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ERDOGAN TAKES IT ALL

Long Road to Executive Presidency

In the past few years, Turkey has faced some of the most monumental challenges in its recent history. Following a failed coup attempt in June 2016, President Erdogan announced a state of emergency, which gave him the right to preside over the cabinet and rule by decree.

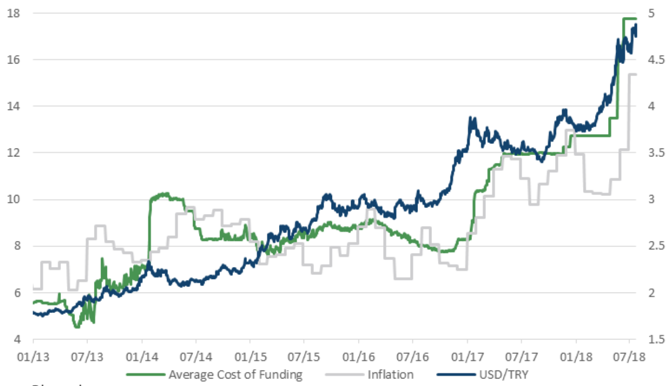
The failed coup attempt coupled with an alleged assassination attempt of Erdogan himself, has seemingly solidified his ambition and added a new sense of urgency to his long-standing dream of turning Turkey's political system into an executive presidency.

Called and conducted under the state of emergency, and heavy media censorship, with scores of journalists and political dissidents in jail or unable to vote, an April 2017 referendum was approved by a small margin of votes. This triggered a string of constitutional amendments, which overhauled Turkey's political system of governance from a parliamentary democracy to an executive presidency, marking the most notable change to the country's political institutions in its modern history.

Tightening grip over dissidents and "unfriendly" media, coupled with an accommodative stance of both fiscal and monetary policy aimed at boosting Turks' prosperity and in turn Erdogan's popularity, was orchestrated to deliver a crushing victory in the upcoming Presidential and Parliamentary elections in 2019.

Loose monetary and especially fiscal policy, in an environment of very favourable external and domestic demand has put Turkey's economic activity in the highest gear possible, delivering stellar growth. The clear policy error of excessively loose monetary policy, together with the ongoing and elevated political uncertainty, has led to a significant weakening of the Turkish Lira. The large FX pass through from the currency weakness, together with higher commodity prices and strong domestic demand, has resulted in a significant deterioration of domestic pricing behaviour. To arrest further Lira depreciation and to prevent inflation from spiralling out of control, the Central Bank of Turkey, belatedly decided to (or was finally "allowed to") tighten monetary conditions in a shock fashion, lifting the average cost of funding by a total of 500bps since the turn of the year.

Exhibit 1: Cost of Lira Liquidity



Source: Bloomberg

The significant rise in the average cost of financing to the real economy, has, as expected, put the brakes on credit creation and, in time, is expected to slow the pace of economic expansion.

Having seen early indications of economic deceleration, whilst still enjoying high levels of popularity, Erdogan called for a snap election in June 2018, meaning opposition parties had insufficient time to put together and run a credible campaign. This maximised the AKP (incumbent centre right)-MHP (right wing) alliance's chances of winning both parliamentary and presidential elections.

Despite a number of polls suggesting the contrary (which helped fuel speculation that the AK party could lose its control over parliament) the result of the twin elections confirmed a status quo: the AKP supported by confidence and supply arrangement from MHP, won a total of 340 seats in a 600 member-strong parliament and comfortably secured a workable majority. As for the presidential election, the results were even more convincing, with Erdogan securing an unexpected first round victory garnering 53% of votes cast. The victory effectively completed Turkey's transition to a presidential system, consolidating Erdogan's sweeping power and undermining a system of checks and balances against abuse of executive power, due to the greatly diminished role of parliament.

