to 13.7% y/y in 2014, from 28% in 2013. Turkish consumers usually tend to finance their consumption expenditures through consumer loans or credit cards. Between 1994-2013, real wages rose by only 0.9% in the private sector, while they declined by 14.2% in the public sector. Households thus have tendency to use loans to finance their needs. This situation increased the ratio of household debt to disposable income to 55% in 2013, from 35% in 2003.

The high volatility of the lira also weighs on consumer behavior, as Turkish people usually cut their spending on non-food purchases, with a fall of 2.2% during the time.

The rise in unemployment is another negative factor for consumer spending. Since the recession in 2009, Turkey has created around 51 million jobs. The unemployment rate rose to an all-time high of 8.1% in June 2013, from 13.1% in 2009. However, the slowdown in economic activity raised the unemployment rate to nearly 17% at the end of 2014. Consumers’ purchasing power has also been trimmed by the rise in inflation. In 2014, headline inflation stood at 8.2%, up from 7.4% in 2013. The sharp depreciation of the lira at the beginning of 2014 lifted inflation as high as 9.7% in May 2014, due to the pass-through effects. Consumer prices also rose by 2.5% in June 2014, as household consumption expenditure has been continuing to increase. In March 2015, the consumer price index hit its lowest level since 2013, at 6.4%, while the lira weakened by 13% against the greenback.

Sub-categories of the consumer confidence index indicate that households are particularly concerned that they will have less possibilities for saving, compared with previous periods. This may decrease the national saving rate, which already hovers at historically low levels (around 13% of GDP). Similarly, retail sales lost some momentum. In the first two months of 2015, the increase in retail sales stood at 3.4% yoy, compared with 8.8% yoy in the same period of 2014. Households especially cut their spending on non-food purchases, with a fall of 2.2% during the time.

The lira’s weakening raised production costs and squeezed profit margins on higher prices of imported raw materials to spend and, a high percentage of the population with no bank account (42% of adults according to the World Bank). The low level of savings leaves the country exposed to international shocks. The real level of private investment has been continuing since the fourth quarter of 2011. In 2012, private investments contracted by 4.9% y/y and grew only 0.5% y/y in both 2013 and 2014. At the same time, public investments accelerated and their share in the total gross fixed capital formation rose to 18% in 2014, from 11.4% in 2012.

Foreign direct investments (FDI) into Turkey have slowed down in recent years. In the 2012-2014 period, total FDI into the country stood at 378 billion USD, far below the 62 billion USD in the 2006-2008 period. This trend is partly due to the deceleration of privatizations. In 2014, privatization revenues declined to around 9 billion lira (3.3 billion USD), 50% down from 2013. This led to a deceleration in foreign investment in the country. Other factors - such as political uncertainty, tax and incentive systems and intellectual property rights - appear to be discouraging investors from putting their money into Turkey.

The exchange rate affects investment expenditures, as the national production system depends heavily on imports of commodity and intermediate goods, the lira’s strengthening after the 2001 crisis, enabled companies to produce to lower costs. But the lira’s weakening since 2014 resulted in a turnaround in this mechanism.

...badly affected by lira’s weakness, regional tensions and, political uncertainty Clearly, the strength of the lira played a major role in this scenario. However this trend had been partly reversed since the US Federal Reserve’s announce- ment, in May 2013, of its exit strategy. Since then, the lira has started to weaken versus the US dollar amid other emerging currencies. This depreciation resulted in a turnaround in the mechanism described above and increased production costs, which squeezed corporate profit margins, as well as the higher prices of imported raw materials and intermediate goods.

With three elections in 2014 and 2015, companies tend to reduce new investments in order to curb production costs. This is a result of Turkey’s growth model. During the period after the 2008 crisis, Turkey greatly benefitted from the advantages of a globally cheap and abundant liquidity. The lira firmed 30% versus the dollar in 2008-2010. As the national production system depends heavily on imports of commodity and intermediate goods, the lira’s strengthening decreased production costs and enabled companies to increase production due to cheaper imports. The stronger lira also allowed the Central Bank to lower its rates. The average interest rates on consumer loans fell as low as to 9.9% in mid-2013, down from the rate of close to 25% in 2008, while it fell to 7.3% from around 12% in 2012 for commercial loans. Coupled with lower rates, globally cheap funds provided by Turkish banks to households resulted in a soaring growth in loans growth. During 2012-2013, personal loans jumped on average by 27% annually, boosting household consumption which in turn supported growth performance. The lira’s firming and the large import-content of the consumer prices index (CPI) dragged down inflation. According to the national authorities, a depreciation (or appreciation) of 10% in the USD/Turkish lira rate on inflation. Thanks to the strong lira, inflation hit its lowest ever level of 3.99% in March 2011.
The Turkish economy recorded a growth rate of 2.9% in 2014, below the government-end-2014 forecast of 3.3%. Households expenditure contributed 0.9 percentage points (p.p.) to the growth rate during the period, declining from 3.4 p.p. in 2013. As household consumption accounts for around 63% of total output, this decline in pace pushed down the country’s growth rate from the 4.2% achieved in 2013. The main reasons behind this slower momentum in household expenditure were the macroprudential tools implemented by the Turkish banking watchdog (BDDK) at the beginning of 2014, in order to curb domestic demand and narrow the current account deficit. These tools implied the number of installments for some goods and imposed higher down payments for auto loans. As a result, the pace of growth of consumer loans declined to 13.7% yoy in 2014, from 28% in 2013. Turkish consumers usually tend to finance their consumption expenditures through consumer loans or credit cards. Between 1994-2013, real wages rose by only 0.9% in the private sector, while they declined by 14.2% in the public sector. Households thus have tendency to use loans to finance their needs. This situation increased the rate of household debt to disposable income to 55% in 2013, from 31.5% in 2003. The high volatility of the lira also weighs on consumer behavior, as Turkish people consider the progressive depreciation of the lira as an economic warning sign (because of their experience during the beginning of the 2000s when they had to use loans to finance their needs. This led to a decrease in real wages, and their willingness to spend. In March 2015, the consumer confidence index hit its lowest level since 2010, at 64.4, while the lira weakened by 13% against the greenback. Subcategories of the consumer confidence index indicate that households are particularly concerned that they will have less possibilities for saving, compared with previous periods. This may decrease the national saving rate, which already hovers at historically low levels (around 13% of GDP). Similarly, retail sales lost some momentum. In the first two months of 2015, the increase in retail sales stood at 3.4% yoy, compared with 8.8% yoy in the same period of 2014. Households especially cut their spending on non-food purchases, with a fall of 2.2% during the time. The rise in unemployment is another negative factor for consumer spending. Since the recession of 2009, Turkey has created around 51 million jobs. The unemployment rate was lowest ever level of 8.7% in June 2013, from 13.1% in 2009. However the slowdown in economic activity raised the unemployment rate to nearly 17% at the end of 2014. Consumers’ purchasing power has also been trimmed by the rise in inflation. In 2014, headline inflation stood at 8.2%, up from 7.4% in 2013. The sharp depreciation of the lira at the beginning of 2014 lifted inflation as high as 9.7% in May 2014, due to the pass-through effects. Coface expects inflation to stand at 8.8% yoy in the same period of 2014. The weak level of private investment has been continuing since the fourth quarter of 2011. In 2012, private investment contracts by 4.9% yoy and grew only 0.1% in 2013, and 0.3% in 2014. At the same time, public investments accelerated and their share in the total gross fixed capital formation rose to 18% in 2014, from 10.9% in 2012. Foreign direct investments (FDI) into Turkey have slowed down in recent years. In the 2012-2014 period, total FDI into the country stood at 378 billion USD, far below the 62 billion USD in the 2006-2008 period. This trend is partly due to the deceleration of privatizations. In 2014, privatization revenues declined to around 9 billion lira (3.3 billion USD), 50% down from 2013. This led to a deaccumulation in foreign investment in the country. Other factors - such as political uncertainty, tax, and incentive systems and intellectual property rights - appear to be discouraging investors from putting their money into Turkey. 

