ABN·AMRO

Turkey Watch

Group Economics
Emerging Markets Research

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Early elections and building vulnerabilities

- **High economic growth leads to signs of overheating**
- **Early elections in June as Erdogan aims to capitalize on economic momentum**
- **Lira continues to weaken as central bank remains largely accommodative**
- **External vulnerabilities are building, with Turkey first in line to take a hit from changing investor sentiment**
- **We expect no major economic changes after the snap elections**

On 4-6 April, we visited Istanbul and Ankara to hold meetings with economists, political analysts, bankers, journalists, government officials, representatives of rating agencies and the Dutch consulate. This publication presents our key findings.

Economic growth stimulated by the government…

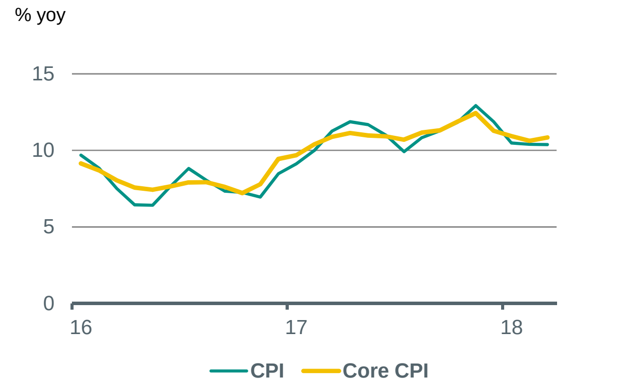
Despite general market stress during the failed coup in 2016, the economy has proven remarkably resilient over the last few years. Real GDP growth picked up to 7.4% in 2017 from 3.2% in 2016. Last year's growth pick-up mainly reflected stronger consumer spending and investment, fuelled by a government-backed Credit Guarantee Fund (CGF) loan scheme, employment incentives and tax cuts. So far, this programme has been responsible for about TRY250bn (around USD50bn) of credit. Since CGF enables banks to offer loans more easily, with the risk transferred to the government, it has substantially increased bank lending to the corporate sector. Credit growth has increased, from 10% yoy just after the failed coup in 2016, to a current level of around 21% yoy. This has created a sharp recovery in credit growth, from 10% just after the failed coup to above 20% yoy now. According the IIF, the CGF contributed roughly 2 pps to last year's 7.4% GDP growth.

… and signs of overheating are widespread

Headline inflation has exceeded 10% for eight consecutive months and the current account deficit is widening. Inflation reached its peak of around 13% at the end of 2017 and then stabilized just above 10% in the beginning of 2018. The combination of a weak lira (higher import costs), rising domestic demand and higher oil prices is preventing inflation from dropping towards the 5% target set by the Central Bank of Turkey (CBRT). Alongside high inflation, external vulnerabilities are growing. The current account deficit widened to 6.2% of GDP at the beginning of 2018, compared to an average of 5.5% in

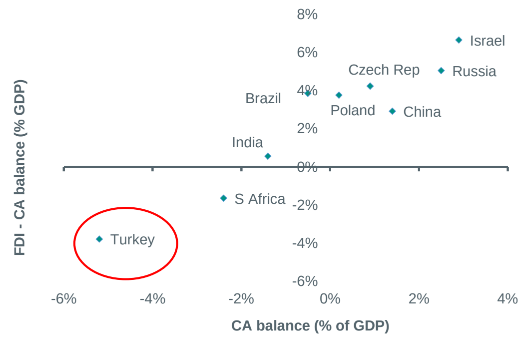
2017. Much of the widening in the current account deficit reflected a nearly 6% terms of trade loss, due to higher oil and gold prices. The larger current account deficit was accompanied by a rise in non-resident portfolio inflows, which increased Turkey's reliance on volatile short-term capital inflows. Already a very large share (70% in 2017) of the current account deficit is financed by short-term portfolio flows. As a result, Turkey is highly exposed to a change in investor sentiment.