New system of governance

The new cabinet, downsized to 16 Ministries, represents a fundamental change towards a highly centralised decision-making process. The new set up includes nine presidential councils, each given the responsibility to formulate specific policies. As such, the main role of Ministries is to implement decisions taken by the President as opposed to take an active role in shaping the future policy paths.

The departure of both the Deputy Prime Minister, Mehmet Simsek, and the Finance Minister, Naci Agbal, the most highly respected politicians from the "old" regime, were the key personnel changes in recent weeks. The power of these two key Ministries was consolidated under the reign of Erdogan's son in law, Berat Albayrak, who is neither an experienced politician, nor well-renowned policy maker.

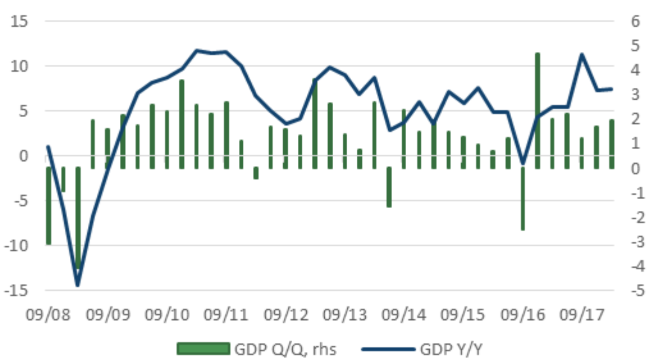
Shortly after being sworn into office, Erdogan also issued a set of presidential decrees. Among them were newly granted powers to appoint central bank governors and deputies, without prior recommendation from parliament. This, together with the removal of both Simsek and Agbal, has greatly reduced the predictability of a policy, at a time when a right mix of monetary and fiscal policy is imperative in order to address Turkey's increasing vulnerabilities.

State of the Economy – The Past

Macro picture – build-up of vulnerabilities

As already discussed, thanks to loose fiscal policy and, until recently, relatively benign monetary conditions (both externally and domestically), the Turkish economy has experienced a period of very strong growth, with the latest gross domestic product expanding at a staggering 7.4%y/y, equivalent to the economy growing by 2% between Q4-17 and Q1-18. The country's policy mix has boosted domestic demand ahead of the elections, with the net effect being a near doubling of the pace of growth for both household consumption and gross fixed capital formation.

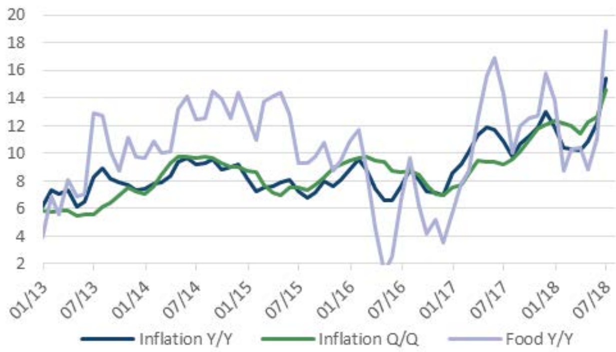
Exhibit 2: Gross Domestic Product



Source: Bloomberg

The strength of consumption and rising oil prices (Turkey imports 90% of its energy needs) has seen a significant rise in its import bill and, in turn, a negative contribution of net exports to GDP growth. Sharply deteriorating price behaviour and inflation expectations led also to an increase in gold imports, which is often seen as a store of value (particularly in countries burdened by rampant inflation).