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Weaker lira weighs on investment expenditure The exchange rate affects investment expenditures, as during periods of weakness for the lira, companies tend to reduce new investments in order to curb production costs. As the national production system depends heavily on imports of commodity and intermediate goods, the lira’s strengthening after the 2001 crisis, enabled companies to produce to lower costs. But the lira’s weakening since 2014 resulted in a turnaround in this mechanism. 

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Continuous higher need for current account deficit...

The last decade showed that the Turkish economy cannot grow without posting progressively larger current account deficits. In 2011, the deficit reached nearly 10% of GDP pushing the authorities to engineer a voluntary slowdown. Studies show that the Turkish economy needs progressively more external funds in order to finance growth. In his article “Turkey: New Challenges for Policy Makers”, Dani Rodrik, economist and professor of international economics, prioritizes the switch to high tech, production and employment.

Higher current account deficit indicates the importance of productivity

Turkish needs to post higher current account deficit to overcome its growth weakness. The structure of the deficit shows that the main reason for the external gap comes from the trade balance. Most Turkish exports are of a relatively average level of sophistication. This reduces competitiveness and contributes to the external gap. The limited export sophistication creates a barrier to increasing the volume and value of export-oriented productive capacities and geopolitical developments and the slow recovery in Europe also seem to have halted the export performance.

The government's 11-step package prioritizes the switch to high tech, production and employment

In recent years, Turkey has reoriented investments from manufacturing to the housing sector. Since 2002, the manufacturing sector's share in GDP has progressively declined from 17.6% to around 15.8%, while the share of construction and real estate activities rose from 4.2% to 4.6% and from 8.3% to 9.8%, respectively. As construction activities involve more than 100 sectors, it is an important driver for growth. However, its added value remains low and its capacity to generate foreign currency inflows is limited. The number of houses sold to foreigners stood at 2% of total housing sales in 2014. During the previous economic crisis, the extraordinary liquidity conditions encouraged Turkish banks to offer mortgage funds in the form of consumer loans. As a result, households prefer to keep their wealth in real estate or gold, instead of placing it in savings accounts, as they feel better protected against inflation. Yet the way of saving money means that funds do not go into the financial system for future investment or finance necessary for economic development. The lack of savings and the allocation of existing funds to the housing sector represent obstacles to better specialization in the manufacturing sector. The government, aware of the need to overcome these issues, announced a new economic package early in April 2015. The 11-step package prioritizes the switch to high tech, production and employment. The new measures include the expansion of treasury-backed warranties to involve small and medium size enterprises in manufacturing, a 50% rise in tax relief for companies that make investments and facilitate access to financing for SMEs. The package also introduces a new tax benefit for enterprises in manufacturing, in order to push Turkey to make efforts to increase its manufacturing of higher added value products and thus its share in global trade.

Investments shifting to the construction sector

In recent years, Turkey has reoriented investment expenditure from manufacturing to the housing sector. Since 2002, the manufacturing sector's share in GDP has progressively declined from 17.6% to around 15.8%, while the share of construction and real estate activities rose from 4.2% to 4.6% and from 8.3% to 9.8%, respectively. As construction activities involve more than 100 sectors, it is an important driver for growth. However, its added value remains low and its capacity to generate foreign currency inflows is limited. The lack of savings and the allocation of existing funds to the construction sector represent obstacles to better specialization in the manufacturing sector. The government, aware of the need to overcome these issues, announced a new economic package early in April 2015. The 11-step package prioritizes the switch to high tech, production and employment. The new measures include the expansion of treasury-backed warranties to involve small and medium size enterprises in manufacturing, a 50% rise in tax relief for companies that make investments and facilitate access to financing for SMEs. The package also introduces a new tax benefit for enterprises in manufacturing, in order to push Turkey to make efforts to increase its manufacturing of higher added value products and thus its share in global trade. The government's 11-step package prioritizes the switch to high tech, production and employment

