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BGA Cable: Turkey On The Brink
Turkey’s economic crisis looms in the face of geopolitical challenges

The situation
The sharp fall in the Turkish lira risks to further undermine an already fragile geopolitical situation in Europe. Despite the external forces inflicting damage onto Turkey’s economy, there is little dissent that the core issues lie within its ballooning inflation rate, unstable current account balance and significant FX liabilities.

However, today’s confidence crisis is exacerbated not only by Erdogan’s inflationary economic policy and lack of structural reform but equally by his aggressive foreign policy stance. Ankara has reached a crossroads at which its allies will do what they can, even if it is limited, to stave off an even deeper economic crisis and prevent market contagion, but the government must take a measured approach in engaging with China and Russia and re-engage with the EU, particularly Germany.

Moving forward, Erdogan will have to make hard decisions, including when or whether Turkey should risk capital controls that would shut the country out of the FX market, or bite the bullet and receive an IMF bailout that comes with politically damaging reform concessions.

Erdogan now has undisputed presidential power following the July elections, but in exchange for that power he is now the single point of entry for blame or credit for Turkey’s economic survival. The sooner and the more resolute Erdogan acts, the higher the probability of containing the contagion. The longer the present decay continues, the deeper and the more difficult it will be to correct the economic and political fall-out of the crisis.

Banking sector is the key vulnerability
The main economic policy issue for Turkey lies in the significant mismatch position of its banking sector with regards to its foreign currency funding and foreign exchange swaps. Unlike in the Asian crisis, banks not only made foreign exchange loans to the corporate sector but also provided lira loans to the household sector that were refinanced with insufficiently hedged USD and EUR liabilities. That makes banks’ balance sheets vulnerable to both a weaker currency that inflates liabilities and to rising interest rates.
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While the private sector has significant foreign currency deposits ($165bn), the risk is that these may not stay in the banking system. The ability of Turkish banks to roll over their estimated $100bn short-term foreign currency liabilities and $50bn FX hedges is vital to Turkey’s economic stability in the coming months. The situation is not helped by a series of rating downgrades by Moody’s (Ba3/neg), S&P (B+/stable), Fitch (BB/neg) and Scope (BB-/neg) over the past couple of weeks.

Against that backdrop, the private sector must roll FX liabilities close to 25% of GDP within the next 12 months. Matters are complicated by US investigations into one of Turkey’s largest banks (Halkbank) as well as foreign control of several smaller banks whose owners may be reluctant to provide further funds. This is especially relevant for Spanish bank BBVA and Bahrain’s Al Baraka, both already under scrutiny by the rating agencies due to their outsized exposure to Turkey.

While the banks were comparatively well capitalised going into the crisis and non-performing loans (NPLs) were low at the beginning of the year, their solvency will be negatively affected by the higher value of their USD and EUR liabilities as well as rising funding costs and mounting NPLs from corporates and households alike.

NPLs will grow due to corporate restructuring and consumer defaults. While the government is supporting the banks with capital forbearance and by releasing liquidity reserves, the deterioration of the balance sheets could ultimately result in a credit crunch (bank lending rates already reached more than 24% in July) and a recession, ultimately requiring a costly bail-out by the government.

Central bank lacks credibility

The precarious state of the banking sector limits the central bank’s ability to fight inflation through a more restrictive monetary policy. Therefore, it is no surprise that the government remains reluctant to raise rates, thus further undermining the central bank’s credibility to manage inflation. Apart from banking sector constraints, it is also unlikely that Erdogan himself will easily change his view that rates should stay low to support economic expansion. The overnight policy rate is currently stuck at 19.25%, compared to an inflation rate expected to exceed 20% in the coming months.

The lax monetary policy stance and the high degree of political interference will make it hard for the central bank to stabilize the currency and keep prices under control. Foreign exchange reserves are very
limited relative to the $350bn foreign private sector debt (gross) and the $58bn current account deficit. While the central bank has $100bn reserves on paper, most of them are owed to the domestic banking system and only a small portion would be available for interventions.

While Turkey has ruled out capital controls for non-residents because such a policy would completely shut the banks out of the FX market, there remains the risk of a bank run that may ultimately require domestic capital controls to deal with an already high loan/deposit ratio.

**Fiscal policy has leeway**

Turkish fiscal policy is less constrained in view of a low refinancing requirement by the central government. The debt/GDP ratio is in the 30% range, even considering the effect of the devaluation on the government’s foreign currency liabilities. Unlike in Argentina, foreign currency debt accounts for less than half of the Turkish government’s direct liabilities and roll-over risk is small compared to the private sector ($10bn over the next 12 months). Nevertheless, the fiscal balance is likely to deteriorate from its 1% average in view of a sharp fall in growth and the prospect of significant contingent liabilities in the banking sector.

