Turkish troubles persist

Turkish troubles and market nervousness are likely to persist. But economic contagion should be limited.

The crisis in Turkey is deepening. We do not expect any rapid improvement, but as this crisis is largely homemade, we believe the risk of contagion to other countries should be mitigated. However, there is good reason to expect markets to remain cautious and volatile.

That there were structural imbalances in Turkey's economy was well known. But it has taken a number of negative steps from the government to turn a smoldering crisis into a fierce one. The election promises ahead of the parliamentary and presidential elections in June this year looked unaffordable. President Erdogan's rejection of high interest rates and his statement that high interest rates caused high inflation troubled investors. The further curtailment of central-bank independence and the appointment of Erdogan's son-in-law as finance minister eroded investors' confidence even more . Finally, last week's open dispute between Ankara and Washington fanned the flames. The continuing imprisonment of American Pastor Brunson led Washington to tighten its diplomatic thumbscrews, culminating in last week's statement by U.S. President Trump that the United States will double the tariffs on steel and aluminum from Turkey to 50 and 20% respectively. The lira then plunged, taking its annual loss against the dollar to almost 50%.

After this sudden ratcheting up of the crisis, we believe that Turkey's most pressing problems are:

- An overheating economy with 7.4% economic growth last year, but an estimated inflation rate of 14% for this year – and this rate may well have to be revised upwards in the course of the year.
- An estimated current-account deficit of 6.4% of gross domestic product (GDP) and a budget deficit of 3.0% of GDP this year.
- Short-term financing equivalent to almost the entirety of the current-account deficit.
- 25% of GDP need to be refinanced in the current year.
- A lira that has depreciated by almost 50% against the U.S. dollar and the euro since the beginning of the year.
- An abrupt rise in the yield of 5-year government bonds from 11% to 21% (for lira) and from 4% to 8% (for hard currency) since the beginning of the year.
- A markedly consumer-driven upswing in the past few years, supported by a large number of debt-financed state benefits.
- An increase in corporate debt (excluding banks) from 20% of GDP in 2004 to almost 70% in 2017, more than half of it in foreign currency.

On the positive side, however, there are also a number of points to be noted:

- The low government debt of 31% of GDP. However, history shows that even such a cushion does not protect against a crisis.
- The positive impact of a weakening currency on exports and tourism.
- Turkey's experience in dealing with crises, which should not be underestimated. Past decades have offered the country plenty of opportunities to learn crisis-management techniques.
- Turkey can bring its NATO membership and its geostrategically important position to bear in the coming negotiations.

There are, moreover, remedies available to treat Turkey's crisis. But we fear the country may be unwilling at present to take the medicine. Two policy steps are advisable:

- A strong interest-rate hike to curb inflation and capital flight and attract back foreign capital.
- Negotiation of an International Monetary Fund (IMF) loan sufficiently large to alleviate the short-term concerns of foreign lenders.

However, Erdogan's aforementioned aversion to high interest rates and the pain they would mean for the domestic economy suggest that a big interest-rate rise will be avoided. Erdogan may also show strong aversion to the usual IMF medicine, which would mean an end to fiscal gifts to the electorate, among other things. Moreover, the United States has already signaled that it would not support a rescue operation by international institutions for Turkey. Elke Speidel-Walz, Chief Economist Emerging Markets at DWS, sums up: "Turkey's financial crisis was not caused by the United States, but at most triggered by it. The fact that Ankara let inflation get out of control and relied on short-term foreign loans to finance the current-account deficit is essentially the reason for the crisis."

For the time being, therefore, there is no alternative but to wait and see which external pressure Erdogan yields to. Though it is also possible he will stick to his unorthodox line. Support from China or Russia could possibly enable him to persist with the current situation for longer.

Asset-class implications

Due to the size of the Turkish economy (2017: 850 billion dollars, calculated at exchange rates at the beginning of the year), we are not too worried about the risk of contagion. The Eurozone exports less than 0.6% of its GDP to Turkey. Nevertheless, we are not taking events in Turkey lightly. Although global macroeconomic figures continue to be robust overall, keeping investors positive, the accumulation of a series of idiosyncratic events could provoke an increase in risk aversion. The rise in yields of Italian government bonds to over 3% on Monday could be interpreted in this way. Diplomatic disputes could worsen quickly this year – though they can also quickly calm, as Juncker's visit to Washington has shown. We continue to assume, however, that the peak of the trade dispute has not yet been reached.

We expect market fluctuations to worsen for the time being, having subsided at the beginning of the summer. We remain somewhat more cautious, but differentiate precisely and also see some opportunities in the recent swings. From a tactical perspective, for example, we have reduced European corporate bonds to neutral, but we view selected emerging-market bonds in hard currency more positively than the market. We expect support from lower refinancing requirements in the second half of the year, for example.

With regard to equities, we assume that the situation in Turkey at the individual stock level is primarily reflected in those banks that have larger activities in Turkey.

On the currency side, we expect further pressure on other emerging markets. In our opinion, the flight into the dollar could lead to further gains against the euro, for example, and thus move even further away from our target of 1.15 in the short term.

Glossary

Current account

The **current account** includes trade in goods and services, a net-factor-income balance (e.g. earnings on foreign investments and cash transfers from individuals working abroad) and transfers (e.g. foreign aid). It is a part of the balance of payments.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

International Monetary Fund (IMF)

The **International Monetary Fund (IMF)**, created in 1945 and headquartered in Washington, D.C., is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Turkish lira

The currency of Turkey

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