The government’s 11-step package

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The normalization of the US monetary policy may bring about a possible reduction of capital flows into emerging markets. In the upcoming period, it may therefore have an impact on decisions to finance investments for Turkey with money borrowed from abroad. The lira’s depreciation did not only affect production costs. It also affected the foreign currency denominated (fx) debt burden of the Turkish corporate sector. This can be considered one of the main challenges for the economy in 2015. Turkish corporates’ total fx external debt stock stood at 202.2 billion USD in 2014 (35% of GDP). Out of this total, 34.6 billion USD was the short-term fx debt of non-financial companies. On the other hand, as of January 2015, Turkish non-financial companies had an fx exposure (fx assets-fx liabilities) of 17.75 billion USD, according to data from the central bank. However, the share of short-term net fx position is low – at 10.6 billion USD. Non-financial corporates’ fx borrowing from banks increased to 18% of GDP in 2013, up from around 5% in 2008, according to the IMF 2014 article IV consultation report. This relatively high level of fx debt and lack of fx hedging in the corporate sector creates a vulnerability for companies during times of high volatility in financial markets. This reliance on short-term foreign currency cash to roll over fx debt suggests that any greater depreciation of the lira would increase the debt burden and further reduce new investment initiatives, as it would increase losses in corporate balance sheets. Turkey’s total external debt stock at 50% of GDP in 2014, raising its vulnerability against a stronger dollar. Yet Turkey is not the only emerging economy suffering from this fortune. Other countries such as Peru, Chile, Russia and Indonesia also have a high level of external debt stock, representing respectively 35%, 33%, and 30% for GDP, according to a PwC report published in May 2015. Weak growth in commodity prices and rising regional tensions also limited new investments, weighing on export performance. Europe-28 is the premier market for Turkish exports, accounting for around 45% of Turkish goods. Yet between December 2014 and February 2015, Turkish exports to Germany fell, on average, by 8% yoy and to Italy, by 6%. During the same period, exports to the EU-28 area declined on average, by 2% yoy. Regional turmoil in the Middle East and the crisis between Russia and Ukraine also negatively impacted Turkish exports. In 2014, Turkish exports to Russia declined by 15%, to Ukraine by 21% and to Iraq by 88%. Exports to Syria also suffered a sharp decrease, due to the civil war.

Chart 3: Turkish non-financial companies fx debt stock (million USD)

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<thead>
<tr>
<th>Year</th>
<th>2014</th>
<th>2015</th>
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<tr>
<td>Total</td>
<td>34.6B</td>
<td>10.6B</td>
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The share of manufacturing in GDP has declined

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2 CHALLENGE OF EXPORT SOFISTICATION

Continuously higher need for current account deficit...

The last decade showed that the Turkish economy cannot grow without posting progressively larger current account deficits. In 2011, the deficit reached nearly 10% of GDP pushing the authorities to engineer a voluntary slowdown. Studies show that the Turkish economy needs progressively more external funds in order to finance growth. In his article “Turkish economic myths”, Dogan Rodrik, economist and professor of Social Sciences at the Institute for Advanced Study in Princeton, indicated that between 1998 and 2014, an added 1 percentage point in Turkey was associated with a 0.4% larger current account deficit as a share of GDP. However since 2005 at any level of growth, the current account deficit is larger by 0.45% of GDP. The structure of the deficit shows that the main reason for the external gap comes from the trade balance. Most Turkish exports are of a relatively average level of technology. This reduces competitiveness and contributes to the external gap. The limited export sophistication creates a barrier to increasing the volume and value of exportable goods and contributes to a slowdown in economic performances. The government’s 11-step package prioritizes the switch to high tech, production and employment. The package also introduces measures to encourage high-technology investments as priority investments, allocating more incentives to companies who make investments and facilitation of access to financing for SMEs. The package also introduces measures to encourage high-technology investments as priority investments, allocating more incentives to companies who make investments and facilitation of access to financing for SMEs. The package also introduces measures to encourage high-technology investments as priority investments, allocating more incentives to companies who make investments and facilitation of access to financing for SMEs.

Higher current account deficit indicates the importance of productivity

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annual exports currently stand at around 160 billion dollars (USD), it represents a critical issue for the Turkish economy to reach 500 billion USD within 9 years. This would require an annual compound growth of approximately 13.7%.

In addition to the government’s measures, the European Central Bank’s (ECB) quantitative easing may also help Turkish exporters to gain some momentum. In January 2015, the ECB announced that it would purchase bonds issued by euro area central governments, agencies and Eurozone institutions. Combined monthly asset purchases amounting to 60 billion euros are scheduled to be carried out at least until September 2016. Coupled with the fall in oil prices, the ECB’s initiative is helping business conditions to improve. Growth forecasts for the region have been upgraded, while business and consumer confidence indexes are slightly picking up. If these improvements continue, they may also assist Turkish companies in increasing their exports to Europe. Although Turkish exporters successfully diversified their export markets and products during the global crisis, Europe is still the country’s top trading partner, attracting 43% of its exports in 2014. Turkey’s exports to the EU-28 are mainly dominated by durable goods with high sensitivity to economic growth—such as motor vehicles and textiles. Thus an improvement in European economic conditions may boost Turkey’s exports over the upcoming period.

Opportunities and challenges...

