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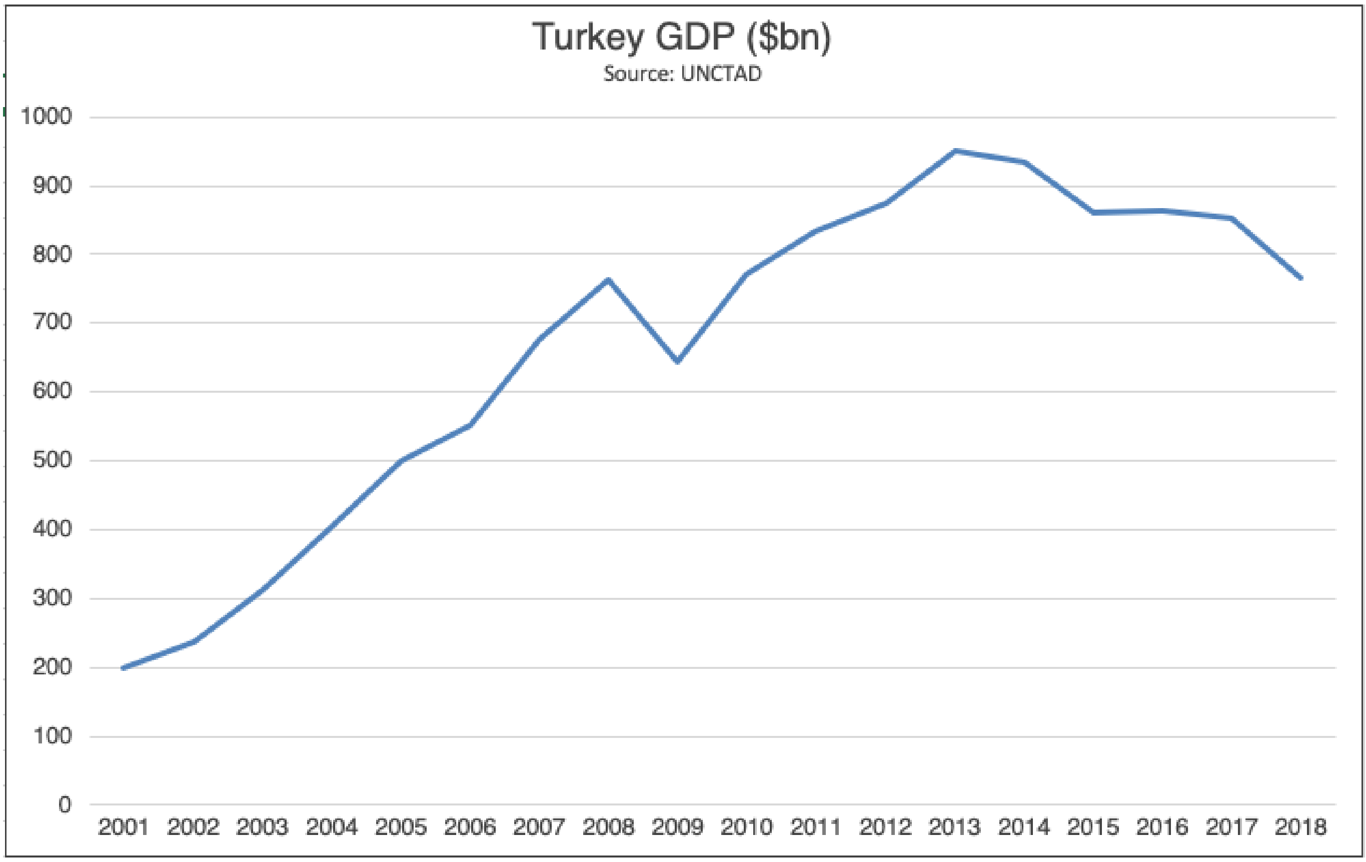
In the midst of renewed tensions with Washington over Ankara’s military incursion in Syria, there are fresh concerns that Turkey’s economy could soon face another confidence shock. The economy has proved relatively resilient to headwinds in the recent past, and the country has maintained a good outlook for foreign investors. The main drawback has been feeble domestic confidence, notably from consumers.

