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Turkey in crisis – Q&A

Nora Neuteboom
Emerging Markets Economist
Tel. +31 (0)20 343 77 31
Mob: (0)639 687 836
Nora.neuteboom@nl.abnamro.com

- **Despite high growth numbers, Turkey's vulnerabilities are growing**
- **Turkey has survived the latest currency crisis…**
- **… but we expect further pressures on the currency after the elections**
- **We do not anticipate a foreign debt crisis scenario**
- **Given the clear signs of overheating, the slowing of the Turkish economy is inevitable…**
- **… we expect a substantial slowdown and adjusted our growth forecast for 2019 to 2%**

Why is Turkey hit?

Turkey is generally seen as one of the most vulnerable emerging markets. While Turkey still has very high GDP growth figures (7.4% in 2017), underneath there are several weaknesses such as high inflation, low productivity gains, large external vulnerabilities and political uncertainty (such as the upcoming Presidential elections June 24). It suffers from a 'twin deficit'; both a fiscal and current account deficit. Furthermore, the country depends heavily on foreign capital, making it very vulnerable to a 'change of mood' of investors.

What sort of 'crisis' are we talking about, when we say Turkey is in crisis?

Multiple, as *crisis* is not a word that has a strict definition. Turkey is generally mentioned in relation to three crisis scenario's (see table on page 5); (1) a currency crisis, (2) an external debt crisis and (3) an economic crisis (or recession). Below we will outline the different scenario's.

(1) Currency crisis

First of all, Turkey has faced a *currency crisis* over de past months, which was characterised by a sharp depreciation of the Turkish lira against the dollar. The crisis started on the back of the strengthening dollar and rising US interest rates (see chart on page 5). With interest rates in the US rising and a loose monetary policy in Turkey, carry trades became less attractive. This incentivised investors to wind down their more risky Turkey exposures (EM Watch: Singling out the weakest links). This resulted in a sharp drop of the lira against the dollar. In response the Turkish Central Bank (CBRT) decided to take action by sharply increasing interest rates at the end of May and making their monetary policy framework more transparent. Higher interest rates should help to bring back foreign capital to Turkey and to support the exchange rate (See: Turkey Short Insight: From fragile to failing?).

Will we see another currency crisis in Turkey?

On May 24, the CBRT have taken serious step to curb the falling lira (for the exact details see: Turkey Watch: TRY again). They took further steps on June 7 (125bp hike). By taking these steps, the CBRT has showed they are willing to take action, despite political pressures from

President Erdogan to keep interest rates low. This boosted confidence, reflected in an appreciating lira (around 7% since May 24). However, higher interest rates do not solve the underlying issues that Turkey is facing, such as high inflation (12.2%) and a high current account deficit (around 6.5%).

While we think that for the near future pressures on the lira have eased, another currency crisis cannot be excluded. Especially if Erdogan wins the Presidential elections, thereby acquiring more executive and legislative powers, we may see another speculative attack on the lira as the independence of the central bank will again be questioned. In this case, the CBRT will again be forced to act by increasing interest rates (one-week repo rate), which will likely be enough to prevent Turkey from sliding into an external debt crisis.

(2) External debt crisis

Secondly, markets speculate on an *external debt crisis,* which basically means that Turkey reaches a point where it cannot (or doesn't want to) meet its payment obligations to foreign debt holders. Turkey has a generally good track record considering debt crises, as its last sovereign debt crisis occurred in 1978 (note: in 2001 Turkey needed help by the IMF, which may also be counted as a 'technical default'). Often, a currency crisis preludes a sovereign debt crisis, as a sharp depreciation of the currency increases the total burden of foreign currency debt.

Will we see an external debt crisis in Turkey?

While Turkey's external debt is also not extremely high (52% of GDP), it does have high external financing requirements. Turkey's annual external financing requirements – reflecting the current account deficit and the maturing debt – sits at USD 200bn (around 24% of GDP). Turkey can finance this shortfall by attracting investments. In 2017 75% of the shortfall was financed by short-term portfolio flows, i.e. 'hot money'. FX reserves are around USD 80bn (liquid reserves are estimated to entail only around 50% of the total reserves). If investors at some point feel the investment return doesn't justify the risk, they will stop providing FX funding to Turkey (i.e. stop to provide loans to the public and private sector and refuse to buy Turkish sovereign bonds). In that case, Turkey will not be able to meet their obligations on their external debt.