The increased participation of Turkish SMEs in foreign trade could be considered as an advantage, but the low level of productivity and competitiveness is a critical issue, as it was ranked 43rd out of 144 countries in the World Economic Forum’s Global Competitiveness Report of 2014-2015. In the sub categories, Turkey’s score is weaker regarding labor market efficiency (131st out of 144), innovation (56th out of 144), institutions (64th out of 144) and technological readiness (54th out of 144). Although the share of SMEs in total exports at around 60%, these companies often suffer from low productivity caused by insufficient equity, lack of feasibility studies, managerial and governance problems and low levels of skills and specialization. In 2012, companies with 1-49 employees accounted for 97% of manufacturing companies, but only for 20% of added value in the manufacturing sector. In the same year, companies with 50-99 employees accounted for 1% of manufacturers and 8% of added value. Large companies with over 250 employees accounted for only 0.5% of manufacturing companies but for 54% of added value. Increasing the productivity of SMEs is an important issue, as they contribute to the sustainability of the country’s export growth. At this point, many are willing to have the EU as the main market, to represent an important advantage for SMEs, as it requires better organization of their production processes. According to the World Bank on Turkey entitled “Trading up to High Income” (May 2014), 7% of the Turkish export products entered MENA for the first time in 2010 expanded there from the EU. This indicates that exporting to the EU creates a process of technology transfers and “learning by exporting”, leading to an increase in productivity.

Although market diversification helped Turkish exporters to overcome the negative impacts of the global crisis, new risks in the global economy are putting more pressure on companies to reach new clients. During the global crisis, the share of Turkish exports to the EU-28 fell significantly, to 41.3% in 2013 from around 57% in 2007. During the same period, the share of Turkish exports to the Near and Middle East jumped to 23% from 14%, the share of Asia rose from 8% to 5% and the share of North Africa rose to 6.6% from 4%. According to the World Bank’s index of export market penetration, Turkey reached only 20% of its potential markets, still lower than many of its peers, including China and India, but its penetration level in the EU is higher. Turkey’s share in total imports to MENA and the EU-28 both stood at 3% in 2013, so there is still room for further expansion. Nevertheless, the emergence of regional geopolitical risks may put pressure on Turkish exporters to reach new markets through more sophisticated products.

In this respect, the framework agreement reached between Iran and five countries (China, Russia, Saudi Arabia, the US, France, the UK and Germany) early in April 2015 may provide an important opportunity for Turkish exporters to increase their exports and investments. Iran is a neighboring country and the current penetration level is quite low. New investments under this agreement set the stage for a comprehensive settlement that will alleviate Western countries’ concerns about Iran’s nuclear weapons production. In exchange, it will lift economic sanctions on Iran. The two sides have until June 30 to discuss the terms of a final agreement. Until that time, the sanctions will remain. A permanent deal would boost Iranian demand for all kinds of products (foods, clothing, chemicals, petrochemicals, infrastructure etc.), representing a unique opportunity for Turkish companies. Although the ECB’s expansionary monetary policy is good for the economic growth of the region, its positive impact for Turkish companies could be dampened by the sharp depreciation of the euro. Indeed, 44% of Turkish exports are denominated in euros, while 64% of imports are denominated in US dollars. The depreciation of the euro against the dollar therefore weighs on Turkey’s export revenues, while the dollar as the currency of the World Bank on Turkey entitled “Trading up to High Income” (May 2014). 7% of the Turkish export products entered MENA for the first time in 2010 expanded there from the EU. This indicates that exporting to the EU creates a process of technology transfers and “learning by exporting”, leading to an increase in productivity.

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Two main Structural Problems for the Textile sector

- Wage cost remains high, due to the high level of taxes imposed on gross wages. This neither encourages employment, nor the transition between service industries and manufacturing. The incentives implemented on a provincial scale do not provide optimum benefits for manufacturers.
- In many cases, it is difficult to see an even distribution of income among provincial districts.

4- How do you assess the general outlook for the Turkish pharmaceutical sector in 2015?

The wholesale drug industry is not deeply affected by recent economic fluctuations and enjoys a stable and sustainable outlook, given the fact that the principal variables are government regulations on exchange rates and public expenditure. Although pharmaceuticals have some problems related to the low level of fixed exchange rates and tight budget policies, the industry has not recently faced a serious downturn.

5- How should Turkish companies react against these challenges? What should they do to manage the risks?

Hedging and efficient cash flow management should be the primary strategy for Turkish companies who are vulnerable to volatility in exchange rates. The need for rational management of exchange rate risks, considering Turkey’s high level of current account deficit and dependence on capital inflows, should also be emphasized. In addition to these points, the management of inventories should be improved in order to avoid putting company operations in jeopardy.

The Turkish government considers the textile and clothing industries as amongst the most strategic in achieving its targets of reaching 500 billion USD worth of exports by 2023. Despite the sharp volatility at the beginning of 2014 and rising geopolitical tensions in the region, Turkey’s textile and clothing industry has been resilient. The second impact of the recent economic fluctuations and the volatility in exchange rates. The need for rational management of exchange rate risks, considering Turkey’s high level of current account deficit and dependence on capital inflows, should also be emphasized. In addition to these points, the management of inventories should be improved in order to avoid putting company operations in jeopardy.

The situation has three major implications. Firstly, this dependence gives European companies “bargaining power” over producers. The big retail companies place the largest part of the orders, allowing them to dominate the market. As producers are dispersed and are usually small or medium size companies, the bargaining power of retailers is reinforced. They ask for the best terms and for price reductions. This means that profit margins in the textile and clothing industries remain tight. The second impact of the European dependence is through the exchange rate. Turkish textile and clothing sector has been troubled by the euro’s weakness against the dollar since the second half of 2014, as 52% of textile exports and 74% of clothing exports were addressed to EU-28 countries. On one hand, the euro’s depreciation resulted in an important loss in export revenues. On the other, the dollar’s strengthening resulted in an increase of production costs, as these sectors import around 65% of their raw materials and intermediate goods in US dollar terms.

The third impact is related to consumer demand. The sluggish recovery in European markets is weighing on Turkish exports. In the first quarter of 2015, Turkish textile and clothing exports to EU-28 decreased by 7% yoy, to Germany by 16.8% and to the UK by 113.8%. Data from the General Secretariat for Industry and Apparel Exporters’ Association (ITKIB) showed that, in total, exports to the EU-28 plunged by 16.4% during the period. Similarly, in the first quarter of 2015, clothing exports to Germany plunged by 23% yoy, to UK by 10.4% yoy, to Spain by 62.2% and to France by 27.7% yoy. In March 2015, the clothing sector’s capacity utilization rate stood at 74.1%, the lowest in the last 39 months. It should, however, be borne in mind that the impact from EUR/USD rate also plays a role in this decline. In the first quarter of 2015, Turkey’s total clothing exports declined 14.8% yoy. ITKIB calculations showed that, adjusted to the EUR/USD impact, this fall eases to 9.9% yoy.

