EMEA

TURKEY: CRASH LANDING

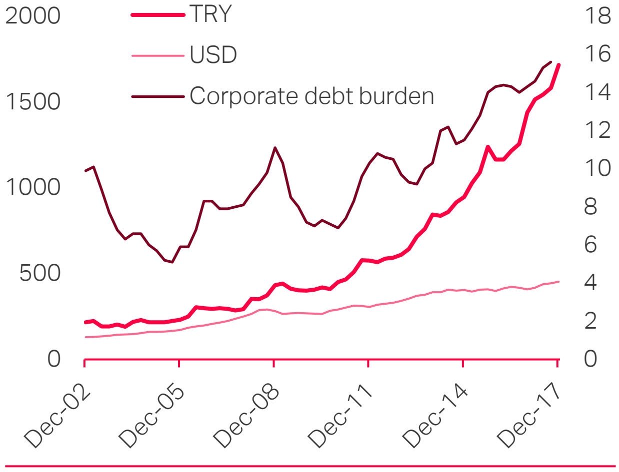
Marcus Chenevix

US sanctions have come just as Turkey's overheating situation reaches a crunch point. Here we assess the outlook for what could be Turkey's worst economic crisis since 2001.

- New sanctions are not likely in the short-term, but going into mid-Q4 there is a real risk of US banking sanctions if the Turkish government does not back down.
- With or without new sanctions though, Turkey is heading into crisis. The roots of current FX volatility go much deeper than the current spat.
- Talk of capital controls and IMF intervention is going too far, but a very hard landing is now unavoidable.
- We maintain a negative outlook on all Turkish asset classes.

External debt levels driven up by FX

Gross external debt in USD and TRY bn and portion of corp. expenses absorbed by debt service, RHS (%)



Sources: BIS, Bloomberg.

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The trigger: US sanctions

How did this happen?

After years of gradual drift, Turkey's increasingly poor relations with the US and EU have led to diplomatic crisis. Erdogan's authoritarian rule at home, support for Islamist causes abroad and continual convening of anti-Israel summits have all been sources of concern and irritation in Europe and America. The reverse is also true, for Erdogan, the maintenance of friendly ties with the Western Powers has not been easy: not only do these powers constantly criticize his domestic policies but they undermine his foreign policies (i.e. by supporting Syrian Kurds). The relationship with the US has always been particularly problematic, not least because the US was the principal foreign backer of the various governments who suppressed Turkey's Islamist parties throughout the 20th century. This friction dramatically worsened in the wake of the 2016 coup attempt. Erdogan and his ministers suspect US involvement in the traumatic events of 15 June 2016, based on possible contacts between the CIA and the Gulenist movement. They have held an actively hostile view of the US ever since.

When Trump won the presidency in 2016 relations thawed somewhat, but not for long. Trump's transition team included the infamous Michael Flynn, who was so supportive of the Turkish government's position that he had concocted a plan to have Fethullah Gulen kidnapped and delivered to a Turkish prison island. Following Flynn's firing, and a US investigation into Turkey's Halkbank (for sanctions breaking with Iran), relations deteriorated again, and this time with all the bitterness of hopes dashed. At some point in 2017 Turkish officials decided a new approach was needed to deal with the US: hardball, namely hostage diplomacy. Turkey began to negotiate with the US using as bargaining chips a jailed American pastor named Andrew Brunson and several local US consular employees.

American officials were surprised by the aggressiveness of the Turkish approach. It is a mark of how important they felt the relationship was that they opted to negotiate at all. Talks carried on until July 2018 and deal was worked out between the two sides: the US would release a jailed Halkbank executive to serve out the remainder of his sentence in Turkey and also secure the release of an imprisoned Turkish national in Israel. In return Brunson and the consular employees would be freed. The US was halfway through delivering its end of the deal when Turkey suddenly reneged, demanding a complete cessation of investigations into Halkbank. Turkish negotiators apparently felt that Brunson was a better lever than they had realised – and that they should use their leverage to maximum effect.