After weathering 12 months of a currency and debt crisis accompanied by high inflation, the Turkish economy shows mild signs of recovery. Higher interest rates have allowed the lira to stabilise and even regain 13.6% from its lowest value in August 2018. This helped bring monthly inflation down to single-digit levels this September for the first time since mid-2017.

A weaker currency this year enabled Turkey to boost exports, decrease its foreign trade deficit by 70% compared to the previous year and reach a positive current account balance in June, after 17 years of consistent deficits. On the back of these positive indicators, at the end of September the government introduced a new economic policy with an ambitious – and inconsistent – set of goals, which are to grow GDP by 5% per year from 2020 onwards and drop the unemployment rate from 13.9% to 9.8% by 2022 while also reducing inflation from 12% to 4.9% and the fiscal deficit from 2.9% to 1.8% by 2022.



The government’s prime tool in achieving its economic goals is credit growth. While Turkey already has the highest real interest rate among emerging markets, at 4.76%, the new central bank governor is likely to further drop rates and allow banks to instigate lower reserve ratio requirements in order to offer cheaper loans to consumers.

Public financial institutions such as the Turkey Wealth Fund have been tasked with shoring up financially troubled borrowers and taking losses on bad loans in order to extend credit in the hope that consumption will shoot up. As a result, this year the banking sector has been deleveraging, lowering external debt and long-term private debt by around 5% and slashing short-term private debt by 24% from 2018 levels.

The economic policy has been built around the premise of long-term political stability with no elections in sight until 2023, enough time to allow reforms to be implemented. However, it does not take into account the fact that political survival remains at the top of the agenda for President Recep

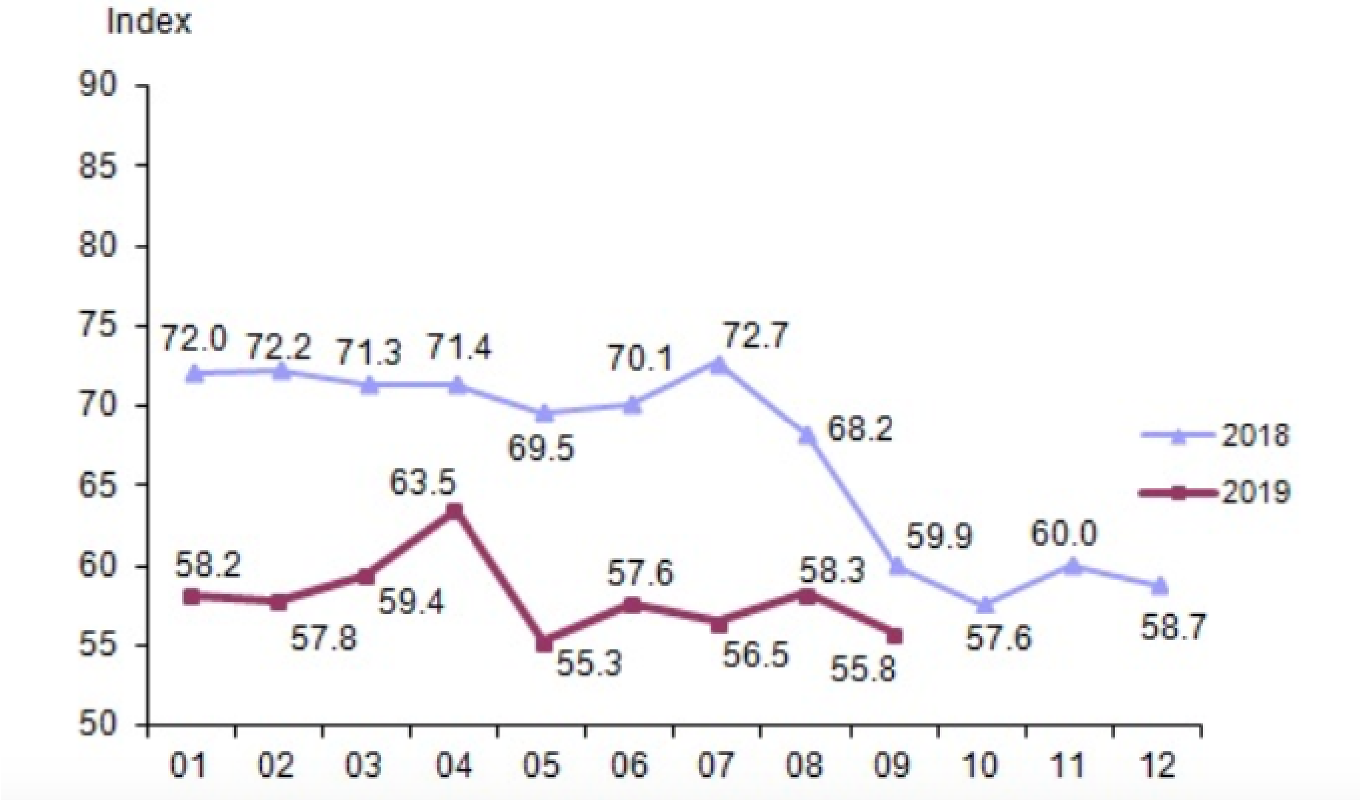
Tayyip Erdoğan, for whom preventing social unrest will take precedence over improving investor confidence.