International and domestic challenges remain

The economic consequences of the tensions between the Ukraine and Russia constitute another important challenge for these sectors in 2015. Co-face exports Russia’s economy to contract by 3% in 2015, to Western sanctions, lower oil prices and the sharp depreciation of the ruble. The slowdown in the Russian economy dragged down Turkish clothing exports by 45% yoy in the first quarter of 2015. Turkish exporters face serious problems with delayed payments and collection of receivables in Russia. Indeed, many exporters used to send their products to Russian customers in the form of open account transactions, meaning that goods were shipped and delivered before payment. This represents another important challenge for Turkish exporters in 2015, as the difficulties they experience with payment collections may weaken their financial performance and deteriorate cash flow management. Turkish retailers who own stores in Russia face problems related to re-pricing issues, because of the ruble’s depreciation and the sharp decline in sales due to the lower purchasing power of Russian households. On the other hand, as the majority of the rented stores in Russia’s shopping malls are denominated in USD, the ruble’s devaluation adds to the operational costs of Turkish retailers. This situation pushed many retailers to delay new season openings and extend discount periods. So far in 2015, it cannot be said that domestic demand has compensated for these negative developments in external markets. In the first two months of 2015, retail sales of textiles, clothing and footwear rose by only 4% yoy, the lowest increase since 2011. January-February 2015 production trends for the textile sector were slightly worse, with a decline of 11.7% yoy in the textile sector and by 12% in the clothing sector on a calendar adjusted basis. Political uncertainty is another challenge, as it holds back investments as well as consumer consumption. Economic agents have concerns about the outcome of the elections due in June 2015, as well as on the economic policies of the new government. This has
The Turkish government considers the textile and clothing industries as amongst the most strategic in achieving its target of reaching 500 billion USD worth of exports by 2023. Despite the sharp volatility at the beginning of 2014 and rising geopolitical tensions in the region, Turkey’s textile and clothing industry has increased its export volume, there is a decline in profit margins and a decrease in budget policies, the industry has not recently faced a serious downturn.

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Companies without efficient cash management have been negatively affected by the deteriorating conditions, which distort their payment performance.

On the other hand, the concentration of export markets for these sectors is high. EU-28 countries remain the main clients, despite a slight diversification in export markets since 2010. Between 2010 and 2014, Turkish textile and clothing exports to the European Union rose 4.3%, on average, to reach 13.7 million euro, accounting for 25.2% of the regions’ total imports from Turkey. In 2014, Turkish textile exports for EU-28 increased by 8.6% for EU-28, accounting for 25.2% of the regions’ total imports from Turkey.

The European Union is the biggest export market for the textile and clothing sectors, according to the World Trade Organization. "The majority of EU-28 countries are strong in the middle and higher sophistication goods and articles. This indicates that apparel producers are strong in the middle and higher sophistication stage of textile production (e.g. knitted and crocheted goods)." The ongoing civil war in the North of Iraq, a growing export market for Turkish companies who shifted their production to Russia. Indeed, many exporters used to send their products to Russian customers in the form of open account transactions, meaning that goods were shipped and delivered before payment. Thisrepresents another important challenge for Turkish exporters in 2015, as the difficulties they experience with payment collections may weaken their financial performance and deteriorate cash flow management.

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The higher volatility in exchange rates, prior to a possible rate hike from the US Federal Reserve, also enables producers to pay for these imports in dollars. The new legislation covers 51 goods. Before this decision, no RUSF was applicable. The removal of this special export fund (RUSF) in order to widen profit margins. Many companies have been done to some extent in foreign markets such as Russia. However this is still an ongoing process and it will take more time to be resolved. Higher competitiveness through cost-efficient strategies may help Turkish producers to take advantage of the strong dollar, as their products would be cheaper.

Separately, there are structural challenges that require more time to be resolved. Higher competitiveness through cost-efficient strategies may help Turkish producers to increase their market shares abroad, as well as their profit margins. Costs related to the labor force, commodity purchases and energy prices are the principal reasons for narrowing profit margins. On the other hand, producers are progressing towards higher added value and designer products. Many companies are investing in creating brands, as has already been done to some extent in foreign markets such as Russia. However, this is still an ongoing process and it will take more time for producers to accomplish concrete results. Companies are benefiting from public support, such as the Turquality programme. The Turquality programme aims to encourage branding and production of high added value products, through incentives and organizational, strategic, financial and informative coaching through accredited consultants.

The Turkish pharmaceutical sector has strong foundations. It was Europe’s 6th largest market and the world’s 16th largest in 2012, in terms of sales. The country’s modernization initiatives, foreign investment and higher demand for healthcare services have all supported the sector’s rapid growth during the last decade. Turkey’s solid economic growth also played an important role in this performance. At that time the Turkish economy posted an average growth rate of 4.5%, while per capita income rose to 10,404 USD in 2014, from 6,110 USD in 2002. Between 2003 and 2012, pharmaceutical sales posted a CAGR of 8.1%...
pushed them to keep investment plans on hold until the end of the elections. The higher volatility in exchange rates, prior to a possible rate hike from the US Federal Reserve, also increases the risks, as it makes it more difficult for exporters in terms of pricing and managing costs. Companies without efficient cash management have been negatively affected by these deteriorating conditions, which distort their payment performance. Receivables collection has become more difficult, which increases the risk of insolvency.