The Turkish government had completely misjudged the situation. Freeing Brunson would be nice for the Trump administration, but it is not a priority. Turkey had no leverage. The US, already only reluctantly engaging in the hostage diplomacy, lost patience. These sanctions, unprecedented for a NATO ally, are about making some points clear:

- The US will not engage in any further "hostage diplomacy", no new deal will be offered.
- Through its actions, Turkey has forfeited the normal privileges given to a NATO member.
- The US now regards Turkey as a sanctionable entity and further sanctions are likely.

Turkish minsters must now back down, release Brunson at the very least and be prepared to tone down anti-American rhetoric.

Worryingly though, Erdogan and his ministers do not seem to understand how much danger they are in. The Turkish government does not seem to understand that these sanctions are the warning not the strike. In fact, these sanctions are in themselves fairly limited: they freeze the US assets of Turkish Interior Minister Suleyman Soylu and Justice Minister

Abdulhamit Gul (should they have them) and prohibit US persons from having any financial dealings with these men. They are a signal and a warning, a shot across the bows and a message to say if Turkey does not change course, the next shots will be aimed at the waterline.

What next for US sanctions?

The US is now going to give Turkey time to respond appropriately. The US is not going to escalate the situation for at least a couple months, it does not want to punish Turkey if such an event can be avoided. However, the ball is now very much in the Turkish court; it is up to them to resolve the mess that they have got themselves into.

Based on past behaviour, the Turkish government will probably back down. Outwardly, Erdogan and his ministers have been defiant in their response to the sanctions. Ministers have ordered retaliatory sanctions against the US, condemned the action as "disrespectful" and pushed ahead with the acquisition of a Russian missile system seen as a threat to US security. However, behind the scenes, officials will now be negotiating feverishly to try to put an end to this situation. As we have seen in the past with both Russia and Germany, Erdogan tends to back down when faced with serious punishment. It is most likely that he will do the same in this case.

However, Erdogan's suspicion of US involvement in the coup attempt may make this a qualitatively different situation. Despite the probability being that Turkey will back down, there is a significant risk that this time Erdogan will behave more destructively. The differentiating factor is the way in which this whole drama is tied to the 2016 coup. Brunson is officially suspected of involvement in the coup, as are the consular employees, Turkish ministers may genuinely believe this to be true, given that they believe the US to have been partially responsible for the coup. In the spats involving Russia and Germany, neither side were ever suspected of trying to murder Erdogan and his family. Given this background, Turkish policymakers may find capitulation to US demands to be a step too far.

If Turkey does not back down then the US will ratchet up the pressure. If Turkey fails to back down and the US does decide to take further action, probably sometime in mid-Q4, it would start with widening the sanctions on specific officials. This will rattle markets but have no substantive economic impact. If the dispute continues to sour then the next step would be to hit the Turkish banking sector. This would involve first a crippling fine on Halkbank, for the old charge of breaking sanctions on Iran, followed by restrictions on US persons doing business with certain Turkish banks. This would be disastrous for the Turkish banking sector, which is already under extraordinary pressure.