Slowdown could be lasting

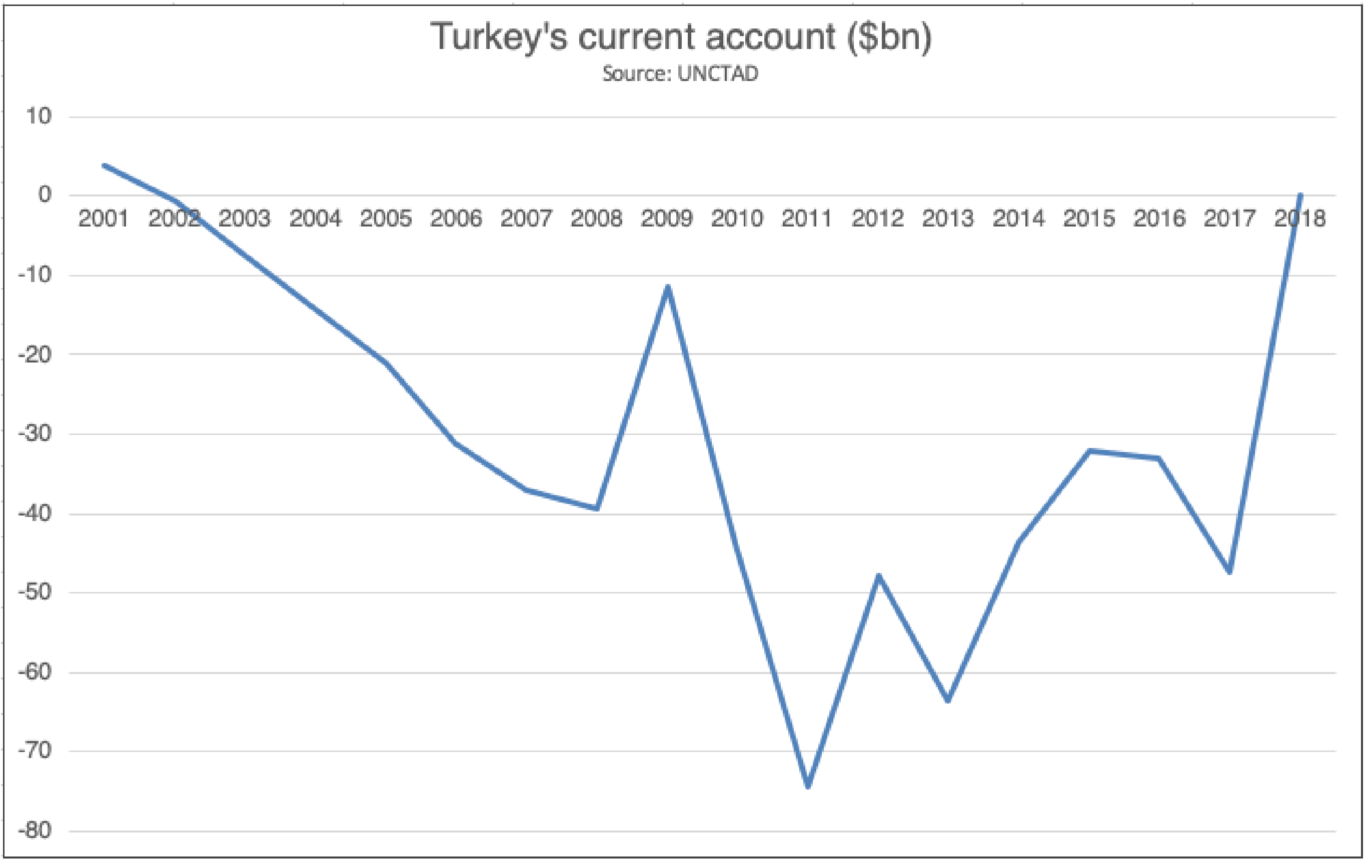
The government’s optimism in the economy’s recovery may not be shared by consumers and the business community, many of whom remain sceptical about exchange rate stability and economic confidence. Strong political interference, especially in the banking sector, has seen uncooperative executives side-lined and banks made uneasy by the pressure to lend. Significant erosion of institutional stability is also evident: since 2013 the country has dropped 52 places to 109th in the World Justice Project’s Rule of Law Index.

