BBVA Research

Turkey Economic Outlook

3Q18

July 2018

Creating Opportunities

Key messages

- Global expansion continues at a steady pace, but less synchronized. Risks related to political uncertainty, vulnerabilities in emerging economies and trade protectionism
- After holding up in the first half of the year, soft landing of the Turkish economy is now under way. We expect GDP growth of 3.8% in 2018 and 3.0% in 2019 as both monetary and fiscal policy will become more restrictive
- Inflation reached worrying levels in June with continued deterioration in pricing behaviour and exceptional food inflation. Assuming no additional negative currency shock, we estimate the year-end inflation to be 14%
- A comprehensive National Anti-inflation strategy should be urgently implemented and placed at the top of the priority list. Monetary transmission mechanism should be enhanced by a sound fiscal policy and the removal of distortions in the monetary transmission mechanism
- The current account balance will start to correct soon but the recent figures remind us of the need for structural measures to correct the problem

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Global environment:
Global growth continues, but risks are intensifying

Global growth continues, but risks are intensifying

01

The pace of global expansion is being maintained, but is less synchronized

Growth is robust in the US due to the fiscal stimulus and stable in China, but it has declined in Europe

02

Increased protectionism

At the moment, its impact on growth is limited, but it could be greater if the measures under discussion were to be implemented

03

Increase in the price of oil

Higher inflation and drag on growth in oil-importing countries

04

Different pace of monetary normalization in Europe and the United States

Strengthening of the dollar and tightening of global financial conditions

05

More volatility in emerging markets

Increased financial tensions due to increased financing costs and protectionist threats

06

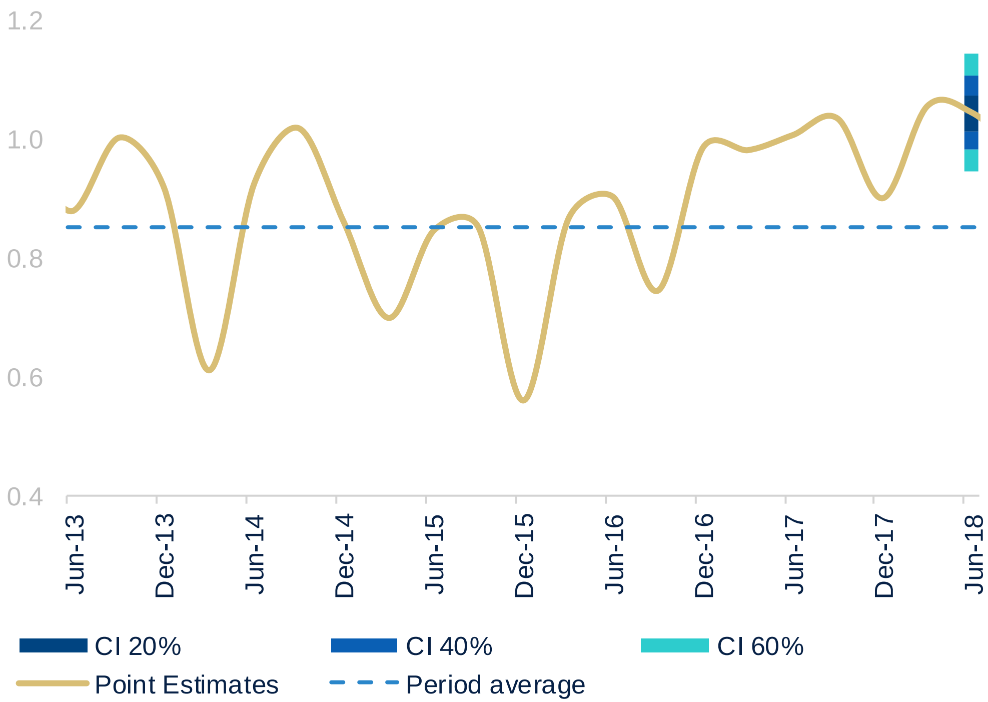
Global risks are intensifying

The possibility of a trade war comes together with greater risks in emerging economies and in Europe