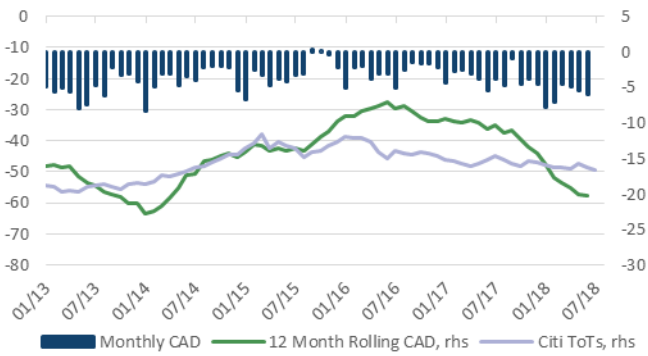
Exhibit 3: Pricing Behaviour



Source: Bloomberg

Higher oil prices have led to Turkey's Terms of Trade deteriorating sharply, which together with the strength of domestic consumption has seen a dramatic widening of the current account deficit. The latest figures showed the 12 month rolling shortfall at close to USD58bn (ca. 7% of GDP), suggesting a near USD22bn deterioration in the country's Balance of Payments Position in the period.

Exhibit 4: Current Account Position



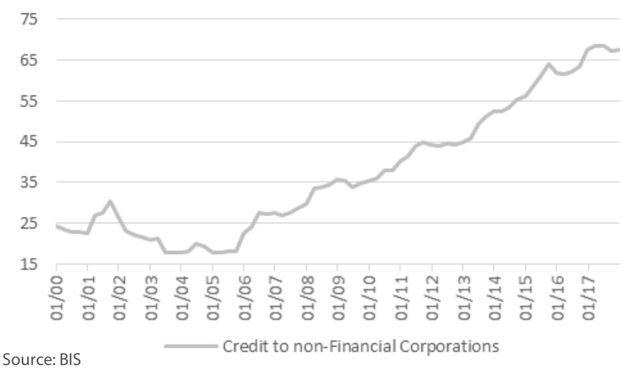
Source: Bloomberg

Given the elevated cost of external financing, when compared to recent years, the funding of the external imbalances has certainly become a costly exercise.

Corporate sector – weathers the storm

The abundance of external liquidity and relatively low domestic interest rates since the end of the Global Financial Crisis, has seen the Turkish corporate sector lever up to circa 70% of GDP, from 30% in 2008.

Exhibit 5: Credit % of GDP



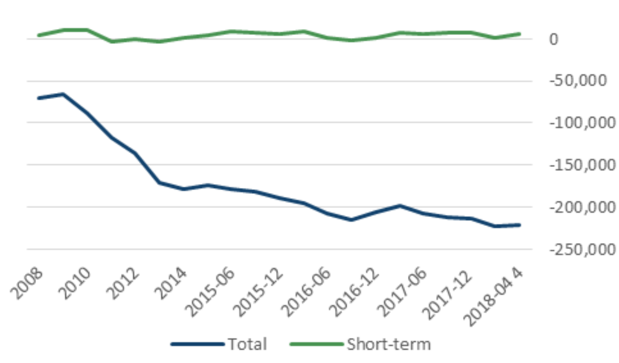
Source: BIS

As such, the balance sheet of the corporate sector has become the largest source of vulnerability for Turkey relative to other parts of the economy (household and public sector). With over 50% of the newly accumulated debt in foreign currency, a net short FX position grew to 25% of GDP (USD 220bn), up from circa 9% (USD70bn) in 2008, making this one of the most critical concerns raised by international investors.
Clearly not all sectors are equally exposed. The service sector (Real estate, Utilities, Hotels and Restaurants) suffers from higher external leverage, with fewer sources of FX revenue than the manufacturing sector. Some of the above (e.g. Hotels and Real Estate) do appear to have partial buffers (pricing is often in foreign currency), however in periods of rapid and deep depreciation of the currency, rising costs are not perfectly passed onto consumers.

Despite a number of episodes of heightened volatility in the rates market since the end of the Global Financial Crisis, which often coincided with sharp Lira adjustment, the domestic corporate sector in Turkey managed to weather the storm largely unabated. There are a number of factors that help to explain this conundrum.

