Turkey

Large-scale manoeuvres

With the approach of municipal elections on 31 March, which will be another key test for the government, major manoeuvres have been launched on both the macroeconomic and geopolitical fronts to stimulate activity and advance a foreign policy agenda (notably in Syria) at the expense of diplomatic tensions with the US. The financial strain has soothed since the currency crisis in August 2018, but cyclical conditions have deteriorated. We seem to be heading for a recession scenario lasting several quarters, with the financial weakness of many non-financial corporates being a main concern. The rapid narrowing in the current account deficit and the disinflationary process initiated in recent months attest to the scope of the macroeconomic currently underway.

A tumultuous relationship with the United States

The year 2018 was marked by the chaotic relations between Ankara and Washington: the US lawsuit against Halkbank, the Turkish state-owned bank, for circumventing the Iran embargo, the US refusal to extradite Fethullah Gülen, and the diplomatic crisis over Pasteur Brunson, which triggered US sanctions in August (he was finally liberated on 12 October).

Historical allies as part of NATO, it is in the geopolitical interest of both countries to cooperate in the Syrian conflict. Yet there are still major divergences, not only on the Kurd question, but also on Iran (one of Turkey's main oil supplier) and Saudi Arabia (historical partner of the US). For Turkey, the mid-December announcement that the US planned to withdraw from Syria was seen as a godsend, prompting it to announce a military intervention as part of its strategy of securing its southern border with the creation of a buffer zone and a sanctuary for accommodating millions of Syrian refugees. Reaffirmation that its ultimate goal is to eliminate the Kurdish forces in Syria once again strained relations with the US, leading Donald Trump to threat to *"devastate the Turkish economy"* before new negotiations were launched to find an agreement.

…which makes the financial stabilisation fragile

The aggravation of macroeconomic imbalances, which was fed by pro-cyclical economic policies through the fall, and Turkey's external financial vulnerability have reinforced the country's exposure to geopolitical factors. Since August's forex crisis, economic conditions have deteriorated markedly, including a cyclical downturn and soaring inflation (see below). Municipal elections at the end of March will serve as another test for the government, whose popularity has eroded since June's legislative and presidential elections. On 15 January the Parliament voted to grant president Erdogan full powers to take all necessary measures in case the country's financial stability was threatened.

Financial turmoil has eased since mid-September, following a massive interest rate hike by the Turkish central bank (CBRT) and Pasteur Brunson's liberation. After a precipitous 42% decline against a euro-dollar basket between January and August, half of which occurred in the month of August alone, the Turkish lira (TRY) rebounded in September-October and ended the year 2018 down 27% (year-on-year and average annual rate). The 5-year CDS premium on sovereign bonds in foreign currencies dropped from 580 bp in early September to 350 bp in mid-January. After soaring by 1400 bp between January and August to 27.3%, 2-year bond yields have declined sharply since September to 18% in mid-January. The yield curve has inverted since the 3-month interbank rate has held close to the key policy rate (7-day repo) at 24% since September.

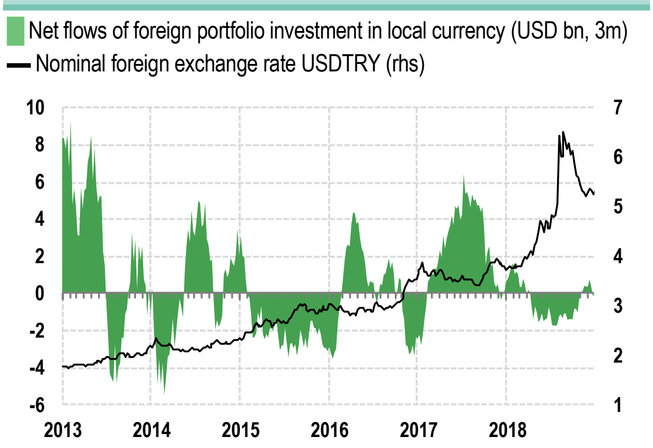
Net outflows of non-resident portfolio investment in local currency finally amounted to only USD 1.9 bn in 2018 (-USD 1 bn from the bond market and –USD 0.9 bn from the equity market). Net flows became positive again between mid-September and the end of November (+USD 0.7 bn). Since December, however, non-resident investors have pulled out of the local bond market again

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	7.4	2.9	2.0	3.3
Inflation (CPI, year average, %)	11.1	16.3	17.1	11.4
Budget balance / GDP (%)	-1.5	-2.0	-2.2	-2.2
Public debt / GDP (%)	28.3	31.1	30.0	29.2
Current account balance / GDP (%)	-5.6	-3.6	-3.3	-3.7
External debt / GDP (%)	53.3	57.4	55.6	56.6
Forex reserves (USD bn)	82.6	72.0	72.0	75.0
Forex reserves, in months of imports	4.0	3.5	3.4	3.2
Exchange rate USDTRY (year end)	3.8	5.3	5.8	6.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Foreign portfolio investments and FX rate



Source: CBRT, BNP Paribas

(-USD 0.8 bn). They now hold only 15% of domestic public debt (vs. more than 20% through 2014).