Robust global economy despite growing uncertainty

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



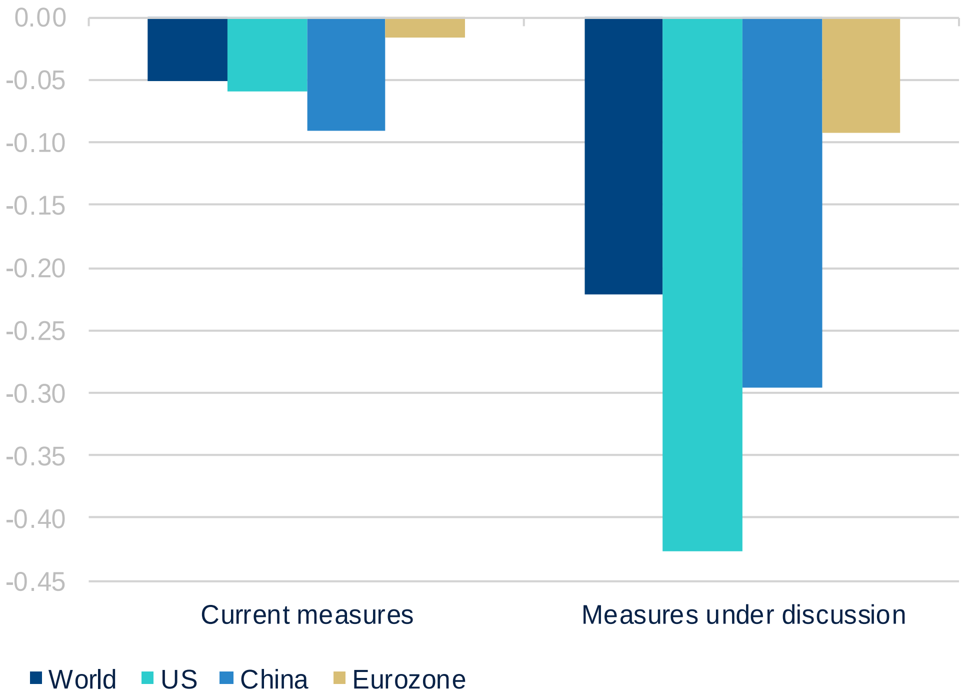
- Global growth continues, supported by private consumption and investment, but with growing differences by region
- World trade continues to show a positive trend, although it is losing momentum and still does not reflect the protectionist escalation
- Confidence indicators show some moderation, but remain at high levels

Source: BBVA Research

Limited effect of approved tariff increases, but significant if those being discussed are implemented

Effect on GDP growth of US tariff increases and the response by other countries

(2018-19, pp)



- The tariff increases approved by the US would have a limited direct impact. Indirect effects, via economic confidence and financial channel, could be felt in 2H18
- With a protectionist escalation, the negative effect on growth would also be significant in the US
- The effect, smaller in Europe, would differ by country and would, above all, affect Germany and the countries in Eastern Europe
- The growth of global GDP could be reduced by around 0.2 pp just due to the trade channel

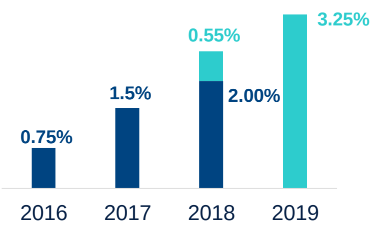
Measures announced: tariff increase to 25% on steel, 10% on aluminium and 25% on Chinese imports for a value of US$50 billion.
Measures under discussion: Tariff increases up to 20% on cars and Chinese imports for a value of US$200 billion.
Source: BBVA Research

Fed and ECB return to conventional monetary policy each at a different pace

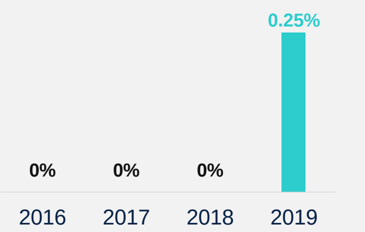
Assessment

Interest rates

- **Reduction** of US$450 billion in 2018
- The pace of **rate hikes accelerates in 2018**