The Crisis: Overheating

With or without new sanctions Turkey is heading into crisis

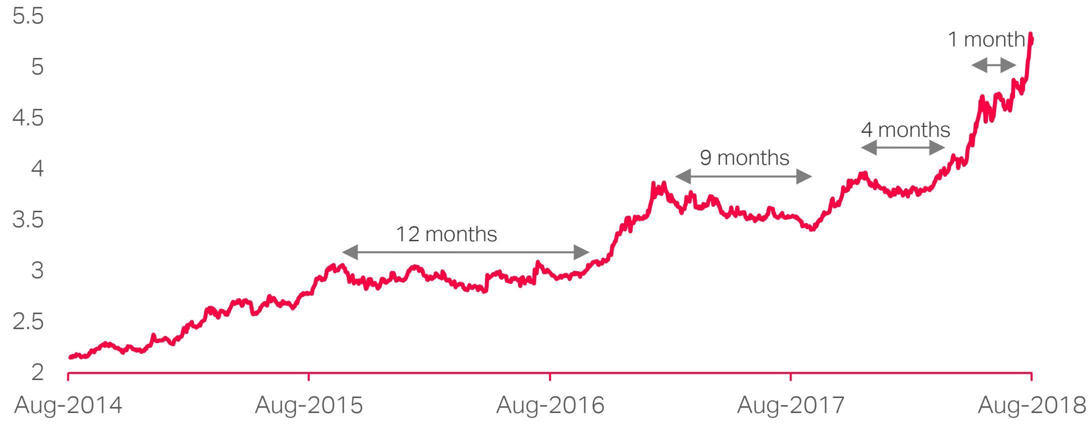
The most important aspect about the current situation, from an investment point of view, is that Turkey is headed into crisis anyway. Back in December 2017 we wrote a report on Turkey that forecast an economic crisis following the next round of lira depreciation, we had several reasons for thinking this:

- Turkey's external debt situation was precarious and we believed that the country would not be able to cope with the looming threat of QE-exit.
- We could not see any possibility of a policy response that would rein in overheating in the domestic economy.
- We believed that Turkey's deteriorating diplomatic relations were going to provide a series of shocks motivating extreme FX volatility.

At this stage, just the first two of those three points is enough to push Turkey into crisis, whether or not this current dispute resolved. The lira is not only depreciating because of US sanctions. The lira has been in an accelerating trend of depreciation for the last three years (see chart below). In every case there has appeared to be some idiosyncratic trigger, but the underlying problems are very deep and very long-running.

A TRY depreciation crisis has been building for years

USD/TRY, with intervals between depreciation cycles

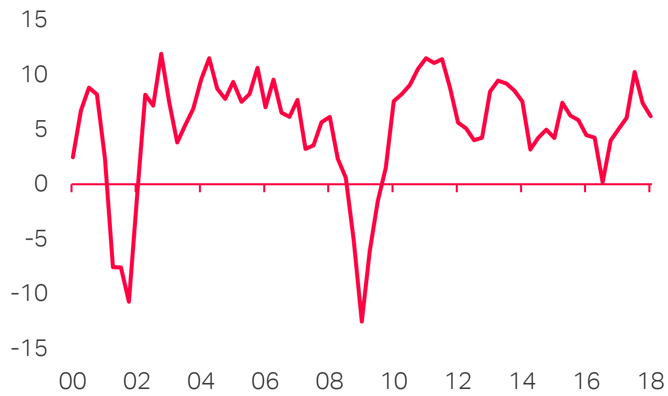


Source: Bloomberg.

Turkey's overheating problem is caused by long-term imbalances interacting with a sugar rush of stimulus policy. Turkey has had a low savings rate for a long time – given that only 20 years ago inflation remained above 60% for an entire decade, it is unsurprising that Turks do not like the idea of letting money lie unused. Pre-2008 this was not a major problem – Turkey was able to achieve fast and balanced growth through very rapid advances in productivity and export volumes; which were able to fund demand growth without imbalances building up. Post-2008 the model changed: amid a deteriorating institutional backdrop, Turkish productivity growth slowed, while fiscal and monetary policy became looser, especially after 2012. It was at this point that Turkey started to build up long-term internal and external imbalances. With consumption rising faster than production capacity, potential growth was limited to just 5-5.5%. This speed limit caused growth to be throttled every two years or so (see chart below) as the Turkish financial sector repeatedly ran out of funding for further growth.

Strongly cyclical growth post-2008

Turkey's real GDP growth, yoy (%)



Source: Bloomberg.

