Turkey: recession on the horizon

- **2017 did not start well for Turkey:** New terror attacks and new purges are taking a toll on an increasingly polarised society. Continuing capital withdrawals and deteriorating confidence of businesses, investors, consumers and tourists are dragging down economic activity. As a result, the lira has fallen from one all-time low to the next. The strong US dollar, the rebound in oil prices and growing economic nationalism around the globe also do not help.
- **Turkey finds itself in an ever more fragile – if not critical – situation, politically as well as economically:** Our forecasts for Turkey mirror this. We expect Turkish economic activity to deteriorate substantially over the next few years, accompanied by a painful current account adjustment and probably more losses for the lira. Monetary policy is constrained in its capacity to support the currency. An aggressive tightening of monetary policy in an effort to support the lira would further weaken domestic demand.
- **Turkey faces a textbook emerging market problem:** On the one hand, there is a growing middle-class in Turkey, hungry for consumption. On the other, domestic savings and domestic production are insufficient and only partially meet the economy's needs. The result is a financing and production gap, which needs to be filled by foreign capital and imports. Almost all oil must be imported. The tourist industry, an important source of foreign exchange revenues, has suffered in the wake of terror attacks. At almost of 5% of GDP, the Turkish economy has one of the emerging world's biggest current account deficits.
- **The Turkish current account deficit makes Turkey dependent on global liquidity flows**, especially on US monetary policy. Turkey is therefore vulnerable to changes in investor sentiment that can lead to critical outflows of foreign capital. As a result, negative political headlines have frequently weighed on Turkish asset prices. This time, outflows have taken a toll on the lira.
- Unfortunately, many factors point to further downside risks for Turkey.
  1) **The US dollar has strengthened:** US inflation is on the rise and unemployment is very low – below 5%. We expect the US Fed to hike its interest rate three times this year. A "Trumpenomics" fiscal stimulus and reform, which markets expect to raise US GDP growth in the coming years, will support a strong dollar – adding further downside pressure to the lira.
  2) **The oil price has rebounded and is likely to stay close to current levels or rise slightly further:** OPEC and Russia have agreed to reduce their oil output. Although fracking in the US will contain the rise of oil prices, we do not expect a decline in oil prices as global demand strengthens. Turkey's substantial oil bill will get bigger, and it has to pay for it in scarce US dollars.
  3) **President Erdogan's remodelling of how Turkey is ruled carries dangers.**
     a) Erdogan wants to enshrine his extended powers in the constitution. To change the constitution, he needs the votes of the Turkish nationalist party, MHP. In return, the MHP wants a tougher stance against the Kurdish opposition, and especially against the Kurdish extremists. This, in turn, will fuel the already bloody conflict between the military and the Kurdistan Workers' Party, PKK, which could trigger not only more battles in the south-east of the country but may also go along with more attacks in major Turkish cities.
     b) The terror threat of the Islamic State, nurtured by Ankara's engagement in Syria, exacerbates the security risks for Turkey.
     c) The purges against all kinds of "opposition" as well as the general split in Turkish society between those for and against Erdogan add to domestic political tension.

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As a first negative result of the purges, entrepreneurs, businesses, investors, citizens and tourists are losing confidence in Turkey. They invest and spend less. That Erdogan has dismissed tens of thousands of highly trained individuals and jailed a significant number of putative opponents, has led to further frictions in society and the economy. Replacing those fired from public service will not be easy. Companies whose top executives were replaced for political reasons cannot be expected to perform better under new management. In addition, the erosion of checks and balances in the government will have a more long-term negative impact on the economy. The more power Erdogan concentrates in his own hands now, the less stable Turkey's transition of power will be when he leaves office one day.

4) **The central bank will not deliver what markets expect:** The central bank could – and indeed is likely to – raise interest rates next Tuesday, when the bank's next official rate decision is due. But markets look for a hike of at least a few hundred basis points to successfully support the lira. Turkish banks and businesses are already finding it harder to re-finance themselves. The Turkish lira LIBOR rates have already jumped over the last few days. A rate hike would worsen this situation. Furthermore, political pressure on the central bank to keep rates low has been very high – probably too high to expect a game-changing rise in rates. The monetary fine-tuning we are currently seeing (such as changes in the reserve requirements) is not going to be a game-changer either. In such a situation, even capital controls (perhaps in connection with anti-terror laws) cannot be ruled out. Such measures, however, would deter the foreign investment that Turkey relies on. Moreover, rising prices of oil and other commodities plus higher import prices via the weak currency will cause a surge in inflation. Any attempt to support the currency or the external balance is likely to worsen conditions in the domestic economy.

5) **The relationship between Ankara and Brussels could suffer further:** Turkey is far from becoming a full member of the EU, to put it mildly. The accession process helps to prepare a candidate country for EU membership. It typically inspires progress and leads to other advantages such as better EU market access. In the past, the desire to join the EU also helped to shape Turkish government policies positively. This is no longer the case. Ankara is now heading in the opposite direction. For example, Erdogan has mentioned in public speeches that he may want the death penalty back. If so, this would probably stop the EU accession.

All these factors raise the risk of aggressive capital flight and a painful external adjustment of the current account deficit. The weakening lira reflects the reduced willingness of foreigners to finance Turkey's excesses. The more the deficit has to narrow, the less that can be invested and consumed. Moreover, the declining lira makes imported inputs more expensive, thus further dragging down economic activity. That increases recession risk heavily. As our base case, we project that output will shrink by 0.1% yoy this year.

The recent restatement of Turkish GDP by TurkStat will probably make future GDP growth more volatile. TurkStat recently restated Turkish GDP as it uses now ESA 2010 accounting rules. On paper, this has led to an upward revision of Turkish GDP by approximately 20 % and higher GDP growth rates over the last few years. But Turkey's new way of calculating its GDP will make its growth numbers more volatile because of the increased prominence of the construction sector. Construction is plagued by low productivity growth, and is particularly vulnerable to swings in the business cycle as well as to patronage and corruption. Moreover, although urban development in the south-east of the country has much potential, the region is partially still a war zone with a risk that the conflict could intensify. The conflict between Ankara and the PKK now weighs stronger on GDP growth.

The situation is not entirely hopeless. First, the cheap lira will make Turkish exports more competitive. But this effect will take time to materialise. This is why we expect growth to pick up only slowly and not before 2018. Second, the government, especially President Erdogan, as well as the Turkish central bank, have the means at hand to cushion the pain ahead. Erdogan could adopt a more conciliatory tone when it comes to opposition in general, and to the Kurds, the EU or the press in particular. In the short term, ending both the country's official state of emergency and the purges could calm down society and the economy. The central bank could make it clear that it is not the executive's prolonged arm but the guarantor of stable prices and a stable financial system. For the medium term, the

government could shift its focus to policies that encourage savings and investments as well as innovation away from policies that intimidate and divide society. But whether that happens remains an open question. For now, the outlook is mostly negative, in our view.

Our forecasts for Turkey

	2016	2017	2018
GDP	1.6	-0.1	0.9
Inflation	7.8	9.3	9.2
Unemployment	11.0	12.5	12.0
Budget	-2.1	-2.7	-2.6
Current account	-4.8	-2.5	-2.8

Yoy; budget and current account as a percentage of GDP
Source: Berenberg

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