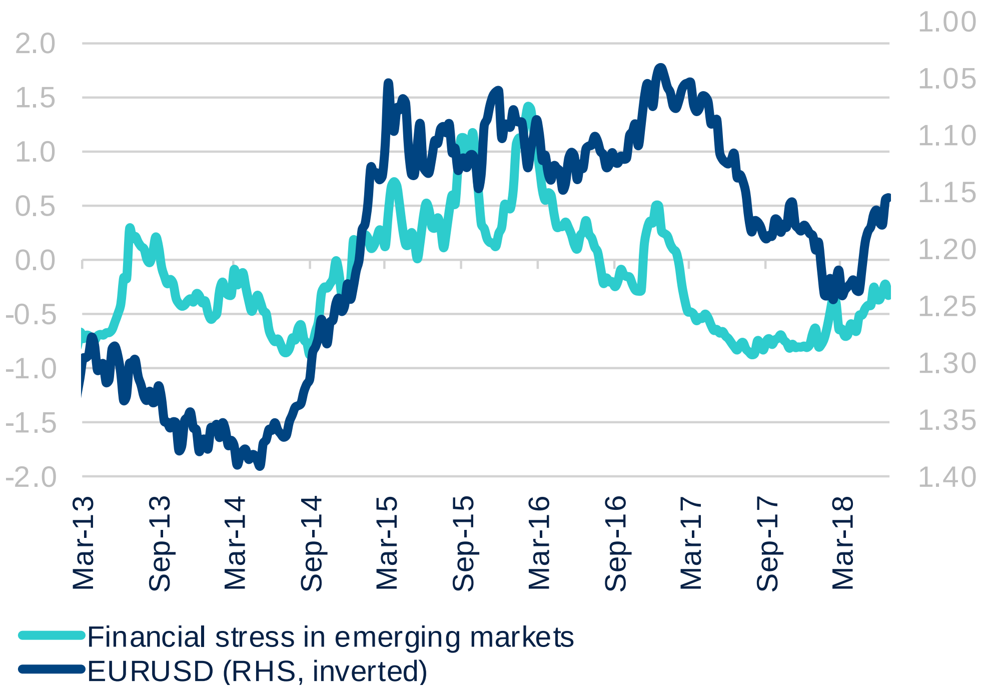
- **Gradual ending of QE between September and December 2018**
- **Delay** in **rate hikes** until **September 2019**



Source: BBVA Research

The strength of the US dollar and higher interest rates are causing an adjustment in emerging markets

EUR-USD exchange rate and BBVA index of financial tensions in emerging markets

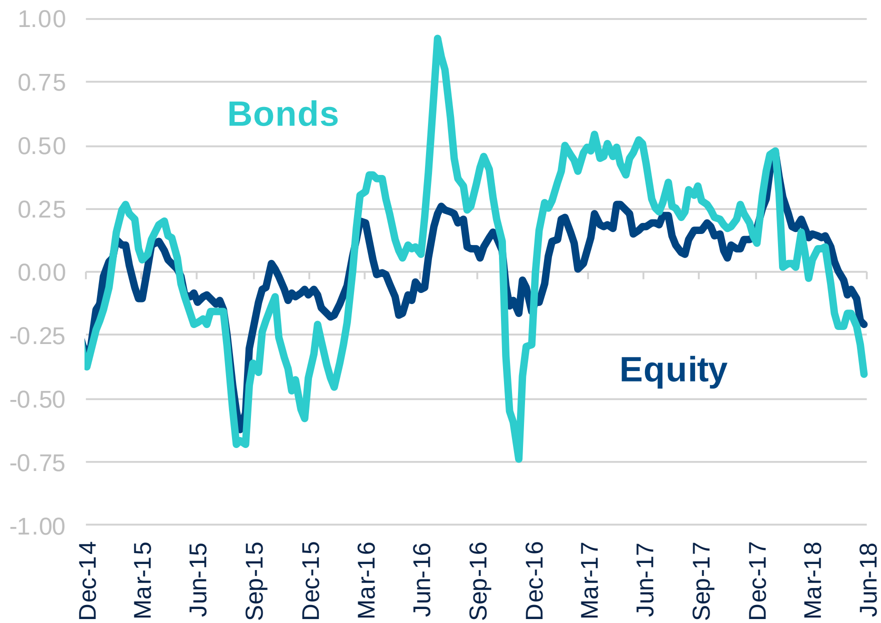


- The most vulnerable countries are those with the greatest trade deficit and the greatest need for external financing
- Shift towards a tightening of monetary policy in emerging countries (except China) to avoid further depreciation of their currencies
- The increase in financial tensions also reflects the intensification of trade disputes