Recent portfolio movements are due in part to the Turkish Treasury's strategy to limit calls on the market and to favour debt in foreign currencies. Given the sharp increase in the cost of financing in the local market, it is effectively soliciting the international markets more, with a Eurobond issue at a rate of 7.7% in January. In the first 11 months of 2018, central government external debt increased by TRY 5.7 bn (about USD 1 bn), whereas the annual programme calls for debt reduction of TRY 1.6 bn. By resorting less to the domestic market, however, domestic debt narrowed to TRY 40.6 bn in November, compared to TRY 62.7 bn initially programmed for the year.

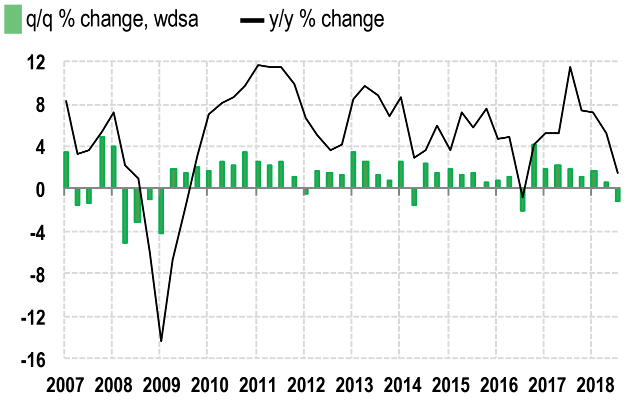
Since September, Turkish banks have managed to turnover about 90% of their external financing in the form of syndicated loans, and the secondary market has picked up again. As the squeeze on liquidity has eased, the banks have been able to rebuild foreign currency deposits, notably via the Reserve Options Mechanism (ROM) with the central bank (CBRT). Foreign deposits had declined by USD 26 bn between March and September. The current account has swung into a surplus since August and financial flows have rebounded (including massive unidentified currency inflows in 2018, which were reported as "errors and omissions"), both of which contributed somewhat to the rebuilding of gross foreign exchange reserves (+USD 7.2 bn between October and mid-January), which had declined by USD 40 bn since 2013. FX reserves cover about 40% of the external debt maturing in 2019 (USD 173 bn for short-term debt and medium and long-term debt to be rolled over) while so-called "free" reserves (i.e. excluding ROM) cover only 15%.

An abrupt macroeconomic adjustment

A recession scenario lasting several quarters seems to be taking shape under the impact of the Turkish lira's sharp depreciation, soaring inflation and interest rates, the contraction of bank lending and the dire financial straits of numerous companies, notably in the construction sector, which has been the main growth engine in recent years. Corporate and household confidence indexes have rebounded slightly since October but are holding at very low levels. The other monthly and leading indicators are still depressed for Q4 2018 and early 2019.

In Q3 2018, real GDP contracted 1.1% q/q using data adjusted for seasonal variations and the number of business days. Real GDP rose only 1.6% y/y, compared to 11.5% in the year-earlier period (a record high since Q3 2011) and 5.3% in Q2. Consumption rose 1.1% y/y in Q3, after 6.4% in Q2. Investment was down 3.8%. Job creations stagnated and the seasonally-adjusted unemployment rate rose from 9.9% in January to 11.5% in October. Net foreign trade made a strongly positive contribution to GDP growth thanks to the dynamic pace of exports (+13.6% y/y in volume) and the drop off in imports (-16.7% y/y in volume). Value added in the construction sector plunged by 5.3% y/y, and industrial production was down by 6.5% y/y in November (down since August). Only services continued to progress (+4.5% y/y in Q3),

3- Real GDP growth



Source: Turkstat

Macroeconomic imbalances are narrowing. Between January and November 2018, the current account deficit shrank to USD 26.2 bn, down USD 13.5 bn from the 2017 figure, thanks to the compression of imports (accentuated by falling oil prices) and the strong performance of export and tourism revenues. Inflation seems to have peaked in October at 25.2% y/y, and the CPI closed the year at 20.3%. Less subject to political pressures, the central bank is unlikely to loosen financing conditions until it has clear confirmation of disinflation.

Economic support, corporates weakened

The increase in the public deficit was relatively mild in 2018, and the primary balance remained very slightly positive. The probable decline in fiscal revenues and non-recurring revenues, as well as the announced stimulus measures (26% increase in the minimum wage, expected wage increases for public-sector employees, and electricity bill rebates for low-income households) should strain public finances in 2019. Other measures could also prove to be an indirect or future liability for the state via public guarantees and contingent liabilities, like the loan guarantee fund that was very active in 2017, and new programmes to bolster real estate and consumer lending via the state-owned banks Ziraat and Halkbank.

Faced with a surge in requests for debt restructuring by non-financial companies (officially 846 *Konkordato* bankruptcy protection procedures were initiated in December 2018) in order to prevent bankruptcies, the banking regulator has asked the commercial banks to honour all of these requests.

Sylvain Bellefontaine
sylvain.bellefontaine@bnpparibas.com