Special Report

Turkey – Erdogan’s new term ushers in period of heightened policy uncertainty and external risks

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1. Introduction

Against the turbulent political backdrop external vulnerabilities have been increasing. Recent snap elections held on 24 June have resulted in President Erdogan gaining re-election with 52.6% of the vote in the presidential poll. The president will now be able to implement constitutional changes, after the constitutional referendum last year, to significantly solidify his position by triggering change to the executive presidency system. However, this change will increase risks to fiscal and monetary policy, as well as elevating long-standing external vulnerabilities.

The Turkish Lira has dropped around 25% versus the USD since the start of the year exacerbated by loose fiscal policy and monetary policy uncertainty, with the central bank deciding to keep rates on hold at its latest monetary policy committee on 24 July. The Lira has been one of the worst performing EM currencies exacerbated by a widening current account deficit as a result of higher trade deficit due to higher oil prices and gold imports.

The weaker Lira also increases exposure of Turkish corporates and banks to debt repayments. Foreign exchange (FX) reserves now cover less than half the countries annual FX repayment needs highlighting increasing pressures though no roll-over issues have been experienced so far this year. Thanks to a track-record of foreign currency issuance, diversification of instruments and increased maturity profiles.

The key issues currently facing Turkey are the rising policy uncertainty, independence of the central bank, fiscal and economic policy direction and rising external pressures (FX risks).

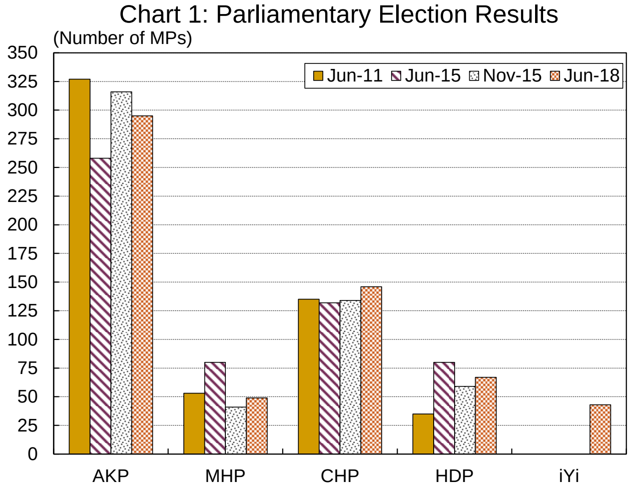
This report will look into the recent political events and their significance, the heightened policy risks moving onto rising inflation and monetary policy. The role of fiscal policy in recent overheating, despite strong overall public finances, and then Turkey’s elevated external vulnerabilities such as the weakening Lira, exposure of the Turkish banking and corporate sector and the current account deficit before concluding.

2. President Solidifies Position, Policy Risks Heightened

In perhaps one of the most significant elections of the recent past President Erdogan won snap elections on 24 June with 52.6% of the vote in the presidential election and the AKP gaining 295 seats out of the overall 600 seats available (increased from 550 seats previously) in the parliamentary election, shown in Chart 1 below. The AKP remains in a ruling coalition with the MHP allowing President Erdogan to trigger the change to the executive presidency system, which was narrowly approved in the referendum result by 51.4% on the 'Yes' side to 48.6% on the 'No' side, held on 16 April 2017.

The raft of new executive powers, shown in Table 1, will significantly increase the president's influence and power. The office of prime minister has also be eliminated with powers shifted to the president, giving the president the right to appoint the central bank governor.

Chart 1: Parliamentary Election Results



Source: Supreme Electoral Council, MUFG Bank Economic Research Office

Table 1: Erdogan's New Powers

Constitutional Court	Now has the power to appoint 12 out of the 15 members of the constitutional court
Board for Judges and Elections	Can appoint six members of the Board for Judges and Elections
Cabinet	Has the ability to appoint the whole cabinet without the need for parliamentary consent.
Parliament	Can dissolve parliament as well as being responsible for submitting the budget to parliament
National Security Decrees	Able to issue decrees over issues of national security, including states of emergency

Source: News sources, MUFG Bank Economic Research Office

The election result is made significant by President Erdogan's recent rhetoric on central bank policy at a time of elevated market pressures, and has combined with the long-term erosion of checks and balances that has occurred under his presidency. The fact the president will now have greater powers has led to greater policy uncertainty.