Driven by limited ability to fund growth

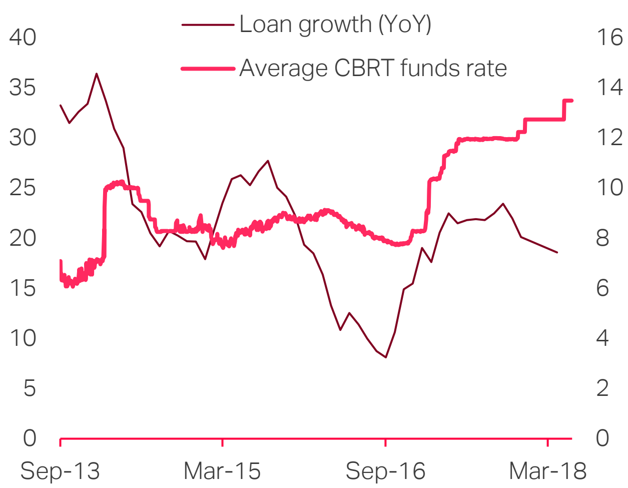
Loan growth yoy from deposit banks (%)

Source: CBRT.

This time though is much worse than all previous post-2008 slowdowns. This is for several reasons:

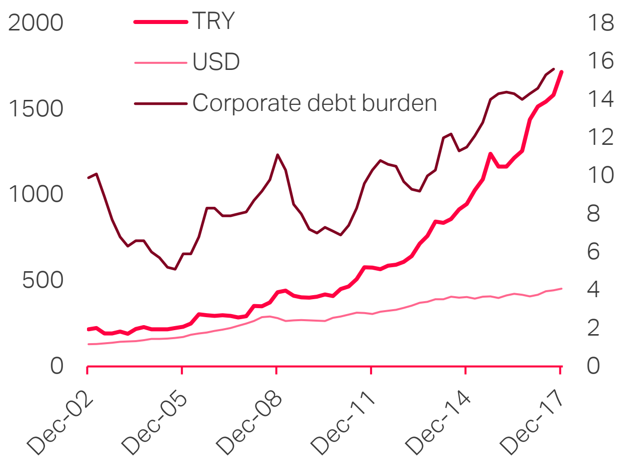
1. **This time there is no credible monetary authority to manage the slowdown.** As we have repeatedly written, Turkey's economic policymakers have been on slow but steady drift away from economic orthodoxy for the last five years. With the appointment of Berat Albayrak as economy minister, this transition is complete. In the past capable policy makers like Ali Babacan or Mehmet Simsek were on hand to engineer soft landings. No such figure holds office this time.
2. **Government economic stimulus in the wake of the 2016 coup attempt was able to drive huge credit growth in spite of rising rates**. One of the key elements of this crisis is the response to the doldrums created by the 2016 coup attempt. A huge government stimulus programme in 2017 was able to get the economy back on its feet, but at the expense of greatly increasing economic imbalances. No previous slowdown has had this burden of stimulus driven credit to deal with.
3. **Generally benign conditions for EM's have given way to anxiety about the end of QE**. Interrelated to the point made about stimulus, is the problem of QE. One of the reasons why government stimulus was so effective was that low rates across Europe and America made Turkish debt incredibly attractive. This allowed banks and non-financials to become dependent on easy foreign money. This allowed much faster external credit growth than would otherwise have been possible.

Stimulus trumps rate hikes
Loan growth yoy from deposit banks (%) and average cost of CBRT funds, RHS (%)



Sources: CBRT, EMIS.

External debt level higher than ever before
Gross external debt in USD and TRY bn and portion of corp. expenses absorbed by debt service, RHS (%)



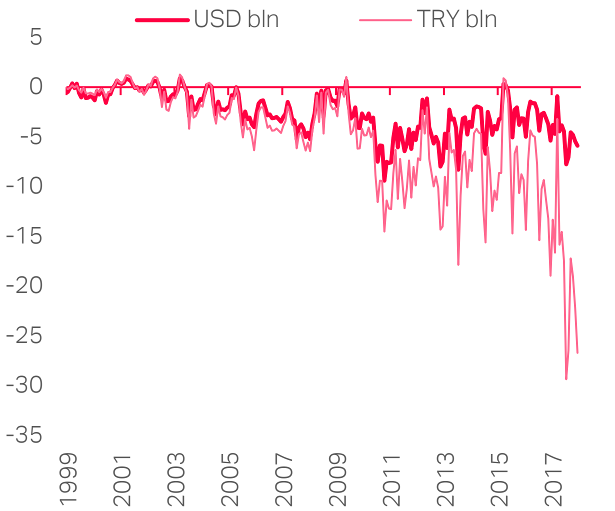
Sources: BIS, Bloomberg.