Amid these challenges, Coface has raised the risk assessment of the textile sector to high risk from medium level. We are also closely monitoring the impact of these developments on the financial performance of clothing companies. These risks pushed textile and clothing manufacturers to look for alternative markets which could partially compensate for the decline in core export markets and domestic demand. Recent news suggests that producers are prioritizing the US market, as it offers some opportunities for Turkish exporters. The Transatlantic Trade and Investment Partnership (TTIP) between the EU and the US constitutes a very important issue for Turkey. In the bilateral trade between Turkey and the United States, Turkey has a net export position in consumer goods and a net import position in capital and intermediate goods. The Caspian Strategy Institute’s publication of January 2016, estimates that the TTIP will decrease production in the textile and clothing sectors by 4.33%. Employment in the manufacturing sector is estimated to fall by 0.49%, added value by 5.18% and corporate profits by 4.9%. The TTIP would give the opportunity to European textile and clothing producers to manufacture goods in low cost countries, put European labels on them and then sell them to the United States exempt from custom tariffs - as would be the case for goods produced in Europe. This situation would create unfair competition for Turkish producers and result in even narrower profit margins. Therefore, the willingness of Turkish producers to strengthen their presence in non-traditional export markets is an important factor in their profitability over the upcoming period. This would also give Turkish producers the chance to make their products more affordable to consumers in the US market.

Table 8: Turkey’s net exports to the United States (2014, bln USD)

<table>
<thead>
<tr>
<th>Metals</th>
<th>Textiles</th>
<th>Minerals</th>
<th>Clothing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.2</td>
<td>0.8</td>
<td>0.4</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Source: TSI

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1-How do you evaluate recent trends in online shopping sector in Turkey?

Online shopping industry in Turkey is relatively young and growing very fast. Major drivers behind this growth are: young population with high social media engagement, reliable & widespread logistics, deep sourcing capability, strong credit card penetration and increasing share of mobile in internet usage. Everyday an increasing number of internet users discover that they can receive even better goods and services via online platforms and this initiated traditional offline businesses to shift to online platforms. With intense competition it is more important for e-commerce companies to provide good customer service & user experience across all platforms.

2-How do you evaluate your sales in 2014 compared to 2013? What are the reasons of this increase/ decrease? What are your objectives for 2015?

Trendyol grew more than 45% yoy in 2014. We continued doing the things that we are best: improving customer experience on our platforms by investing in our mobile apps, our data/fact driven CRM programs. We expect to grow 45%+ in 2015.

3-What is the place of your company in Turkish online shopping market in terms of sales and membership?

Trendyol is by far the market leader in fashion ecommerce in Turkey with over a half billion Turkish Liras in sales. We have 8+ million members, which includes more than 80% of women who shop online.

4-Since the start of 2015, we witness a slowdown in domestic economic activity in terms of investment and consumption mainly due to the volatility in exchange rates and the political uncertainty. How your sales have been affected by these factors so far in 2015?

Our sales have grown more than 45% during the first quarter and we are expecting the same growth to continue throughout the year. There are more than 35 million people online, however only a fraction of it has ever bought something online, which means there’s room for growth. Moreover our business is focused on providing a wide range of fashion products at accessible prices, thus even a downturn could help.

5-What are your opinions about the risks and opportunities in Turkish clothing sector and online shopping in the medium term?

Turkey has strong sourcing advantages in textile manufacturing. Fast speed to market and manufacturing high quality items at lower prices attract many global fashion retailers to source in Turkey and it is also a good opportunity for Turkish retailers to scale their business both locally as well as globally. Today ecommerce constitutes less than 2% of total retail sales in Turkey, which is around 10% for US and above 5% for many European countries. Given recent trends in internet industry and favorable demographics we expect ecommerce market to grow 5-10 times of its current size in the next 5 years.

The Turkish pharmaceutical sector has strong foundations. It was Europe’s 6th largest market and the world’s 16th largest in 2012, in terms of sales. The country’s modernization initiatives, foreign investment and higher demand for healthcare services have all supported the sector’s rapid growth during the last decade. Turkey’s solid economic growth also played an important role in this performance. At that time the Turkish economy posted an average growth rate of 4.5%, while per capita income rose to 10,504 USD in 2014, from 3,492 USD in 2002. Between 2003 and 2012, pharmaceutical sales posted a CAGR of
around 10%. Pharmaceutical expenditure is expected to reach $6.6 billion USD in 2015, a rise of 3.5% compared to 2014, while healthcare expenditure is expected to increase by 6.4% (to $19.8 billion USD), according to the BMT. The major reasons behind this increase are the aging population, higher average life expectancy and cost of healthcare services. Costas assesses Turkey’s pharmaceutical risk level as low. The value chain in the pharmaceutical sector begins with discovery and R&D activities. This phase includes drug formulation and adjustments, applications for registration and patent registrations. As this requires heavy investments, equivalent to billions of dollars, Turkey does not currently focus on this level. The second phase of the value chain concerns the production of raw materials. According to data from Invest in Turkey, as of 2012, there were 10 companies and 12 raw material production facilities involved in this phase. Turkey has a large population, the population is aging, access to healthcare is attractive for foreigners since this is a cyclical sector. Turkey is among the strongest economies in the world and the government has decided to increase its budget allocation for research and development (R&D) activities to 4% of GDP. The health care expenditure is expected to reach 8.6 billion USD by 2015, a rise of 3.5% compared to 2014. The aging population, higher average life expectancy and cost of healthcare services are the major reasons behind this increase.

This strong production capacity, coupled with a young and skilled workforce, attracts foreign companies into Turkey. According to official figures, merger and acquisition (M&A) activities totaled 17 billion USD between 2006 and 2012. Turkey’s growing population, which enjoys easier access to the healthcare system, has supported the arrival of international pharmaceutical companies.

The government’s healthcare transformation programme, initiated in 2003, has played an important role in easing citizens’ access to healthcare services (with an estimated 44 million citizens since 2005). Within the transformation programme, the government reduced VAT on drugs from 18% to 8%. In 2012, the government placed the pharmaceutical sector on the “priority list” of investments its incentive programme. Moreover, as Turkey, needs to strengthen its added value products, the government has decided to increase its budget allocation for research and development (R&D) activities to 4%, by 2023. This budget ratio stood at 0.39% in 2013, up from 0.48% in 2003 but still below that of countries such as Russia (1.1%), Czech Republic (1.9%) etc.