Inflation in double-digit territory



Source: Thomson Reuters

CA funding shortfall worrisome



Source: Bloomberg

And now, snap elections

After repeatedly rejecting speculation about early elections, on 18 April Erdogan called for snap elections, which will take place on 24 June 2018 instead of the end-2019. The vote will complete the transformation of the political system and strengthen the president's role**.** According to Erdogan, snap elections were necessary to overcome uncertainties in the midst of developments in the region and the cross-border operation in the north of Syria. However, it is more likely that Erdogan wants to capitalize on the economic momentum of high growth and a vastly declining unemployment rate to solidify his power base. As the elections are only two months away, Erdogan has left little time for opposition parties to organize and campaign. According to a poll done by the government, Erdogan support stands at 55.6%. However, another poll released yesterday, showed that it will be hard for the incumbent President Erdogan to secure a majority (>50%) in the first round. In a second round, it will be a neck and neck race between Erdogan and Aksener (from the Good Party).

Growth will remain strong

The Turkish government expects a growth rate of 5.5% in 2018, whereas most market participants expect growth to be around 4.5%. For the government, this summer's snap elections are key. It became clear in 2017 that the government is absolutely committed to fostering growth and decreasing unemployment, and would rather overshoot than undershoot its growth target. We think the government will continue to stimulate the economy in the run-up to the presidential elections. Furthermore, while the TRY250bn CGF has been largely utilized, there will be a positive lagged effect in investment activity. Moreover, the government will continue to roll over the loans provided by the fund, thereby making enough liquidity available to the market. In light of these events, we adjusted our 2018 growth forecasts upwards, from 4.5% to 5%.

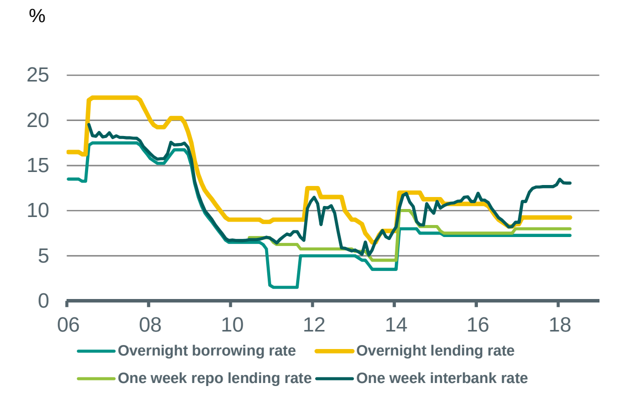
Turkey's rising external vulnerabilities are reflected in the lira
The Turkish lira has been among the weakest performing emerging market currencies so far this year. It has declined by 6% versus the US dollar and by 8% versus the euro. The main reason for its weakness is that investors are shying away from the currency due to the perception of higher Turkish political risks. Since the start of 2018, Turkey's CDS has increased 33%, from 155 to around 200. Moreover, higher 10y US Treasury yields, volatile stock markets and geo-political tensions have also weighed on the lira.

We expect the Turkish lira to remain under pressure because investors are questioning the policy measures taken by the government. Indeed, in light of the snap elections, the lira may show more volatility. Moreover, investors don't appreciate the grip that the government seems to have on the Central Bank of Turkey (CBRT). Investors will continue to test the CBRT on how far the lira can decline before rates are increased. We think it is unlikely that we will see any significant hike before Q4. Furthermore, the lira remains highly vulnerable in an environment marked by a tighter Fed policy and an uncertain geo-political framework. Our year-end 2018 forecast remains USD/TRY 4.20.