Firstly, despite a very high headline figure, the FX position of the corporate sector in the sub 12-month maturity profile is in fact in a small surplus of USD3bn. This often works as a buffer during episodes of a temporary US dollar liquidity squeezes. However, with as much as 35% of total external loans in the 1-five year maturity range, a sustained period of currency depreciation (combined with higher interest rates) could see the external vulnerabilities present a considerable challenge for corporates' ability to refinance debt liabilities.

Exhibit 6: Net FX Position



Source: CBRT

Secondly, with nearly 40% of the corporate sector classified as Small and Medium Sized Enterprises, it isn't inconceivable to assume that private owners often use their own sources of dollar liquidity to shore up their short-term liquidity needs. This is particularly likely given a relatively high level of dollarization of the economy.

Furthermore, in periods of heightened market volatility, the net error and omission entry on the Balance of Payments often balloons. This suggests that there are informal sources of dollar funding outside of the domestic financial sector and corroborates the alleged claim of large corporates underreporting their exports revenues in order to keep some overseas hard currency stores undisclosed.

It is often argued that the large headline figure of net short FX liabilities at around USD220bn is misleading, as a large number of particularly blue-chip companies are either financially or naturally hedged, making the actual FX mismatch less of an issue for some. Also, very strong growth momentum domestically has boosted firms pricing power, which allowed for higher pass-through of costs related to the higher price of capital onto consumers.

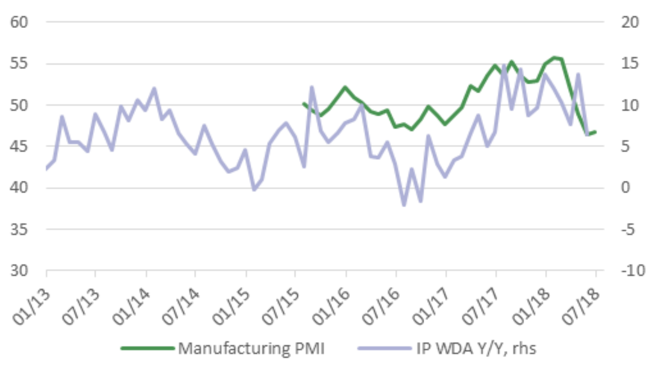
Lastly, irrespective of the true extent of FX mismatch between companies' assets and liabilities, the prolonged period of cheap dollar liquidity (due to Quantitative Easing) has proven to be the most likely reason why Turkish corporates have managed to balance their FX exposure in an orderly fashion. The abundance of monetary liquidity allowed corporates relatively unimpeded access to funding via domestic banks, which have often enjoyed roll over ratios in excess of 100%, predominantly from parent banks based in continental Europe.

State of the Economy – The present

This time could be different?

We have reasons to believe that the recent political changes (and related uncertainty regarding future policy) together with the normalisation of monetary conditions globally could present a significant challenge for a country burdened with large external liquidity needs, as a rising costs of funding are likely to coincide with a meaningful deceleration of domestic economic activity. Despite the latest GDP print showing very strong economic momentum, a number of more timely indicators suggest a potential soft path lies ahead. The Markit Manufacturing Purchasing Manager's Index has corrected sharply, declining nine points from February this year, down to 46.8 as of its latest release for June.

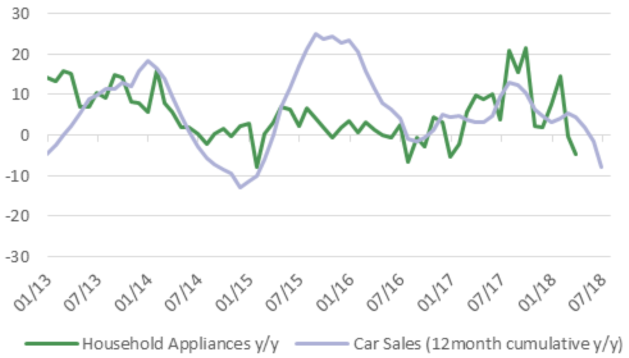
Exhibit 7: Activity Data Producers



Source: Bloomberg

The moderation in this survey-based indicator has also been confirmed in hard data, with industrial production output for May decelerating to an annual pace of 6.4%, from double digit rates of growth observed during most of last year. Consumer demand has also waned, a consequence of both higher political uncertainty and higher costs of credit. Car sales have generally been weak for some time now, but the recent correction in house sales and sales of household appliances ought to be watched closely.