Turkey lost its investment grade ratings as a result of the erosion of checks and balances as well as the erosion of the independence of key institutions. Moody's downgraded Turkey in September 2016 to 'Ba1' from 'Baa3', with Fitch Ratings later following in January 2017 downgrading the rating to 'BB+' from 'BBB-'. S&P however never had Turkey at investment grade rating with Turkey only reaching 'BB+' before being downgraded to 'BB' in July 2016.

Turkey's rating has subsequently been downgraded by a further notch by all three ratings agencies, most recently by Fitch in July 2018 due to downside risks to macroeconomic stability that have 'intensified owing to the widening in the current account deficit (CAD), more challenging global external financing environment, jump in inflation and the impact of the plunge in the exchange rate on the private sector'. Moody's currently has Turkey's ratings under consideration for a potential further downgrade to 'Ba3' from 'Ba2', with Fitch's rating also on a negative outlook, and S&P's rating outlook stable but at 'BB-'.

The implication of the negative outlook is that a further downgrade is now more likely than a stable outlook due to the negative factors affecting the sovereign.

According to Fitch Ratings the triggers for a further potential downgrade comprise the following factors. A sudden stop of capital inflows or hard landing of the economy especially if these factors heighten stresses in the corporate and banking sector. Other triggers include a failure to re-balance the economy by addressing structural deficiencies, marked increase in government debt or a serious deterioration in the political or security situation.

Out of these factors the sudden stop of capital inflows would be the most likely factor to result in the downgrade of the Turkish sovereign, together with a sudden hard landing of the economy. It therefore makes sense when analysing the external vulnerabilities of Turkey later in this report to focus on these two variables, however capital inflows are impacted directly by the monetary policy framework, which is key to resolving Turkey's vulnerabilities, so we will start off on this topic first.

3. Monetary Policy Key as Inflation Surges

The key risk is whether President Erdogan's executive changes or his rhetoric increases pressure on the institutional independence of the Central Bank of the Republic of Turkey (CBRT) which has been feeding into increased policy uncertainty. The president believes CBRT policy rates are too high with the recent appointment of Erdogan's son-in-law, Berat Albayrak, as the Treasury and Finance minister in his new cabinet likely to increase these pressures in the medium term.

These concerns are highlighted by the CBRT's most recent monetary policy committee (MPC) decision on 24 July to keep rates unchanged. Markets viewed this meeting as a test of the CBRT's resolve to bring double-digit inflation under control and were expecting a rise in rates. The announcement of no policy change led to a sharp drop in the Lira by 4.9% versus the USD with the Lira ending the day some 3% weaker versus the USD.

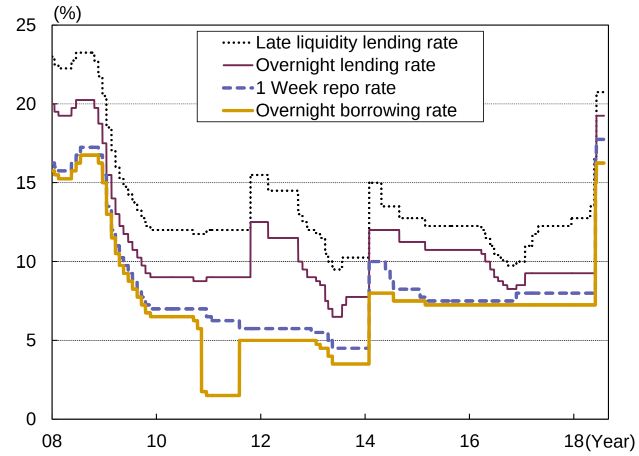
The latest MPC decision comes after in an emergency move in April 2018 to increase policy rates by 3 percentage points, shown in Chart 2. This move was aimed at Lira stabilisation. Due to increasing market pressures, risks from global financing conditions and rising oil prices against a turbulent political backdrop. Although the emergency move did highlight the CBRT's willingness to combat rising inflation with higher rates and came despite President Erdogan's rhetoric, it feeds into rising policy uncertainty.