While the government has promised a minor fiscal tightening and expects to announce further measures in September, this will not work and will be counterproductive at a time when the private sector needs to deleverage and private demand is falling. To avoid public turmoil, the government also needs to watch food prices, that are rising well above the official inflation rate. Therefore, demand for transfers and subsidies will most likely rise in the coming months, not at least in view of the regional elections due to take place in early 2019.

**Weak currency and rising inflation will lead to recession**

The weak currency is necessary to rebalance the economy and reduce the external financing needs. The most likely outcome at this point is a period of accelerating inflation, which is expected to reach more than 20% over the next 12 months due to higher import prices.

The devaluation will therefore reduce real wages, domestic consumption, but hopefully rebalance the current account. However, in combination with tighter financial conditions and falling confidence, this
24 August 2018

BGA Cable: Turkey On The Brink

Turkey’s economic crisis looms in the face of geopolitical challenges

could easily lead to a recession. Since Erdogan’s support and popularity is largely based on the promise of steady per-capita growth for a rising population, the political repercussions of the slowdown and a possible recession could destabilise the regime.

External demand will not fix the current account

With no access to net new foreign investment, Turkey will have to quickly reduce its current account deficit ($57bn over the past 12 months), that reached more than 8% of GDP by mid-year at current exchange rates. In the short-term, most of the reduction will have to come from falling real wages, tightening credit and lower consumption. This implies a slowdown in economic growth that could well turn into a recession if problems in the banking sector get out of hand.

While the currency is now fundamentally undervalued (now more than 66% undervalued on a “Big Mac” purchasing power basis), few sectors outside of tourism (receipts +30% this year) and textiles will benefit from a currency devaluation, as most corporates will need to cut capital expenditure in view of the rising foreign currency debt burden, especially in real estate and energy.

US tariffs on steel and aluminium and the incoming Iran sanctions further complicate matters for the export sector as well as for certain US imports that are affected by the Turkish government’s retaliatory measures.

Turkey’s political allies want to avoid a deepening economic crisis

Faced with the prospect of a severe recession and a meltdown of the financial sector, the Turkish government has turned to its allies for outside help. This is hardly a trivial matter given Erdogan’s very aggressive foreign policy moves in recent years. Furthermore, it is unlikely that these countries will commit significant resources without a change in Turkey’s economic policy restoring its credibility. Their main priority will be to avoid a further deterioration of the currency crisis that could have severe geopolitical ramifications if Turkey is pushed into a full-scale IMF bail-out: Erdogan’s regime would be undermined and political instability in the region could increase.
Qatar and China likely to act opportunistically

Offers by Qatar to provide $15bn fall well short of what is required to restore confidence, as they would cover little more than 5% of Turkey’s foreign currency liabilities, half of which are due within a year. In comparison, Argentina recently received a $40bn bailout package and Turkey would need a lot more in case of another run on the currency.

However, those funds from Qatar could help resolve immediate pressure points, such as the need to recapitalise certain banks and conglomerates. Given that Turkey is one of the few countries that support Qatar against the Saudi-led boycott and that the two states have developed a quasi-symbiotic relationship, there could be more support, though Qatar is unlikely to bankroll a failed economic policy. Since Turkey has no LNG facilities, Qatar will not be able to provide cheap energy, e.g. to reduce the dependency on Russia.

Ironically, Qatar and Turkey share the ambiguous foreign policy position of opposing the US and its allies in the Middle-East while at the same time providing US forces with strategically important air bases in Al Udeid and Incirlik, respectively.

The Chinese may decide to stay on the side-lines initially, but they are likely to move in and buy up strategic assets in the transport and energy sectors on an opportunistic basis, similar to their strategy in Greece. The massive drop in the currency and the significant dislocation of corporate balance sheets should provide plenty of opportunities. Alibaba recently invested $750mn into a Turkish start-up, Trendyol, and there could be an opening for Turkish corporates to issue RMB-denominated bonds.

Qatar and China are also supportive of Iran and may want Turkey to play a more active role in their trade in view of US sanctions against Iran.

The EU is Erdogan’s best bet

The EU already supports Turkey with EUR 6bn annually under the refugee deal and may well have some flexibility to accelerate or expand these payments, as it is in its interest to stabilise Turkey. Ahead of the EU elections in 2019, the EU will want to avoid a major crisis in Turkey, which could lead to a surge in refugee flows from the Middle-East. Building a stronger external border is a key theme for the EU,
BGA Cable: Turkey On The Brink
Turkey’s economic crisis looms in the face of geopolitical challenges

ahead of human rights concerns, and Turkey plays a crucial role in sealing off the Balkan route for refugees.