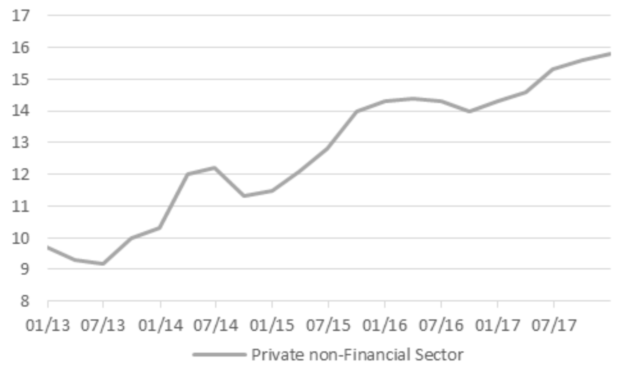
Exhibit 8: Activity Data Consumer



Source: Bloomberg

Returning to the corporate sector, an environment of meaningful slowdown in economic activity will diminish producers' pricing power, and in turn their ability to pass on the costs of the rising price of dollar liquidity and a weaker currency to consumers. All this implies that firms with higher leverage and greater FX asset-liability mismatches are likely to bear the brunt. Their debt service cost (defined as: [interest payments + amortisation] / income) will get squeezed from above and below, and, depending on the scale, and/or policy response, could lead to a deterioration in banks' asset quality.

Exhibit 9: Debt Service Ratio



Source: BIS

State of the Economy – The future

A new regime

The supercharged rates of growth observed recently are unlikely to be sustained in the future. A number of forecasters have even called for an outright contraction of GDP in Q2-18 and near zero rates of growth for the remainder of the year. Given a near exhaustion of the funding capacity of domestic banks (as ascertained by credit rating agency S&P) it is becoming unclear where growth could come from.
The apparent deceleration of economic activity coinciding with rampant inflation (which is yet to peak) and a de-anchoring of inflation expectations, bears all the hallmarks of stagflation.

The growing risk of domestic stagflation, rising funding costs of large external liabilities, less favourable external backdrop (exacerbated by fears of a trade war between the US and its trading partners) and perhaps most importantly, the conclusion to the much feared transition to a presidential system of governance (which effectively puts Erdogan in charge of nearly all key institutions responsible for shaping the country's policy agenda) quite clearly constitutes a radical change in investment climate.

In order to address a growing set of vulnerabilities, without unduly inflicting pain onto consumers and producers alike, requires a pragmatic policy response, supported by strong domestic institutions. This requirement is now unlikely to be met in Turkey.

Recent changes to the central bank charter, with respect to personal appointments, are set to further undermine the institution's strength and credibility by making it even more susceptible to political pressure. Erdogan's strong belief in a positive relationship between interest rates and inflation (i.e. lower interest rates lead to lower inflation) has seen him put undue pressure on the country's central bank to keep rates too low, with the eventual response being deemed as "behind the curve" or "too little too late", leading to unnecessary volatility and underperformance of lira-denominated assets.

Historically, fiscal prudence and relatively low public debt was a key anchor for Turkey from the perspective of international investors. The appointment of a relatively unknown and inexperienced Minister to run both the Treasury and Finance Ministry has eroded investors' confidence in prudent fiscal policy, leading, unsurprisingly, to large currency falls at the point of the announcement.