The CBRT also made changes on 1 June to its unconventional multi-rate system, by changing the main policy rate back to the one-week repo rate from the late liquidity window. The one-week repo rate is supported by an interest rate corridor with the overnight borrowing and lending rates set at 150bp above and below the benchmark respectively and the late liquidity lending rate reverting back to an emergency fund instrument, shown in Chart 2.

This marked a return to a more conventional monetary policy framework and a positive move welcomed by international investors. However has had little effect so far in bringing down double-digit inflation and with the complex multi-rate system still in use means the monetary policy transmission channel will remain an issue.

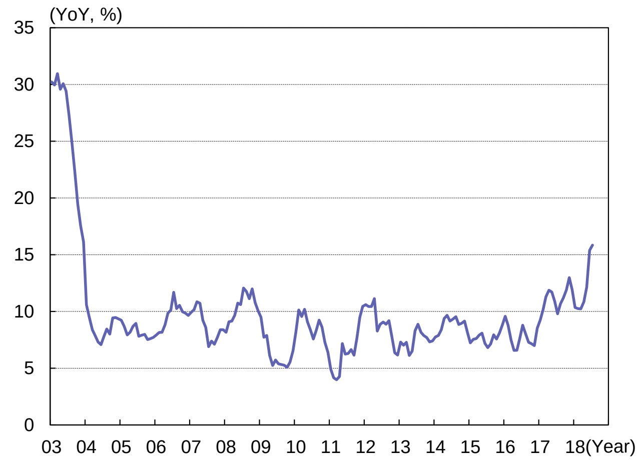
Recent monthly inflation figures for July 2018 show a particularly large uptick reaching 15.8% YoY, shown in Chart 3. This is the highest it has been in over fourteen years and is mainly due to the pass-through effects of the recent weaker Lira.

Chart 2: CBRT Policy Rates



Source: CBRT, MUFG Bank Economic Research Office

Chart 3: Consumer Price Index



Source: CBRT, MUFG Bank Economic Research Office

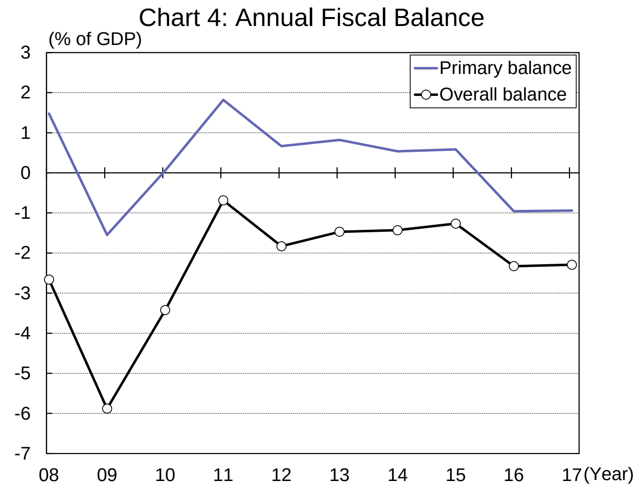
According to latest consensus forecasts, taken from July, inflation is estimated at 12.8% YoY in 2018, before falling slightly to a forecasted 11.0% YoY in 2019. We think that risks will remain to the upside, especially if there is further depreciation of the Lira or higher oil prices.