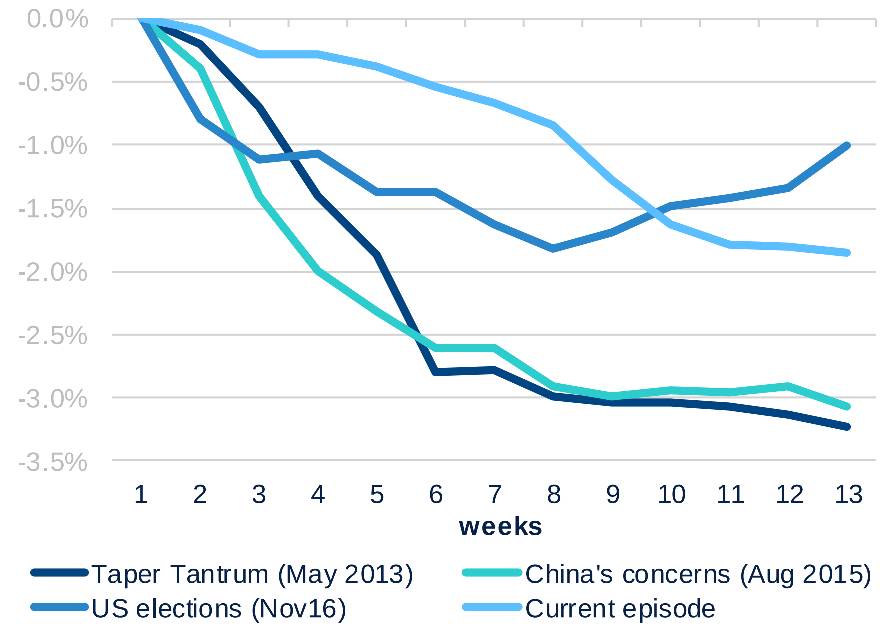
Source: BBVA Research based on Bloomberg

Unlike previous episodes, EM outflows have crept in slowly yet persistently

GIF flows to EM
(weekly flows, 4w moving average, % AUM)



Outflows from EM in different episodes
(cumulated flows in different episodes, % AUM)