Moreover, contrary to the government’s claims, lower inflation and a balanced current account are signs of slowing credit growth and consumption. Credit growth averaged 13.6% in the first eight months of this year compared to 22% last year, while consumer confidence has not risen above 70 index points since July 2018 – well below the 100 points indicating an optimistic outlook.

Seasonally adjusted consumer confidence index, September 2019



Source: Turkish Statistical Institute /TCMB



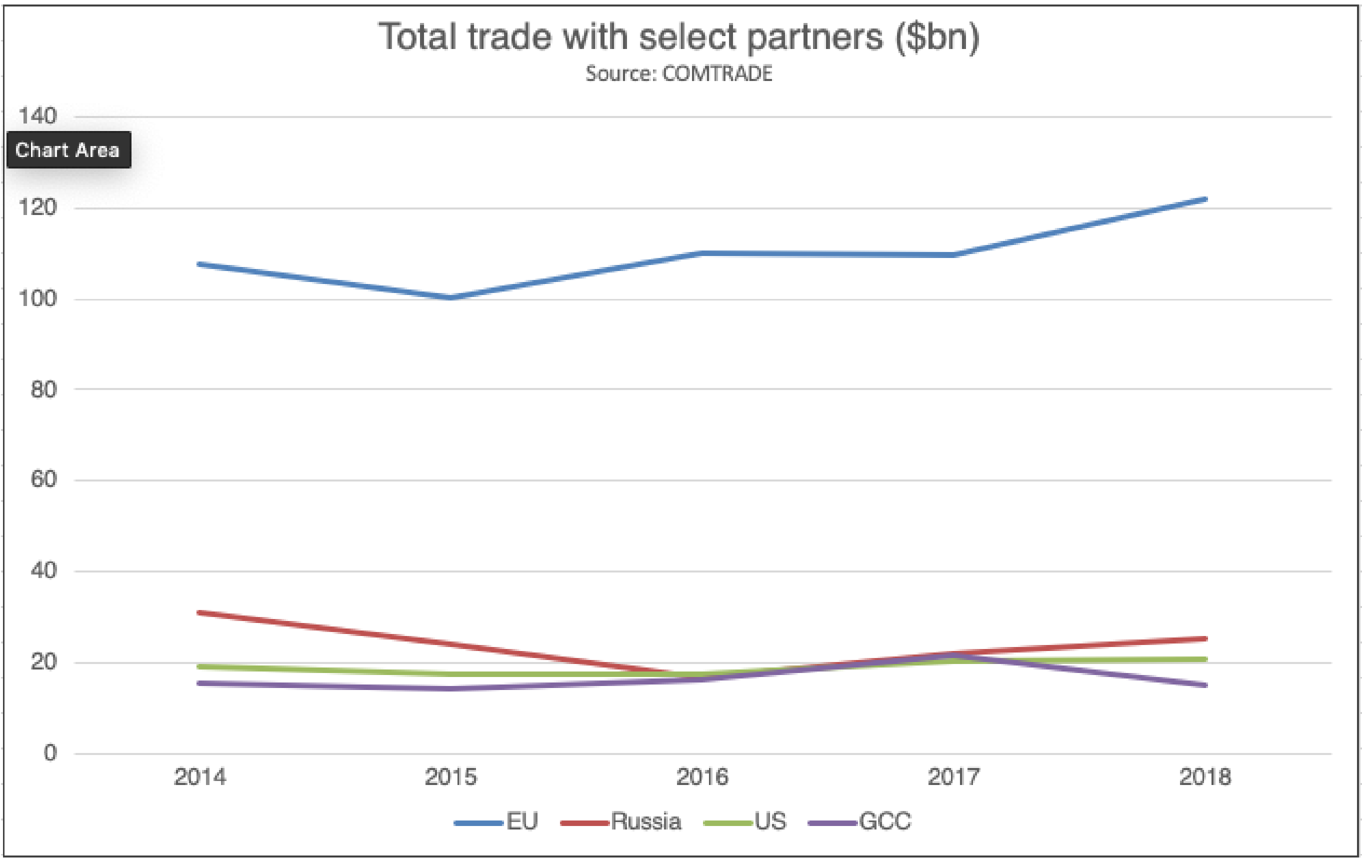
Current account deficits usually widen in times of growth, making shrinking deficits a negative sign for economic recovery.