4. Fiscal Deficit Adds to Overheating Risks

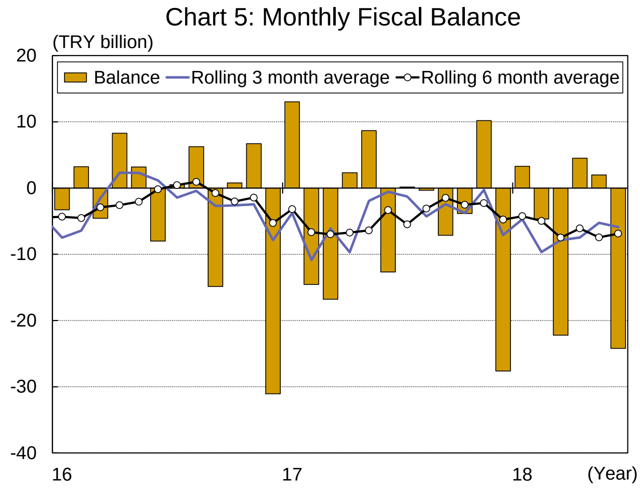
Fiscal stimulus was used in 2017 to support growth and comprised an extension of the government guarantee for the Credit Guarantees Fund (CGF) lending capacity to 1% of GDP. There were also expenditure measures such as supporting minimum wages and providing interest support to SME's. These measures together came to 3.8 billion TRY, added to a further 6.7 billion TRY of tax reductions. The government has also used the build-up of contingent liabilities to support growth through the use of public-private partnership (PPP) activity.

Annual GDP growth in 2017 was exceptional at 7.4% YoY in 2017 up from 3.2% YoY in 2016. This exceeded the government's target and central bank estimate of potential growth of 5.5% YoY highlighting concerns over economic overheating. Growth was driven by strong growth in key trading partners as well as the rebound in tourism and underpinned by counter cyclical policy and strong household demand.

After a period of primary balance surpluses from 2011 to 2015, the primary balance fell into deficit in 2016 and has remained in deficit since, as Chart 4 shows. Latest monthly figures show that the accumulated fiscal deficit, from January to June in 2018, is more than 2x larger versus 2017. A rolling 6-month average of the deficit, shown in Chart 5, shows the deterioration in the first half of 2018, with the average deficit in June recording a deficit of 6.9 billion TRY.



Source: IMF, MUFG Bank Economic Research Office

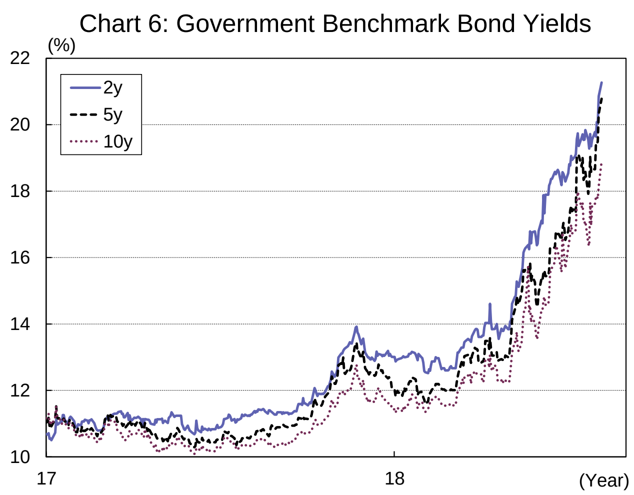


Source: Ministry of Finance, MUFG Bank Economic Research Office

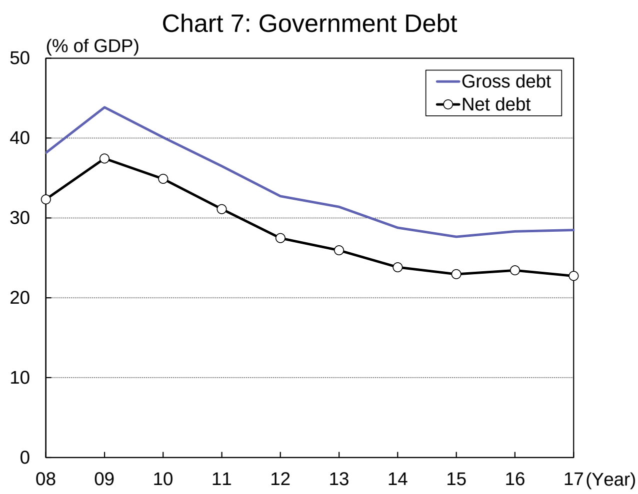
The government is trying to increase revenues through higher corporate income tax rates which have been hiked to 22% from 20% temporarily for 2018-2020, as well as higher taxes on vehicles and soft drinks. Tax revenues will also be increased through broadening the tax base by unifying reduced VAT rates as well as reforming the VAT refund mechanism. On expenditures authorities are planning to contain the wage bill as well as reducing some capital expenditure; however the deficit is still expected to be larger in 2018 and 2019.