The high level of competition in the generic drug segment is also putting pressure on prices and negatively affecting profitability. This may lead to equity problems, particularly for local firms. In parallel, the pharmaceutical sector needs increases in operating capital increases, as companies seek to maintain existing production capacities while investing in new technologies. In summary, the burgeoning regulatory environment and complex procedures represent restrictive factors in order to make the sector attractive to international companies. The still relatively low per capita healthcare spending suggests that the market continues to offer opportunities for investors. The expansion of insurance coverage and the population increase support the sector’s outlook. As the currently, young, population grows, there may be an increase in demand for healthcare services. Turkey is among the strongest economies in the world and the government has decided to increase its budget allocation for research and development (R&D) activities to 4% of GDP. The health care expenditure is expected to reach 8.6 billion USD by 2015, a rise of 3.5% compared to 2014. The aging population, higher average life expectancy and cost of healthcare services are the major reasons behind this increase.

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around 10%. Pharmaceutical expenditure is expected to reach 8.6 billion USD in 2015, a rise of 3.5% compared to 2014, while healthcare expenditure is expected to increase to 18.5 billion USD, according to the BMI. The major reasons behind this increase are the aging population, higher average life expectancy, and increased healthcare services. Coface assesses Turkey's pharmaceutical risk level as low.

The value chain in the pharmaceutical sector begins with discovery and R&D activities. This phase includes drug formulation and adjustments, applications for registration and patent registrations. As this requires heavy investments, equivalent to billions of dollars, Turkey does not currently focus on this level.

The second phase includes the production of raw materials. According to data from Invest Turkey, as of 2012, there were 10 companies and 12 raw material production facilities involved in this phase.

The third phase includes the production facilities being located in Istanbul. The wholesale phase includes warehouse management, storage, control of lots and serial numbers. Around 200 companies actively operate in this phase in Turkey. Their main role consists of selling drugs to pharmacies.

Retailing, in the final phase, includes the pharmacies which sell the drugs to consumers. In Turkey, there are more than 24,000 pharmacies, so it is a very fragmented market.

The major client for pharmaceutical products in Turkey is the Social Security Institute, which purchases around 90% of its drugs. The remaining 10% is sold to the private sector. This phase has reduced the possibilities for pharmaceutical companies to negotiate prices. As a result of this pressure on prices, pharmaceutical companies have seen their profit margins narrowing. On the other hand, the euro exchange rate within the reference pricing system has been fixed to 15955 liras since 2009. Although the exchange rate has not changed since 2009, the exchange rate applied currently is 19595 liras since 2009. The exchange rate applied currently is 19595 liras; although the actual rate is above 3. Producers have increased limits for pharmaceutical expenditures and set these reference prices, thus increasing the need for capital. That’s why companies are focusing on R&D expenditures. Profit margin has depleted too. Now, there are not many opportunities for pharmaceutical companies with profit on balance sheet. This is affecting profitability. This may lead to equity issues and potentially affect growth, as companies seek to maintain existing production capacities while investing in new technologies.

In summary, the burdensome regulatory environment and complex procedures represent restrictive factors to make the sector attractive to international companies. The still relatively low per capita healthcare spending suggests that the market continues to offer opportunities for investors. The expansion of insurance coverage and the population increase support the sector’s outlook. As the currently young, populous country, there may be an increase in demand for healthcare services. Turkey is among the strongest economic growth engines in the region and it offers a good knowledge base, an efficient infrastructure and proximity to strategic markets for investors.

Our current situation is indeed the expansion of the process that started in 2009, when the Government introduced the practice of global budgeting in pharmaceuticals, introduced limits for pharmaceutical expenditures and set these limits on a yearly basis. In Turkey, pharmaceutical prices are referenced in Euro. But the exchange rate has not changed since 2009. The exchange rate applied currently is 19595 liras; although the actual rate is above 3. Producers have increased limits for pharmaceutical expenditures and set these reference prices, thus increasing the need for capital. That’s why companies are focusing on R&D expenditures. Profit margin has depleted too. Now, there are not many opportunities for pharmaceutical companies with profit on balance sheet. This is affecting profitability. This may lead to equity issues and potentially affect growth, as companies seek to maintain existing production capacities while investing in new technologies.

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healthcare services is expanding. Turkey is geographically well-positioned and thus can make exports. As far as exports is concerned, Turkish pharmaceutical industry enjoys high quality of technology. Foreign companies choose to buy at low prices and don't mind suffering losses for a few years considering that they can make profits later on. Turkish investors do not have the capacity to fund this any more, as they have run out of money.

How would reference pricing system be affected if Greece leaves Euro?

The reference pricing system originally included five countries, but then it was increased to 27 by a decree. No body remembers this. The Government is keeping these five countries as reference countries. But it can replace countries, as it wishes. It can increase the number of countries from five to ten as it wishes. Therefore I believe the system would not be affected if Greece leaves Euro.

How do social security deficits affect the industry in Turkey?

I do not think this would affect the industry. The budget for pharmaceuticals is defined approximately 17 billion TL for 2015. You mentioned that India had increased its exports share more than Turkey did. How do Turkey’s pharmaceutical export dynamics function?

Pharmaceutical exports differ from other exports. You can find them everywhere. This is understandable. But you must get a license to sell a pharmaceutical product in a given country. The Government must permit. This applies to each and every pharmaceutical product and each formula. For instance, Germany comes and sees the place of production allowing a license for a pharmaceutical product, and allows it to be sold if it conforms to standards. This process takes 25 - 3 years on average. Therefore pharmaceutical export is actually more difficult than how it seems like. The length of this process causes loss of competitiveness. India made progress in exports because Turkish pharmaceutical industry could not open out to external markets due to lack of innovation. Industry must focus on innovation front, i.e. research front. But the capital accumulation needed to do this has been depleted.