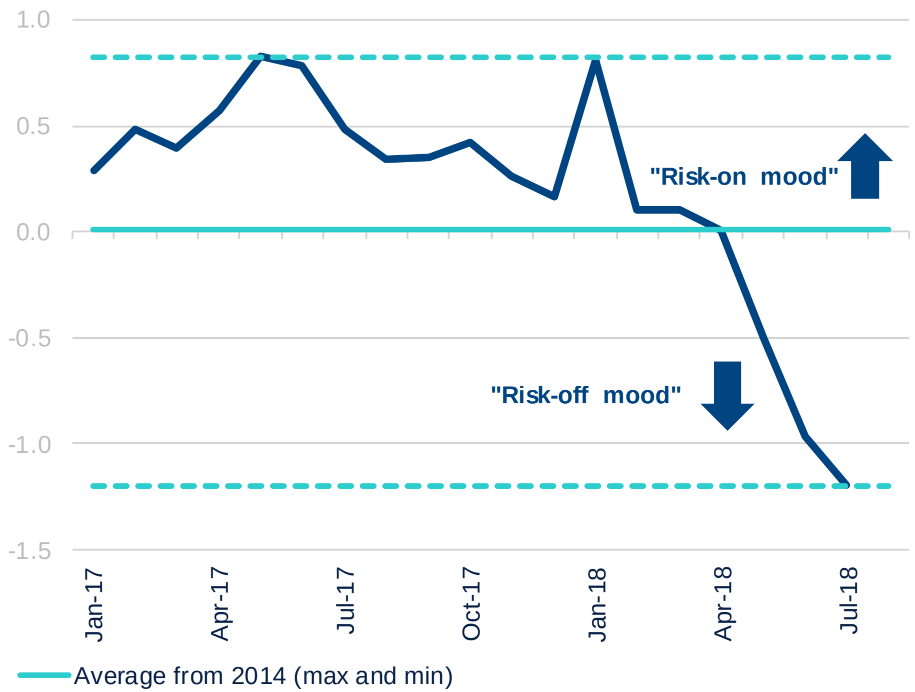
Source: BBVA Research, Bloomberg

Early in the quarter, tightening of global funding led to outflows from bond funds, while the escalation of trade tensions, affecting particularly Asia, boosted outflows from equity funds

The accumulation of sources of risk during the quarter is behind the persistence of the recent EM sell-off. Outflows since April have already surpassed those registered after US elections

Protectionism and political factors lead to a growing risk aversion

Risk appetite/aversion indicator

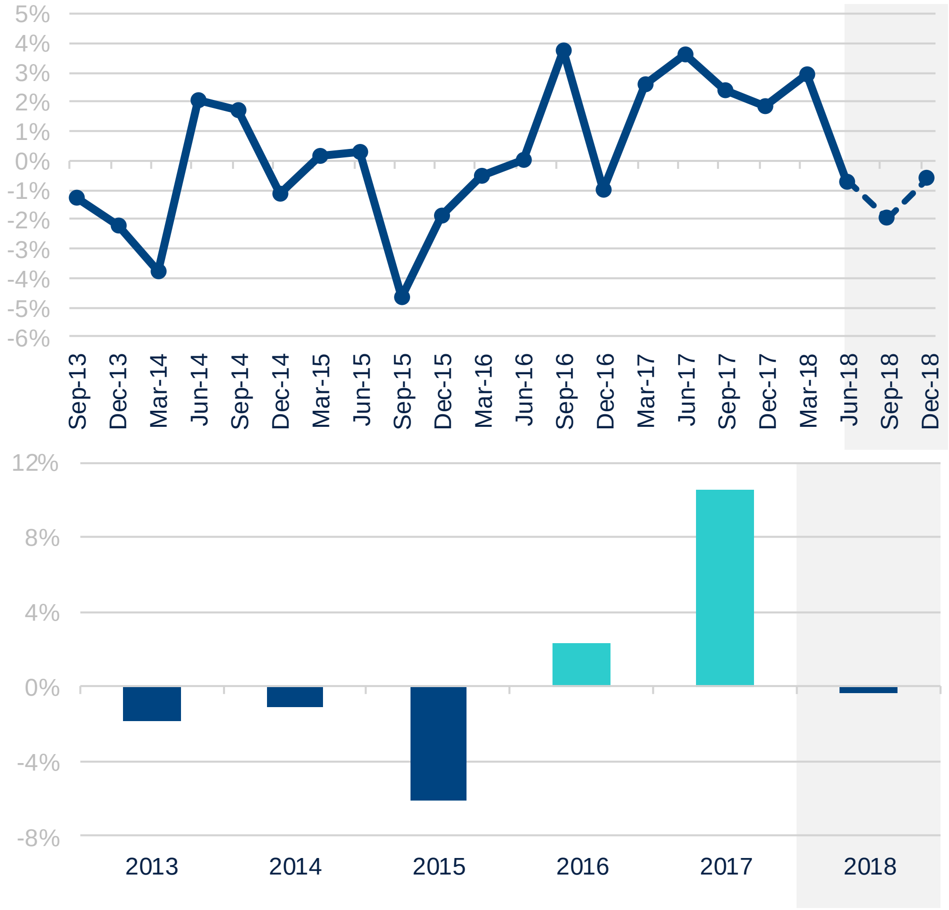


- Investor sentiment has shifted from risk-taking mode (and even a certain complacency) to one of risk aversion
- The change is causing a rotation of flows between assets: from emerging markets to developed ones, and from equities to bonds
- Trade tensions could lead to an environment of flight towards quality

Source: BBVA Research

What to expect about portfolio flows to EM?