Lira continues to weaken against the dollar

Source: Thomson Reuters

Monetary policy will remain largely accommodative



Source: Thomson Reuters

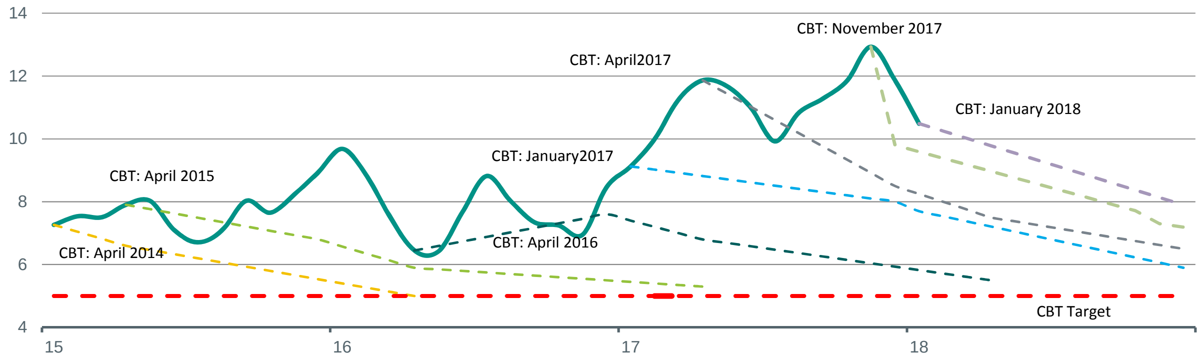
Central bank will continue to disappoint
Despite signs of overheating, the challenging external financing and inflation outlook, the CBRT has kept all its rates unchanged since December[1] (the average cost of funding stands at 12.75%). Following the depreciation of the lira, CBRT Governor Cetinkaya reassured markets on 12 April that the CBRT may tighten, if necessary. This prompted some market participants to increase their forecast of interest rate hikes at the monetary policy committee meeting on 25 April. The market expects an interest rate hike between 50-100 bp. We have a 50/50 scenario of a small rate hike (25bp) or no rake hike.

[1] The late liquidity window interest rate at 12.75%, the one-week repo rate at 8%, the over-night lending rate at 9.25%, and the overnight borrowing rate at 7.25%.

We think the central bank will announce only a very small (25 bp) rate hike. As the lira is recovering from its low against the dollar on 11 April, and inflation has been hovering around 10% since the beginning of the year, we expect the CBRT does not feel a sharp hike is necessary. Over the years, the central bank has persistently underestimated the inflation outlook (see graph below), and never reached its inflation target. Moreover, it is well-known that the CBRT's policy is politically motivated. Therefore, ahead of the presidential elections we believe the government wants to avoid any strong tightening.

Inflation projections by the CBRT are often somewhat optimistic; their target hasn't been met for many years

Green line: real headline inflation, dotted lines: CBRT inflation forecasts



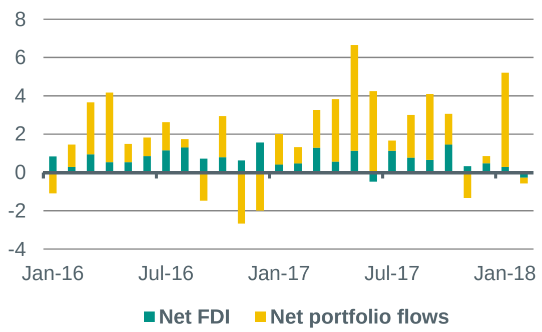
Source: TCMB and ABNAMRO Group Economics

Weak, weaker, weakest…

Turkey has a relative high current account deficit (around 6.2%), financed mainly by short-term portfolio flows (around 70%). External debt has increased, nearly doubling in absolute terms over the past 10 years to a current level of around USD450bn (53% of GDP). The corporate sector's foreign currency debt (around 40% of GDP) is rising as the lira continues to weaken. The net foreign debt stands at USD222bn. While total gross FX reserves are mediocre at around USD90bn (approx. four months of import), the net FX reserves are estimated to be around USD26bn. However, it is unclear how much of these net reserves are liquid, as a substantial proportion is held in FX holdings in commercial banks. A weaker economic structure, combined with tightening by western central banks and higher energy and commodity prices, is a toxic cocktail for investments in Turkey (see also: Turkey Watch: on the eve of change).