In the past, the EU has provided substantial balance of payment support to its members, (e.g. Hungary in 2011) and even more so during the euro crisis, albeit as part of an IMF programme. The crucial point here again is that Turkey (technically still an EU accession candidate) would need to take the appropriate shift in economic policy before any material funds could be made available.

However, any financial support by the EU would require a reset of the bilateral political relationship between the EU and Turkey and of the relationship with Germany in particular. Next to refugees, the latter economy is exposed to Turkey not only through trade but also through significant direct investment. Germany is home to 4mn Turks with a huge potential for unrest and disruption. It is therefore no surprise that German politicians have come out in support of Turkey despite Erdogan's ongoing human rights violations and his very negative political rhetoric in the past couple of months.

Erdogan’s planned state visit to Berlin on 27/28 September will be of crucial importance as this provides an opportunity of a face-to-face meeting with Merkel. Nonetheless, any further financial support that goes beyond what was agreed in the refugee deal will be highly controversial in the eyes of the German public, so it would have to be arranged in a discreet and disguised way.

Erdogan risks bear hug if he moves too close to Putin

Any rapprochement with the EU would require a careful rethink of Turkey’s relationship with Russia. Turkey’s economy is heavily dependent on Russia for its exports as well as for energy imports. This provides Russia with several levers to support or hurt Turkey, which leaves open the question of what Russia will want in return. Lavrov’s visit to Turkey at the height of the crisis did not yield any decisive support when it mattered most for Erdogan.

While upsetting NATO (e.g. by selling advanced air-defence systems to Turkey) has been one of Putin’s prime goals, he could further draw Turkey onto his side by offering cheap energy, which would take off some of the pressure on the current account and inflation. However, Russia does not have the funds to prevent a full-blown financial crisis in Turkey, and, like other countries, it would probably wait and see how the economic crisis unfolds.
The Brink
Turkey’s economic crisis looms in the face of geopolitical challenges

A higher dependency on Russia would make it more difficult for Turkey to find sympathy in the EU and leave the country exposed in Syria, where Putin supports Assad against Turkish-backed forces in the Idlib province. There could also be other political demands by the Russians, notably over their naval forces’ access rights in the Mediterranean. The prospect of Russian troops on Turkish soil would certainly be a nightmare scenario for NATO, should Russia push that far.

US relationship terminally damaged?

While the US tariffs on steel on aluminium can hardly be blamed for the economic crisis that unfolds in Turkey, it is very unlikely that the Turkish side will ever forgive the US administration for unscrupulously exploiting its economic vulnerability in a dispute over a jailed US clergyman. At the same time, the US rhetoric makes it easy for Erdogan to distract his supporters’ attention from the real economic problems. However, Erdogan is well advised to settle the dispute and not risk further sanctions against Turkey’s banks or its national airline. In the worst case, he may even need US support for an IMF bail-out.

Beyond the economic necessities, there seems to be precious common ground between the countries. There is no incentive for the US to support an autocratic regime that collaborates with Russia and Iran against Israel and Saudi Arabia in the Middle-East. Given the harsh treatment of Turkey by the US, it does not seem that the latter assigns much value to its military presence in Incirlik.

Implications for investors

Fundamentally, the Turkish economy remains an attractive long-term market in view of its large diversified economy, good demographics, strong trend growth, high competitiveness (thanks to a flexible exchange rate regime) and unique location. It is also hardly the first liquidity and banking crisis that threatens the country. Unlike in previous episodes, global demand from Turkey’s major trading partners remains strong and government debt is low.

While a significant economic slowdown is inevitable at this point, the severity of the recession will depend entirely on the question whether Turkey can avoid a banking crisis and therefore a credit crunch. This cannot be achieved without a decisive change in monetary policy combined with measures...
BGA Cable: Turkey On The Brink

Turkey’s economic crisis looms in the face of geopolitical challenges

allowing corporates and households to reduce their balance sheet. Mending its foreign policy relationship with the US and key partners such as the EU and Germany could also help Turkey to improve confidence. With so much in the air, investors are best advised to sit on the side-lines and wait to see how the government plays its cards in the coming weeks.

Key Dates

Early September: Erdogan, Putin and Rohani summit in Tehran over Syria
During September: Turkey expected to release fiscal plan
September 28-29: Erdogan’s state visit to Germany
October 8 – 14: IMF / World Bank Annual Fall Meeting in Nusa Dua, Bali, Indonesia
November 4: US plans to have Iran sanctions in place (no oil exports)
Q4 2018: Possible four-way meeting with Turkey, Germany, France and Russia on Syria
March 2019: Local elections in Turkey
May 2019: EU elections
BGA Cable: Turkey On The Brink
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BGA Experts

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