Due to the deterioration of Turkey's external position, CDS-spreads (5y) have increased sharply since April this year to a current level of 280bp. Moreover, the rating agencies have, over the past half year, systematically downgraded Turkey from investment grade to junk. Yet, for the foreseeable future we do not anticipate an external debt crisis scenario. In other words, we believe that investors will continue to fund Turkey's external financing requirements (see also: Turkey Watch: Early elections and building vulnerabilities). Underlying our view are the following assumptions:

1. While normalisation of US monetary policy poses a risk, its cautious approach and reliable forward guidance are limiting the risk of shocks in the market as hikes are already priced in. Moreover, the Fed tightening is on the back of strong US and global growth, benefiting Turkey's export sector.
2. Related to the previous point, Turkey is always singled out as one of the weakest links in times of broader pressures on EMs. However, we expect pressures to ease in the remainder of the year (see EM Watch: Singling out the weakest links), which will also take some heat of Turkey.

3. We expect some temporary weakness in commodity prices, especially in oil and precious metal prices, improving Turkey's current account balance.
4. Relative to its peers, Turkey has a well-developed financial market and bank regulations adhere to Basel III standards. Also, banks have decent foreign currency buffers (due to the ROM-mechanism by the CBRT). Moreover, some large Turkish banks have foreign parents, which mitigates dollar liquidity issues.
5. As mentioned before, in case of renewed pressures on the lira, we think the CBRT will again act by increasing interest rates, preventing Turkey from sliding into an external debt crisis.

(3) Economic crisis

Thirdly, some fear that Turkey may face an *economic crisis or recession* going forward. An economic crisis is characterised by falling GDP - two quarters of negative GDP growth when economists call officially a recession -, drying up of liquidity and increasing unemployment. An economic crisis is not triggered by one factor, but often a combination of factors (see chart on page 5). Often a period of 'overheating' – usually fuelled by credit growth - is followed by a period of contraction. Furthermore, countries that face a domestic or external debt crisis are more prone to get into a recession as confidence weakens and the public/private sectors start to deleverage.

Will we see an economic crisis in Turkey?

Turkey has seen a severe crisis in 2001 and another downturn in 2009 during the global financial crisis. In the third quarter of 2016 Turkey experienced negative GDP growth as a result of the failed coup. However, due to strong fiscal stimuli, such as the relaxation of macro prudential policies (lowering provisioning requirements for loans) and the set-up of the Credit Guarantee Fund (CGF), Turkey saw a quick revival of growth. On the flipside, clear signs of overheating have appeared as Turkey printed 7.4% GDP growth over the course of 2017 and again 7.4% in the first quarter of 2018. Inflation continues to trend far above the 5% target of the Central Bank's: 12.2% in May this year. Credit to the non-financial sector has increased by around 30% from 3Q2016 until 4Q2017 according to BIS data and is estimated to have risen even further into the first quarter of this year.

Growth in 2018 is projected to remain strong, around 5% (we are above consensus), on the back of fiscal stimuli and the continuation of the GCF. However, we think growth have peaked in the last three quarters and will substantially slow going into 2019. While a recession is not our base case scenario, we believe that, given the clear signs of overheating, the slowing of the Turkish economy is inevitable. Therefore, we have adjusted our growth forecasts down from 4% to 2% in 2019. The first cracks in the system are already visible. Property prices are declining in real terms. A broader definition of impaired loans - including restructured credits and NPLs sold to third parties – currently stands at 8% of all loans, signalling deteriorating loan quality. Furthermore, according to the latest article IV report by the IMF, there are clear indications that most of the outstanding CGF-backed loans has been used for working capital and rolling over existing debt, instead of productive investment. The combination of higher interest rates (one-week repo stands at 17.5%) and the CGF almost depleted, credit growth will slow substantially, leading the way for slower growth.