Policy response

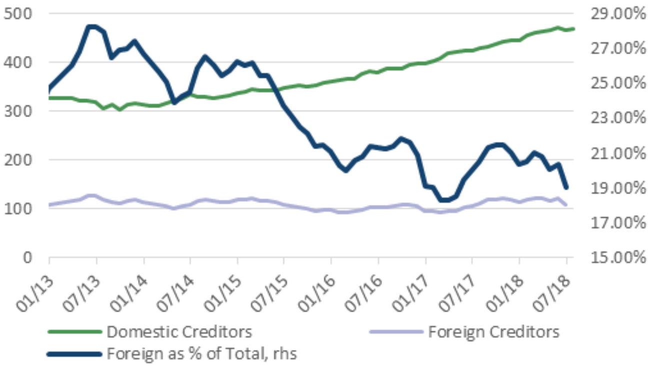
Given a growing set of imbalances both domestically and externally, formulating an adequate policy response ought to be of a paramount importance in order to instil some stability in domestic asset prices.

An overheating economy, which suffers from high and rising inflation, an excessively high and widening current account deficit and, by implication, a weakening currency, requires upmost vigilance in conducting monetary policy, in order to regain investors' confidence. In the case of Turkey this should mean offering a large real yield buffer, sufficient enough to offset investors' concerns related to the risk of further currency depreciation.

Bringing about stability in the currency is imperative not only from the perspective of high and fast FX pass through to domestic prices, but also due to the outstanding issues related to corporates' large net short FX positions, as any prolonged depreciation of the currency is set to put downward pressure on companies' balance sheets.

Higher domestic interest rates should also cool off domestic credit creation, supporting a much-needed rebalancing of the economy, in turn reducing the large current account deficit. Similarly, fiscal policy ought to retain its prudence by not straying towards excessive fiscal loosening, and thus complementing the central bank's effort in bringing the current account deficit to a more manageable size.

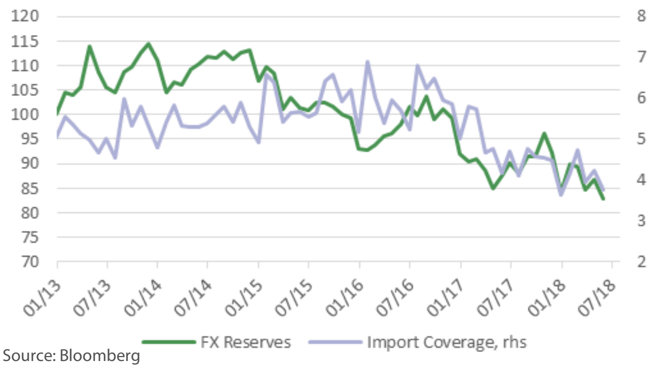
Exhibit 10: Government Domestic Debt Holdings



Source: Bloomberg

Due to a heavy reliance on energy imports and low domestic savings rate, Turkey needs to regain the credibility of its institutions and predictability of its macroeconomic policy. Without it, the ongoing erosion of confidence will see further declines in bond ownership on the part of foreign investors, in turn putting undue pressure on local government bonds and the currency. Inability to attract investors would also see the very limited stock of foreign reserves shrink, a scenario that market participants will certainly be keeping a very watchful eye on.

Exhibit 11: Central Bank's FX Buffer



Source: Bloomberg

Conclusion

There are a number of events over the past few years that have culminated in regime change in Turkey. A pragmatic policy response now needs to be formulated in order to address the country's growing set of vulnerabilities. We remain sceptical that this will be achieved, given Erdogan's relentless attack on, and disregard towards, the institution of the Central Bank, resulting in the loss of its independence. Similarly, local elections next year are likely to see fiscal policy in an accommodative mode for some time still. As such, despite the significant repricing of late, we fear that an environment of heightened risk premia in Turkish assets is unlikely to abate any time soon, with heightened volatility in both bond and currency markets. In this stagflationary environment, banks' asset quality is also likely to deteriorate, but given the relative strength of the sector, the risk to financial stability ought to be contained, hence a credit crisis should be avoided.

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