Turkey’s fiscal deficit is expected to be slightly higher at 2.6% of GDP in 2018 and 2019 from 2.3% in 2017, according to the latest July consensus forecasts. Risks will remain to the upside in 2018 due to potential larger than expected government spending to support growth before recent elections. Looser fiscal policy has led to increasing concerns of economic overheating and fed into inflationary pressures.

Government bond yields, shown in Chart 6, have been rising strongly across all maturities in the first half of 2018. This comes despite a low and stable level of government debt shown in chart 7. Highlighting the increasing potential risks of domestic financing issues the 2-year and 5-year yield for a government bond are nearly at 21% and 10-year at around 19%.



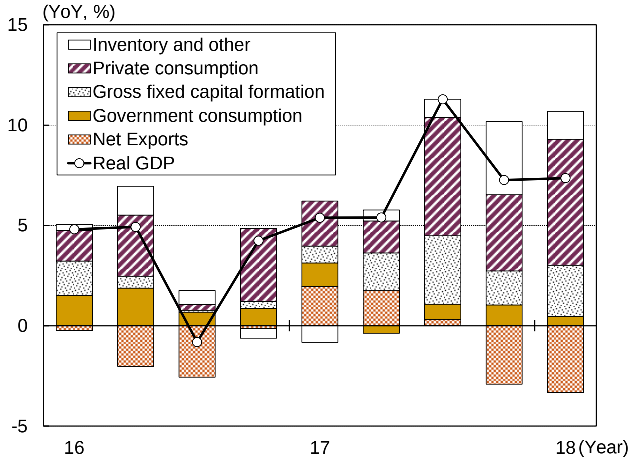
Source: Macrobond, MUFG Bank Economic Research Office



Source: IMF, MUFG Bank Economic Research Office

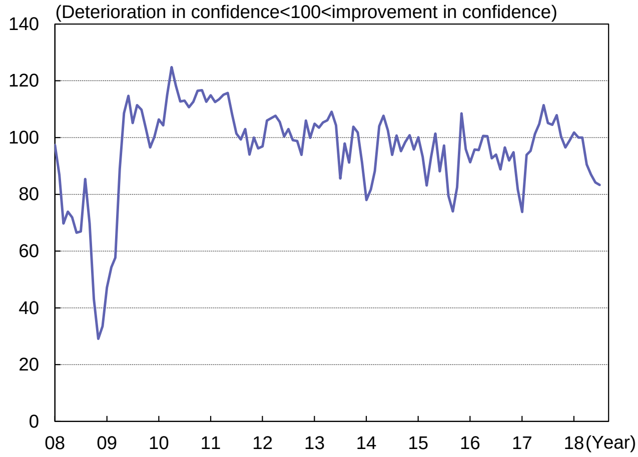
Quarterly GDP figures in Q1 2018 show strong growth of 7.4% YoY as shown in Chart 8 however growth is expected to fall over the rest of the year. This is highlighted by the latest general business environment, shown in Chart 9, which shows deterioration so far this year. A tighter fiscal budget will also feed into lower growth. Latest consensus forecasts from July show a mean growth forecast of 4.1% YoY for 2018 and 3.3% YoY in 2019, down from the exceptional 7.4% YoY growth in 2017.

Chart 8: Contributions to Real GDP Growth



Source: CBRT, MUFG Bank Economic Research Office

Chart 9: General Business Environment Survey



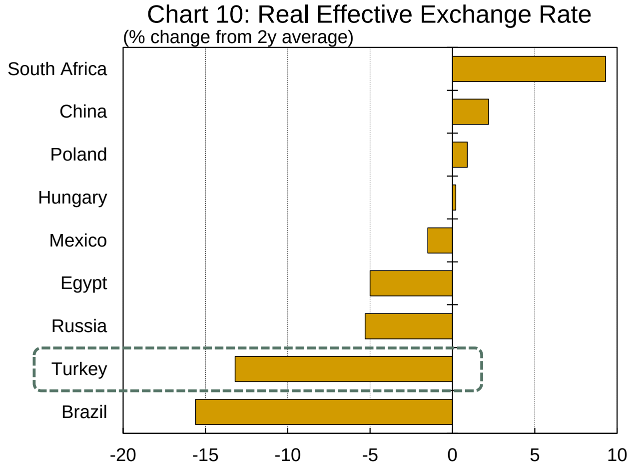
Source: CBRT, MUFG Bank Economic Research Office

