Facing contraction in 2019

- We foresee a prolonged period of subdued economic growth
- We expect growth of -1.5% in 2019 and 2.5% in 2020
- We see upside potential for growth in the event of clearer evidence of a rapprochement towards the West or if Turkey implements structural reforms
- We see downside potential if the central bank prematurely lowers rate, the Turkish banking system comes under pressure or tensions between the US and Turkey flare up again

Introduction

Turkey has been experiencing a decade-long, credit-led economic boom, largely funded by short-term portfolio flows from abroad, with strong domestic demand leading to a deteriorating of the current account deficit. In August the lira then started falling sharply on the back of growing tensions between the US and Turkey over the detained US pastor, Andrew Brunson. Given the high current account deficit and high inflation, investor sentiment towards the country turned negative. Fears then arose that Turkey would be unable to finance its external borrowing requirement and would need help from the IMF. The markets calmed down again in September after the diplomatic spat was resolved and the central bank of Turkey sharply increased interest rates. However, while the currency crisis has passed, the underlying vulnerabilities that caused this crisis have not fully disappeared. A continued fall in TRY loans indicates a sharp deleveraging, which will further weigh on investments (see graph). This, in turn, will put more pressure on the asset quality of banks’ balance sheets. With a weaker currency and continued high inflation, the Turkish economy is now heading towards a recession.
Turkey Watch – 18 December – Turkey to face contraction in 2019

Credit growth negative

Loans in TRY

Source: BSRA

Exchange rate panic is over

USD/TRY

Source:

Leading indicators point towards a contraction

GDP growth decreased from 5.3% yoy in the second quarter to 1.6% yoy in the third quarter. Although growth was supported by exports, which increased from 4.2% to 13.6% yoy in the third quarter, consumption slowed considerably and investments contracted for the first time since 2009. Going forward, an analysis of leading indicators points towards a contraction. Especially the indicators that have a high correlation with GDP growth, such as retail sales, consumer confidence and construction activity showing particularly significant deterioration (see graphs).

Leading indicators point towards slowdown

Business sentiment – construction sector

Retail sales WDA yoy %

Source: European Commission, Bloomberg

PMI dropped below 50 in early 2018

Purchasing Managers’ Index – Markit

Source: Bloomberg

After a recession in 2019 we expect subdued growth in 2020

Globally we expect conditions to remain neutral to supportive for EMs, depending on the extent to which the Fed continues to raise rates (we expect one hike in 2019, see: US Outlook 2019: Slowdown, not recession). Global growth is expected to ease marginally from its current levels to 3.5% (See: Global Outlook 2018: Slower but continued growth).

We have changed our view since our previous outlook (see: Turkey Watch: The crisis – a long time coming) and are now forecasting a prolonged period of contraction, albeit less steep than previously expected. We believe the recovery will be slow and that the trend
growth will not return until after 2020. Details of our 2019 and 2020 forecasts are set out below.

<table>
<thead>
<tr>
<th>Turkey growth outlook (% yoy)</th>
<th>2018: 3.5% yoy</th>
<th>2019: -1.5% yoy</th>
<th>2020: 2.5% yoy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
<td>Q4</td>
</tr>
<tr>
<td>7.2</td>
<td>5.3</td>
<td>1.6</td>
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For 2019, we have increased our forecast from -3% to -1.5%
We expect Turkey to enter recession in 2019, with three quarters of negative growth. The currency depreciation, in combination with high levels of inflation (21.6% yoy in November), will continue to slow consumption. We expect inflation to stay around 21% until mid-2019, before coming down swiftly to an estimated 12% in December 2019. Given the central bank’s most recent communication that it will maintain a tight stance for as long as necessary, we are assuming that the monetary policy rate will stay at 24%, at least until mid-2019. This should be sufficient to avoid a further depreciation of the currency and should create the conditions needed for a further improvement in market sentiment. While higher interest rates have stabilised the exchange rate and curbed inflation, they have also led to a sharp decline in credit growth and to negative investment growth. Given the increased impairments at banks and harder external financing conditions, we expect credit growth to remain subdued in the near term, thus depressing both investments and consumer demand.

That said, we expect some fiscal spending in the form of tax exemptions ahead of the local elections in late March, and this should be positive for growth. In the past few months, the government has taken various steps to prevent a sharp recession, including discounts on high-interest loans and regulatory forbearance to help banks deal with non-performing loans. Meanwhile the tight monetary stance will help prevent exchange rate volatility. Last but not least, the relationship with the West has improved following the release of Pastor Brunson and the support Turkey has received from Western countries in the Khashoggi case. So while the economy is heading towards recession, we have upgraded our forecasts for 2019 to a contraction of -1.5% instead of -3%, on the back of the action taken by the government and the improved sentiment towards Turkey.