Current account deficit financed by portfolio flows

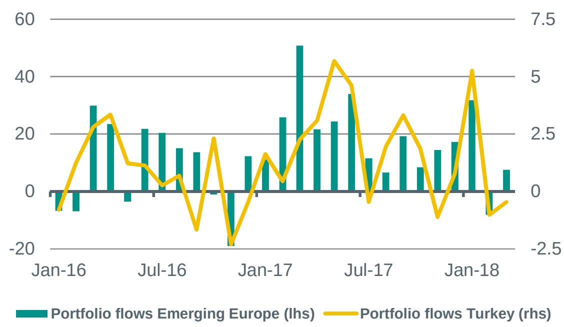
USD billions (data until February)



Source: Thomson Reuters

Portfolio inflows to Turkey more volatile

USD billions



Source: IIF

… but no immediate crisis

Despite these vulnerabilities, we do not anticipate a crisis scenario, at least in the short term. Underlying our scenario are the following assumptions:

- While normalisation by the Fed poses a risk, its cautious approach and reliable forward guidance are dampening shocks in the market as hikes are already priced in.
- Relative to its peers, Turkey has a well-developed financial market and bank regulations adhere to Basel III standards. This factor helps mitigate liquidity risks.
- Dollarization of the real economy is higher than the numbers may suggest. Households and SMEs hold FX reserves which are not included in the official figures. Furthermore, the government has acted to reduce the corporate sector's short FX position. On 25 January, the government announced amendments to Decree No. 32[2], which severely limits the ability of Turkish companies to borrow in FX. The decree, which comes into force at the beginning of May, especially focuses on companies in the non-export sector.
- Strong growth figures in 2018 will continue to lure investors who seek higher yields.

It should be noted that the loss of investor confidence continues to pose a risk for Turkey. This risk is especially relevant in the current unstable geopolitical environment. The situation is not helped by the increasing recriminations in US-Turkey relations revolving around the conflict in Syria, US and Western support for the Kurdish Democratic Union Party (PYD), Halkbank's circumvention of sanctions against Iran and Turkey's sustained backsliding on democratic norms. Some US senators also threaten to impose sanctions on Turkey over the imprisonment of the US pastor Brunson. Given that (geo)political uncertainties are building, foreign investors may become less complacent and Turkey would be first in line to bear the consequences.

[2] Decree No. 32 on the Protection of the Value of Turkish Currency.

Long-term outlook is bleak

The question arises what will happen *after* the presidential elections. The market reacted positively to the announcement of snap elections. The lira gained almost 2% against the dollar, while CDS spreads declined to under 200. Investors appear to be hoping that after the elections, the government will roll back efforts to promote growth at the expense of increasing vulnerabilities. Furthermore, investors anticipate that after the elections, the political pressure on the CBRT will abate. We are not convinced that such a normalisation will actually take place. Economic growth and job creation will remain the key anchor of AKP economic policy. Furthermore, Erdogan has continuously stated that higher interest rates lead to higher inflation. Whether or not he really believes this, he seems to consistently act upon this assumption, thus decreasing the likelihood of higher rates. In the past, deputy prime minister Simsek, who is seen as more 'investor-friendly', has often balanced Erdogan's views by promoting rational economic theory. However, according to political analytics, Simsek's position has weakened. It remains to be seen whether Simsek will continue to have the political leverage to openly question Erdogan's economic policy after the elections.

Key forecasts for the economy of Turkey

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	6.0	3.3	6.5	5.0	4.0
CPI inflation (% yoy)	7.7	7.8	11.1	10.5	8.5
Budget balance (% GDP)	-1.0	-1.1	-1.5	-2.0	-2.5
Government debt (% GDP)	29	29	29	28	28
Current account (% GDP)	-3.7	-3.8	-5.5	-5.0	-5.0
Gross fixed investment (% GDP)	29.7	29.3	30.0	30.2	29.9
Gross national savings (% GDP)	28.4	28.2	30.5	29.4	28.9
USD/TRY (eop)	2.9	3.5	3.8	4.2	4.0
EUR/TRY (eop)	3.2	3.7	4.5	5.0	5.2

Economic growth, budget balance, current account balance for 2018 and 19 are rounded figures
Source: EIU, ABN AMRO Group Economics