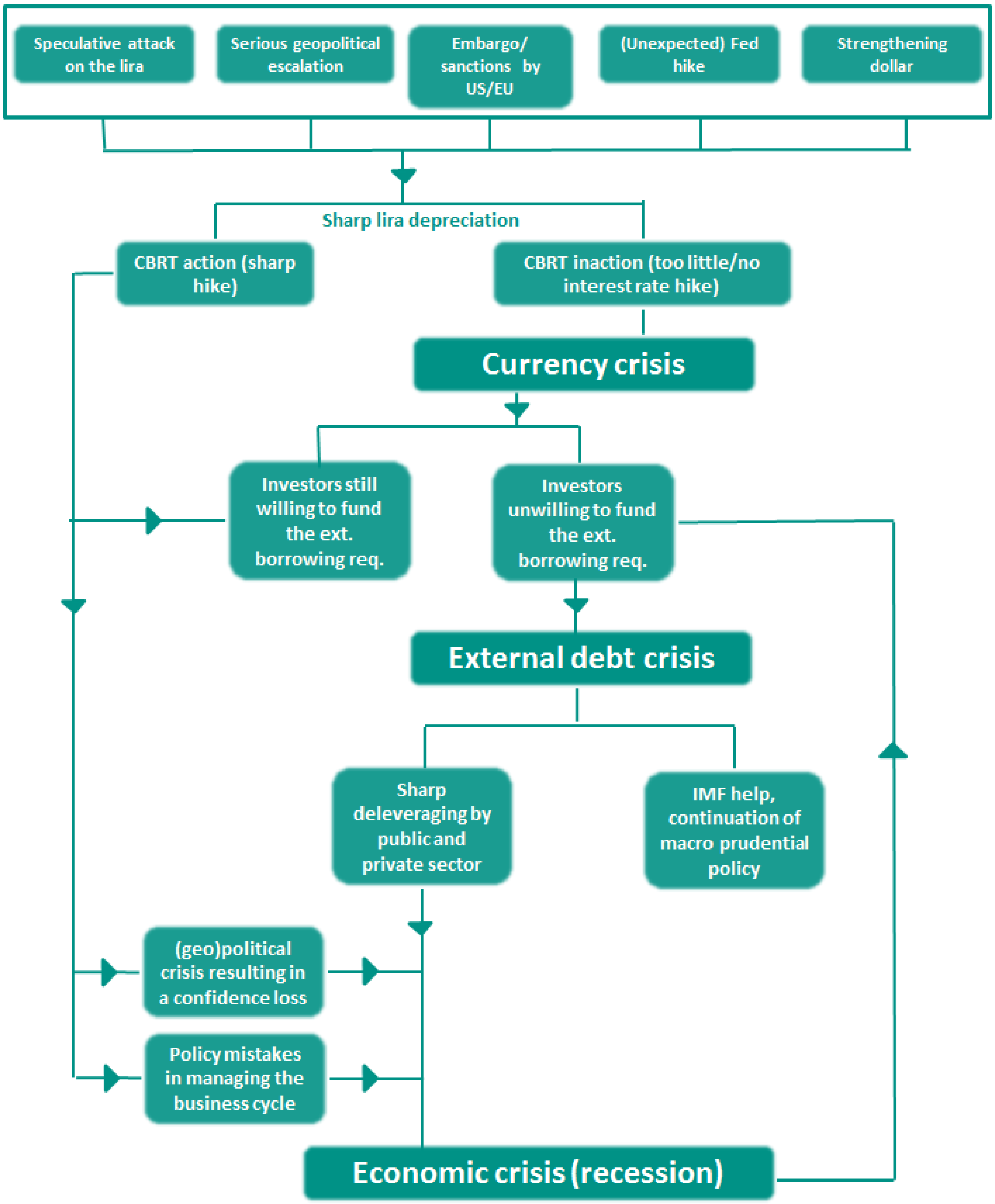
That said, as also shown in the chart on page 5, (geo)political events and policy mistakes could potentially trigger a full-blown recession. In the case of Turkey, we are especially worried about the latter. Turkey has to recalibrate macroeconomic policies in such a way that it reduces the vulnerabilities, without pushing the economy into crisis. Such 'gradual slowdown' requires delicate economic policy making. The elections on June 24 are expected to have an unstable outcome, as it is likely that Erdogan will remain President, while the AK-party will lose its majority in parliament. Erdogan is generally not considered as 'market friendly', and as economic policy making will be further hindered by a deadlock in the parliament, we think the process of gradual slowdown will be a tough one for Turkey.

Conclusion

Turkey's economic fundamentals are weak and we believe the economy is heading towards a substantial slowdown. Especially in the scenario where Erdogan will remain President in the upcoming elections, we believe it is likely that Turkey will face renewed pressures on the lira and an increased likelihood of a recession. Thus far, an (external) debt crisis is not in our base case due to some specific mitigating factors.

Chart 1 – *flow chart on possible crisis scenario's*

The five shocks at the top of the chart could individually or in combination with each other lead to a sharp lira depreciation



Key forecasts for the economy of Turkey

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	6.0	3.3	6.5	5.0	2.0
CPI inflation (% yoy)	7.7	7.8	11.1	10.7	8.8
Budget balance (% GDP)	-1.0	-1.1	-1.5	-2.2	-2.5
Government debt (% GDP)	29	29	29	28	28
Current account (% GDP)	-3.7	-3.8	-5.5	-5.0	-4.0
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	4.5	4.0
EUR/TRY (eop)	3.2	3.7	4.5	5.2	5.0

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