For 2020 we expect 2.5% growth
We expect the recovery to start in the first quarter of 2020. By then, lower inflation will allow the central bank to reduce interest rates, thus stimulating the credit flow and therefore boosting investments. Lower inflation will also have a positive impact on consumer demand. Net exports, in turn, will make a positive contribution to the recovery as, providing geopolitical conditions remain supportive and no major security incidents occur, we expect exporting sectors to flourish, with companies possibly redirecting production towards Turkey. However, growth of 2.5% is still well below the trend growth (around 4%-4.5%). Given that Turkey will have to redesign its growth model from being credit-oriented towards focusing on productivity gains, we expect it will need some time to recover from the economic slowdown. The more subdued recovery will also help keep the current account deficit in check. This, together with the deleveraging process, will reduce Turkey’s vulnerability if investors become more risk-averse towards emerging markets.
Turkey Watch – 18 December – Turkey to face contraction in 2019

Sharp correction in imports; increase in exports

-80 -40 0 40 80
07 08 09 10 11 12 13 14 15 16 17 18
Export Import

Remarkable recovery in the current account balance

-12 -10 -8 -6 -4 -2 0 2 4
07 08 09 10 11 12 13 14 15 16 17 18

Source: Bloomberg

We see several upside and downside risks to our scenario, the most important of which are listed below:

Upside potential for growth:

1. **Rapprochement towards the West and renegotiation of the customs union**
   Negotiations on Turkey’s accession to the EU have continued over the past year, despite several diplomatic spats with individual EU members. These accession talks may create impetus for upgrading the customs union as, according to a 2016 evaluation conducted for the European Parliament, the agreement has become outdated. A new deal could provide for greater market liberalisation, not only in goods, but also in services and public procurements, in a spirit similar to the free-trade agreements concluded with South Korea and Canada. Turkey is also keen to see progress in discussions on a visa-free regime with the EU. Taking serious steps towards a revised customs union and visa-free regime could have a positive effect on sentiment towards Turkey and stimulate FDI inflows.

2. **Real evidence of structural reform**
   A well-structured fiscal package focused on structural reforms would create upside potential. A transparent plan to target Turkey’s rigid labour market and tax reforms to increase its total tax base would strengthen trust in policymakers and would probably also be well-received by the markets. Rumours have it that the IMF is assisting Turkey to navigate through its crisis, and this increases the prospects of structural reform.

Downside potential for growth:

1. **Turkish central bank lowers interest rates prematurely**
   We see the risk of a premature policy-loosening, which would ultimately result in another round of lira destabilisation. Given November’s lower than expected inflation of 21.6%, inflation may undershoot the central bank’s year-end target of 20.8%. Erdogan may also put pressure on the central bank to lower interest rates ahead of the local elections in late March. As the central bank wants to support growth by stimulating credit growth, it may decide to loosen monetary policy in early 2019. As we expect inflation to remain above 20% at the start of 2019, any such loosening will be perceived...
as premature and put further pressure on the lira. We consider the probability of this risk to be low, given that the central bank stated in its latest communication on 13 December that risks to price stability continued to prevail despite the recent improvement in the inflation outlook. The central bank also repeated its message that, if needed, further monetary tightening will be forthcoming.

2. **Turkish banks prove less resilient than expected**

   The tougher economic circumstances, tightening financing conditions and weakening of the lira will further increase the pressure on Turkish banks (see also: Turkey Watch: The crisis - a long time coming). Due to regulatory forbearance, capital ratios and NPL ratios are not accurately depicting the true quality of banks’ balance sheets. Any sudden liquidity-related issues at a large Turkish bank will therefore weaken confidence in the banking system as a whole and may undermine credit growth even further. The government may then find itself in the position where it has to provide a capital injection to a bank, and this may weaken the country’s fiscal position more than currently expected. If, in a highly unlikely scenario, trust between banks reaches a low point, this could trigger a banking crisis that would cause a more abrupt and pronounced economic crisis.

3. **New tensions between the US and Turkey**

   While the diplomatic spat with the US over Pastor Brunson has been resolved and the Khashoggi case has created some positive sentiment towards Turkey, the country’s relationship with the US remains unstable. This relationship will be tested by a number of issues in 2019. Firstly, there is the issue of US support for the Syrian Kurdish People’s Protection Units (YPG), which Ankara regards as a terrorist group related to the PKK. This, in turn, means an elevated risk of unintended escalation in Northern Syria. Secondly, Turkey’s intended purchase of the S-400 missile defence system from Russia defies US sanctions on Moscow and emphasises Turkey’s increasingly cosy relationship with President Putin. President Trump has consequently signed a law to prohibit the delivery of F-35s if Turkey follows through with this purchase. Thirdly, there is the matter of the Turkish state bank Halkbank, whom US authorities have accused of violating sanctions against Iran. While some positive developments were seen this week, with the US prosecutors withdrawing an appeal seeking to extend the sentence of a former Halkbank executive, nothing is yet known about the size of the fine Halkbank is facing.
### Key forecasts for the economy of Turkey

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
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<tbody>
<tr>
<td><strong>GDP (% yoy)</strong></td>
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<td><strong>CPI inflation (% yoy)</strong></td>
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<td>11.1</td>
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<td><strong>Budget balance (% GDP)</strong></td>
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<td><strong>Government debt (% GDP)</strong></td>
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<td>28</td>
<td>28</td>
<td>31</td>
<td>32</td>
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<td><strong>Current account (% GDP)</strong></td>
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<td>-4.6</td>
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<td><strong>Gross fixed investment (% GDP)</strong></td>
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<tr>
<td><strong>Gross national savings (% GDP)</strong></td>
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<td>6.1</td>
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</tbody>
</table>

Economic growth, budget balance, current account balance for 2019 and 2020 are rounded figures.

Source: EIU, ABN AMRO Group Economics