5. External Vulnerabilities Rising

Turkey's external vulnerabilities have increased due to rising political risk, inflation and uncertainty over monetary policy, exacerbated by high sensitivity to global financial conditions. Turkey is characterised by a saving-investment imbalance which manifests itself in the large external financing needs of the banking and corporate sector.

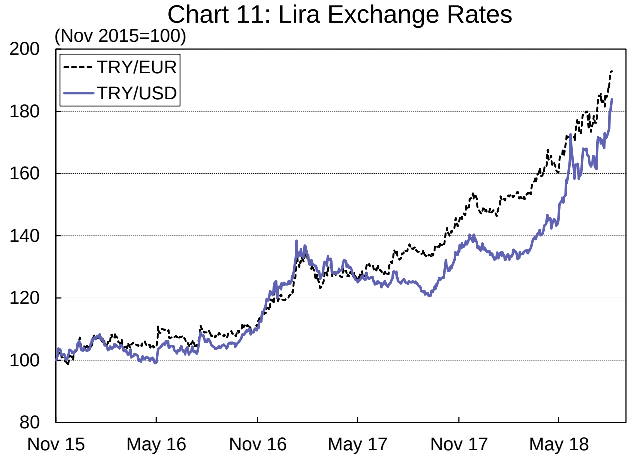
Rising vulnerabilities has led to increased Lira depreciation. The Lira is now among one of the worst performing emerging market currencies (Chart 10), having depreciated around 25% versus the USD so far this year (Chart 11). This feeds into higher inflation and further external vulnerabilities such as increased exposure of Turkish banks and corporates to higher foreign currency risks and widening current account deficit (CAD).

Chart 10: Real Effective Exchange Rate



Source: European Commission, Bruegel,
MUFG Bank Economic Research Office

Chart 11: Lira Exchange Rates



Note: General election held in November 2015
Source: Macrobond, MUFG Bank Economic Research Office

Turkish corporates and banks' foreign currency risks have increased. Foreign exchange reserves now cover less than half the country's annual FX repayment needs. External financing (including short-term debt) is now projected to rise to 214 billion USD in 2018, 226% of projected end-2017 reserves.

Turkey's international liquidity ratio, which also assesses the risk of an external liquidity crisis, is estimated at 81.6% in 2018, highlighting the increasing pressures of the private sector when meeting its foreign currency needs. The international liquidity ratio is calculated by dividing the country's liquid external assets in previous year comprising official international reserves, gold and banks external assets, by its liquid external liabilities comprising external debt service in the current year plus stock of short term debt and non-resident holdings of short term debt in the previous year. A low ratio of less than 100% indicates external assets are lower than external liabilities.

Banks have worked to diversify their instruments and increase maturities, while maintaining a strong relationship with external to ensure consistent roll-over of foreign debt. The private sector also has a track-record of meeting its foreign currency obligations with no roll-over issues so far this year.

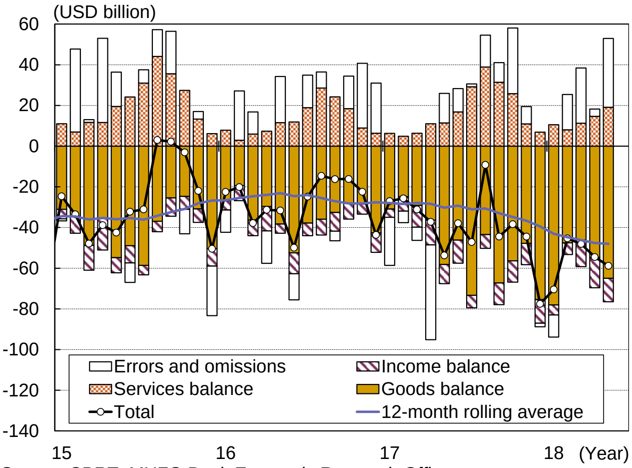
The balance of payments will be key to monitoring rising risks on the external side, if inflows to fund the CAD decrease. This could lead to increased pressure for corporates and banks in accessing foreign currency. For now corporates and banks have managed to roll-over foreign currency debt, however risks since the start of the year have been elevated.