As a result of sluggish domestic growth, the government revised 2019 growth levels from 2.3% to 0.5%, much closer to the IMF's forecast of 0.25%. In this period of slowdown, it is difficult to see how Ankara, in pursuit of its policy goals, could draw on domestic resources by redressing the chronically high unemployment rate and low savings rate.

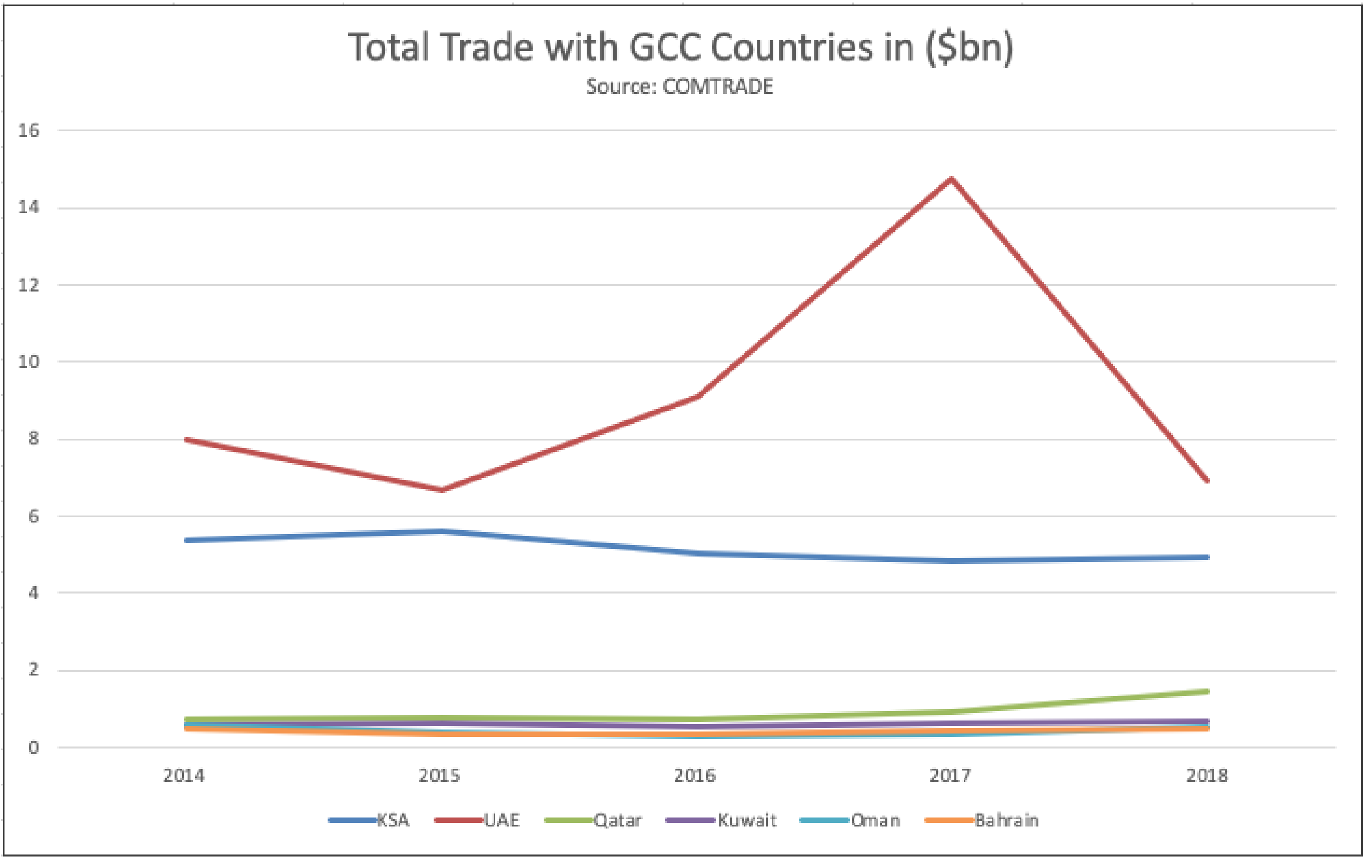
Erdoğan's risky foreign policy in Syria, the Eastern Mediterranean and even Libya is capable of exacerbating economic challenges by rendering investors more circumspect. While harsh sanctions are still unlikely, recent events have shown that the lira is vulnerable to shocks, and renewed scrutiny of Turkish financial transactions have raised the odds on major public bank Halkbank eventually being designated as an institution of illicit financial activity by the US federal court system. The political noise has already reached the notice of foreign investors, including Volkswagen. The automaker has decided to hold off on a $1.54bn production plant, originally hailed as a vote of confidence in Turkey’s automotive industry, as the single-largest investment in the sector since the 1990s, at a time when automobile demand has halved.