Hard landing/crash landing

Turkey now faces a sharp slowdown. In some ways the situation in Turkey is now beyond saving: imbalances have reached such a point (see charts below) that the only solution to the overheating crisis is a sharp slowdown, which in any case, is unavoidable. As the supply of credit dries up, producer prices will rocket and consumer demand falter, growth will grind to a halt just as fast as it roared into a boom last year. Turkey's hard landing will be a painful experience for Turkish households and companies, particularly as both will still have to deal with an external debt burden that becomes increasingly onerous with every TRY depreciation cycle. Investors should expect to see a wave of corporate debt restructurings in the coming months.

External imbalances

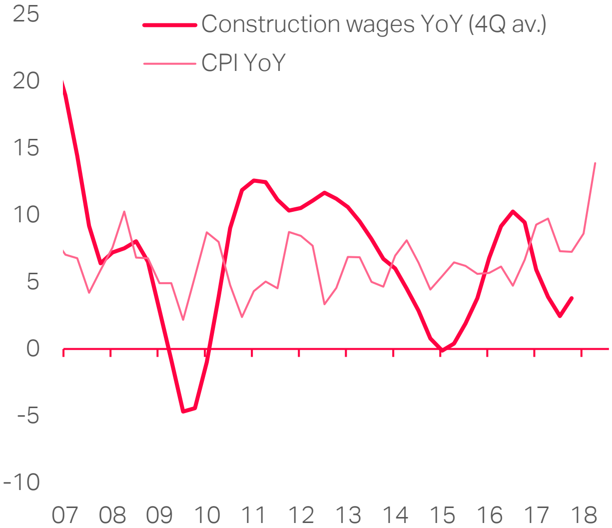
Turkey CA balance, USD and TRY bln



Source: Bloomberg.

Internal Imbalances

CPI and construction sector wages



Source: Turkstat.

Despite talk of capital controls or IMF intervention, neither is very likely. Such economic drama inevitably excites speculation over extreme policy responses. We would counter though that the whole problem with this government's response to this crisis has been an excessive unwillingness to take extreme measures, or really any measure for that matter.

Furthermore, quite apart from the extreme unpopularity of taking either measure (and remember the AKP faces important local elections in 2019), the AKP is a party wedded to the idea of an open economy, it is the defining feature of AKP economic policy. Access to foreign trade and foreign capital is vital for the AKP's base in industrial cities like Konya and Kayseri. As for the idea of having the IMF, Erdogan sees his getting rid of the IMF as the key achievement of his first decade in office. He is not going to invite them back.

Investment conclusion

As we wrote in our most recent EM Strategy Monthly we currently hold a negative view on all Turkish asset classes. This is a crisis, and even though valuations are very cheap, they can still fall further. The very attractive carry offered by Turkish fixed income assets is not worth the risk posed by the macro environment – even before we start to think about the possibility of escalation in the crisis with the US.

The important question now is: when will the turnaround come? One of the key lessons of Turkish economic history over the last 60 years is that recovery comes round in the end, and usually not that long after the crisis. Turkey has immense institutional depth, excellent trade links with the EU and an enormous tourist industry. This is the sort of economy that does very well out of being very cheap. The signal for a turnaround will be when the government starts to change its institutional position and takes seriously the idea of economic rebalancing. This will be the point at which growth-first economics has decisively failed.

Authors

Marcus Chenevix
Analyst, EMEA and Global Political Research