Latest monthly CAD figures have been widening for some time and now stand at their widest since late 2014 (Chart 12). The wider CAD is due to a large trade deficit due to higher oil prices and higher gold imports as a result of greater household demand. Exports, despite increasing due to a rebound in tourism and strong global growth, have been unable to counter balance the higher energy prices and gold imports as well as rising domestic consumption.

Turkey has increasingly relied upon reversible portfolio flows such as short term government debt, bank debt securities and deposits to fund its CAD, increasing its vulnerability to changes in flows and global conditions. Net FDI is expected to fall in 2018 from 2017 and remain weak due to the ongoing effects of the political backdrop and policy uncertainty.

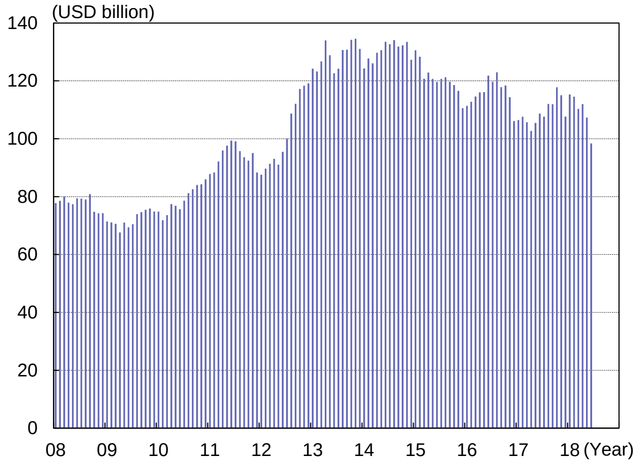
Official reserves have fallen in order to fill the financing gap and, with a widening CAD, are expected to continue on their gradual fall (Chart 13). If there were a sudden reversal of inflows, this would lead to severe liquidity issues. In particular in the short-term for the banking and corporate sector as they would not be able to roll-over their foreign currency debt, and this would then severely impact on macroeconomic stability and public finances.

Chart 12: Current Account



Source: CBRT, MUFG Bank Economic Research Office

Chart 13: External Reserves



Source: CRBT, MUFG Bank Economic Research Office

Continued uncertainty over monetary policy, the political backdrop as well as tighter global financial conditions over 2018 and particularly 2019 could add further to foreign currency risks. The external financing requirement is also expected to rise with higher US interest rates and policy normalisation, a key risk to Turkey's external debt vulnerabilities. The external financing requirement is large and will remain a major weakness over the long term.

6. Risks Elevated

The snap election win for President Erdogan increases the likelihood that the CBRT's policy will now be subject to greater political pressure, highlighted by the recent monetary policy decision to keep rates on hold. This increases the potential for policy mistakes and increases policy uncertainty which could eventually lead to a crisis, with the Lira having already fallen around 25% versus the USD so far this year.

Recent policy rate hikes and changes to the main policy rate have had little effect on bringing down double-digit inflation with risks to the upside and the recent announcement of President Erdogan's son-in-law as the Treasury and Finance Minister increasing market concerns.

The recent depreciation of the Lira has increased pressure on inflation and external balances leading to rising foreign currency exposure for the private sector and a higher current account deficit. Risks of corporates and banks being unable to access foreign currency has increased though measures taken over the last year by banks have helped the private sector to maintain good relationships with key financiers as well as diversifying their base.

Turkey has been through similar periods and continues to benefit from strong public finances and a diversified economy. Real GDP annual growth has averaged 5.1% over the last ten years (2008-2017) highlighting the sustainability of the Turkish economic model and its resilience, having survived a number of intense financial periods over the last decade. However, there have been no significant longer-term economic reforms to boost potential growth or reduce external vulnerabilities. Pressures have increased significantly since the start of the year and events will have to be monitored closely.