The longview: a resilient economy facing uncertainty

A lack of clear signs pointing to recovery coupled with Ankara’s alienation from traditional allies is likely to cast clouds of uncertainty over the country’s future political and economic trajectory. Yet, Turkey has a track record of maintaining sound trade relations in spite of political turmoil; over the last decade it has expanded foreign trade, even with countries with which Ankara entertains a tense relationship. Last year trade flows increased with both the US and major EU countries. On the other hand, with the exception of Qatar, trade with the GCC stagnated, or in the case of the UAE – which is at odds with Turkey on several regional issues including Libya and Qatar – dropped significantly.



Of all the countries impacted by Turkey's foreign policy, only the GCC has reduced trade with Ankara. (EU7 = UK, France, Italy, Spain, Germany, Austria, Netherlands).



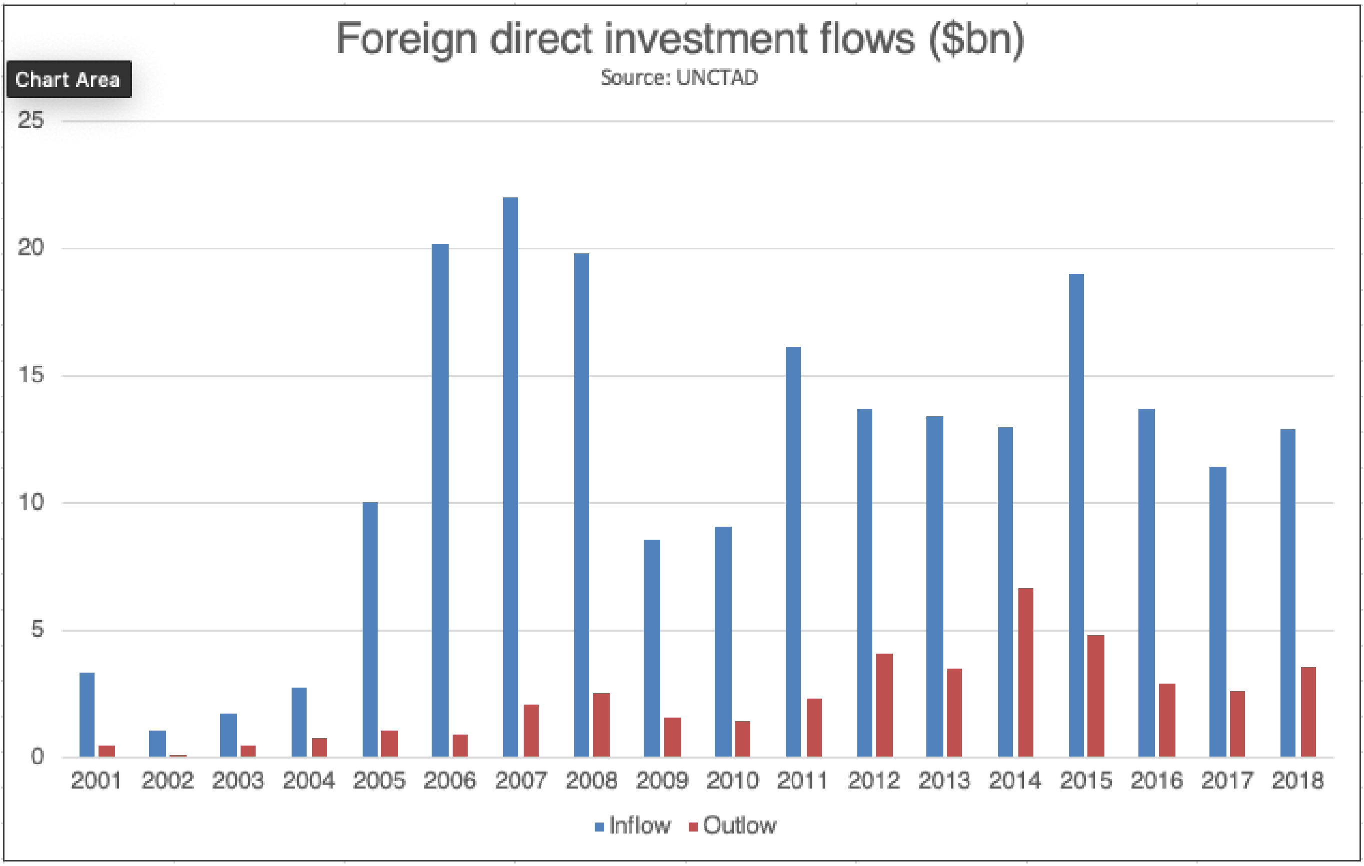
Qatar is the only GCC country to have increased trade volumes with Turkey. Stagnating or downwards trade with the GCC is very costly for Ankara, as Gulf capital and markets are important for growth.

Turkey’s investment environment has also remained secure: the country has risen from 71st to 43rd place on the World Bank’s ease of doing business index since 2013 and, despite growing political turmoil, last year foreign direct investment inflows increased by 13% to $12.9bn compared to 2017.

This does not mean that investors are risk averse: yields on most of the country’s outstanding debt have grown following geopolitical tensions in recent weeks. For example, Turkey’s $2bn bond, maturing in 2021, offered a yield of just over 4.5% on October 21, up from 3.97% on October 7. This latest increase follows a downwards trend in yields throughout September and into October – a sign of the attractiveness of emerging market credits amid a global low rates environment. In fact, Turkey will remain an accessible safe haven for regional investors facing a severe economic downturn at home, such as Iranians.

However, any further deterioration in the political or economic sphere could push yields on sovereign, and indeed corporate bonds, much higher. This will add to the fact that nearly 30% of all Turkey's outstanding debt is due to mature in 2020 and 2021, and much of it may require refinancing through the bond markets.

Growing overseas direct investment also illustrates that the Turkish population is less inclined to invest at home and more inclined to exchange their assets into foreign currency, such as the US dollar or euro, in order to hedge against the lira's volatility – private debt is kept at 94% in those two currencies. This phenomenon reflects low consumer confidence and is mainly attributed to political instability and growing polarisation.



Inflows increased in 2018 but growing outflows shows a growing propensity among Turks to invest abroad.

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