What can you tell about licensing and intellectual and industrial property rights in the industry?

Licensing process in Turkey is neither faster nor slower than the process in other countries. According to the EU licensing rules, this process takes approximately 210 days. Turkey also follows the EU, but there was no authority issuing a license within 210 days in the EU. There was only a line in Turkey as well. I mean, this is not an issue specific to Turkey. From the perspective of protecting intellectual property rights, there is a patent dearth adopted by Turkey. It was issued in 1996. How it is due to the amended. There is a conflict of interest between government and private companies. Generic companies want the protection period to be shorter, whereas originator companies want it to be longer. But I do not think there is a problem in this regard in Turkey. What are the opportunities in the industry?

There are still great opportunities. There are opportunities in the domestic market, but export opportunities are much greater. Turkish pharmaceutical industry must focus on opening up to external markets, there are regions with huge potential, such as Africa. Pharmaceutical consumption is higher where population is higher. Turkish pharmaceutical industry has one of the lowest unit costs in the world. Therefore, it can be competitive in African market. Furthermore, the industry must focus on innovation front, i.e. research front. But the capital accumulation needed to do this has been depleted.
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How would reference pricing system be affected if Greece leaves Euro?

The reference pricing system originally included five countries, but then it was increased to 27 by a decree. No body remembers this. The Government is keeping these five countries as reference countries. But it can replace countries, as it wishes. It can increase the number of countries from five to ten as it wishes. Therefore I believe the system would not be affected if Greece leaves Euro.

How do social security deficits affect the industry in Turkey?

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You mentioned that India has increased its exports share more that Turkey did. How do Turkey’s pharmaceutical export dynamics function?

Pharmaceutical exports differ from other exports. You can sell a product after issuing a license for a pharmaceutical product, and allows it to be sold if it conforms to standards. This process takes 2.5 - 3 years on average. Therefore pharmaceutical export is actually more difficult than how it seems like. The length of this process causes loss of competitiveness. India made progress in exports because Turkish pharmaceutical industry could not open up to external markets due to the attractiveness of domestic market between mid-1980s and early 2000s. It hid its head in the sand. If we had set the target of becoming a global actor since the outset, we could be twice as big as India today. This is a fault of our Government. If we had set the target five to ten as it wishes. Therefore I believe the system would not be affected if Greece leaves Euro.

What is the most immediate targets. But the largest pharmaceutical market in the world are constant: US, EU and Japan. You have to export to these markets if you want to make money on exports. There is some export to EU. There is no export to Japan. Mustafa Navbaz used to export to the US in the past, but it also stopped now.

Who are the risky actors in the sector?

If pharmaceuticals face a congestion, the sector would face a congestion downstream in any case. WE saw its examples in the past, during mid and late-1990s, during Financial crisis, etc. This is because pharmaceuticals sell also to the government. In Turkey the end user of pharmaceuticals is the government. Pharmacy is just an intermediary. When a pharmacy sells a pharmaceutical, the end user pays for the contribution share. Then the pharmacy sends the prescription to the social security institution, and SGK pays the money to the pharmacy in a given term. If this chain is congested, the pharmacy cannot pay to the warehouse, and in turn the warehouse cannot pay to the manufacturer. Therefore, the primary actors in value chain are the manufacturers and government in Turkey. All other actors along the chain are intermediaries. There have been significant delays in payments recently. Government mostly pays in time.

What can you tell about licensing and intellectual and industrial property rights in the industry?

Licensing process in Turkey is neither faster nor slower than the process in other countries. According to the EU licensing rules, this process takes approximately 210 days. Turkey also follows the EU, but there was no authority issuing a license within 210 days in the EU. This is a political target in Turkey as well. I mean, this is not an issue specific to Turkey. From the perspective of protecting intellectual property rights, there is no difference for sectors with a higher value such as Turkey. It was adopted by Turkey. It was issued in 1995: How it is due to the amended. There is a conflict of interest between originator and generic companies. Generic companies want the protection period to be shorter, whereas originator companies want it to be longer. But I do not think there is a problem in this regard in Turkey.

What are the opportunities in the industry?

There are still great opportunities. There are opportunities in the domestic market, but export opportunities are much greater. Turkish pharmaceutical industry must focus on opening up to external markets, there are regions with huge potential, such as Africa. Pharmaceuticals is closely linked to demographics. Pharmaceutical consumption is higher where population is higher. Turkish pharmaceutical industry has one of the lowest unit costs in the world. Therefore, it can be competitive in African market. Furthermore, the industry must focus on innovation front, i.e. research front. But the capital accumulation needed to do this has been depleted.

Conclusion

The robust growth in the US economy, the Fed’s exit strategy and the questionable easing program of the ECB, the global economy is entering into a new era. Amid these new economic conditions, the Turkish pharmaceutical economy faces new challenges as it struggles to keep its growth performance as solid as in the past. The continued appreciation of the lira since the second quarter of 2014 has deteriorated the financial performance of companies who do not have efficient cash flow management systems. This, in turn, has negatively affected their payment performance. This chain of circumstances increases the risk of insolvencies. Concerns about the outcome of the general election in June 2015, the fragile recovery in Europe and rising tensions in the region are adding to this challenging environment.

The ability to produce higher added value products in order to increase export revenues is another challenge for the Turkish economy. Increasing the market diversification and sophistication of exports have become important subjects for Turkey. In the current circumstances, risks seem to be increasing across all sectors. Coface has increased the risk levels. Risks are higher in sectors such as food, metal and clothing sectors. Additionally, exporters with euro exposure are also subject to higher risks. The textile and clothing sectors are among the most affected by the recent developments in the global economy. They are also affected by rising regional tensions. Coface has increased the textile sector risk assessment to high-risk level from sound fundamentals. Coface assesses the risk level of this sector as low.