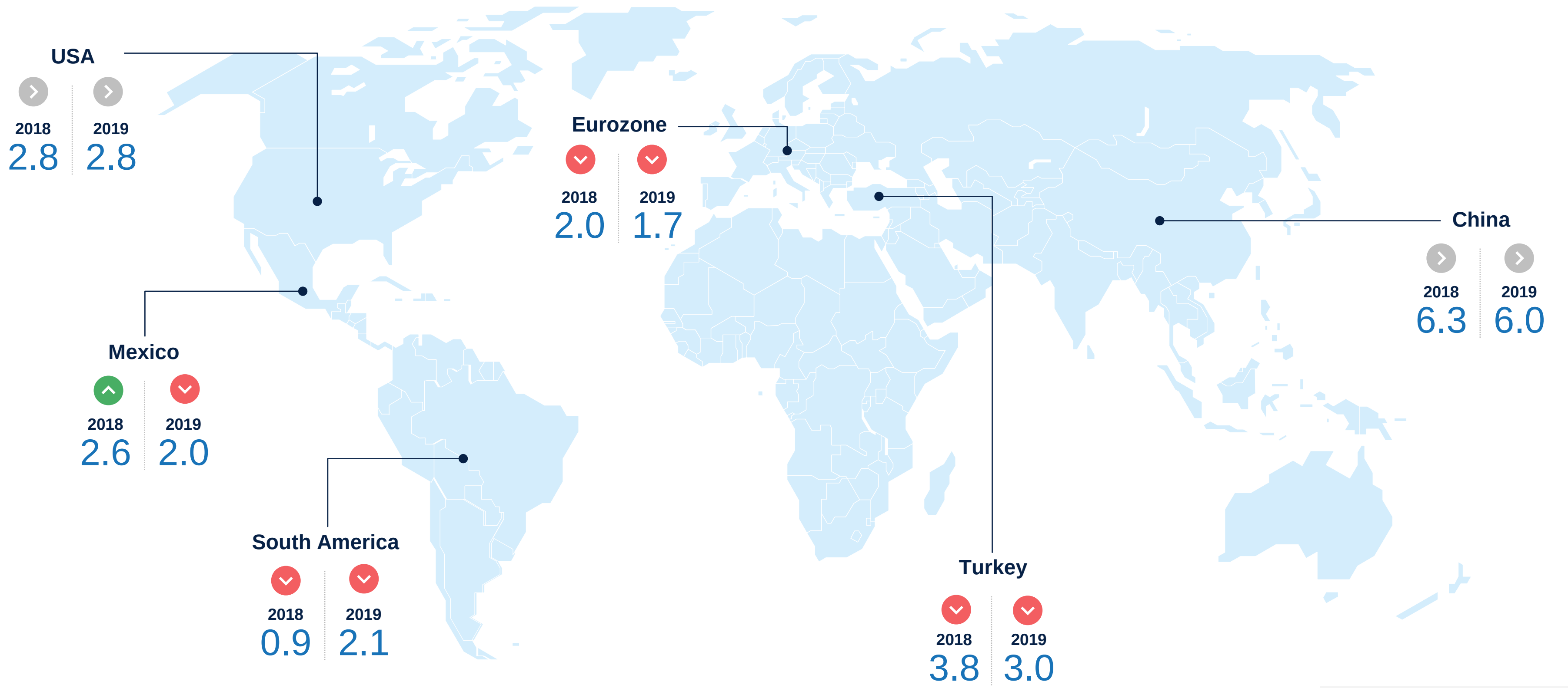
Global Investment Funds to EM
(as % of Assets Under Management)



Source: BBVA Research

- EM funds registered portfolio outflows in the 2Q18, similar to the sell-off led by Trump`s victory due to global factors
- We expect outflows to accelerate in the second half of the year. Thus, 2018 would be the turning point for EM after two consecutive years of strong inflows
- Risks are tilted to the downside (higher outflows) in line with rising global risks

Stable growth in the US, but a slowdown in other areas



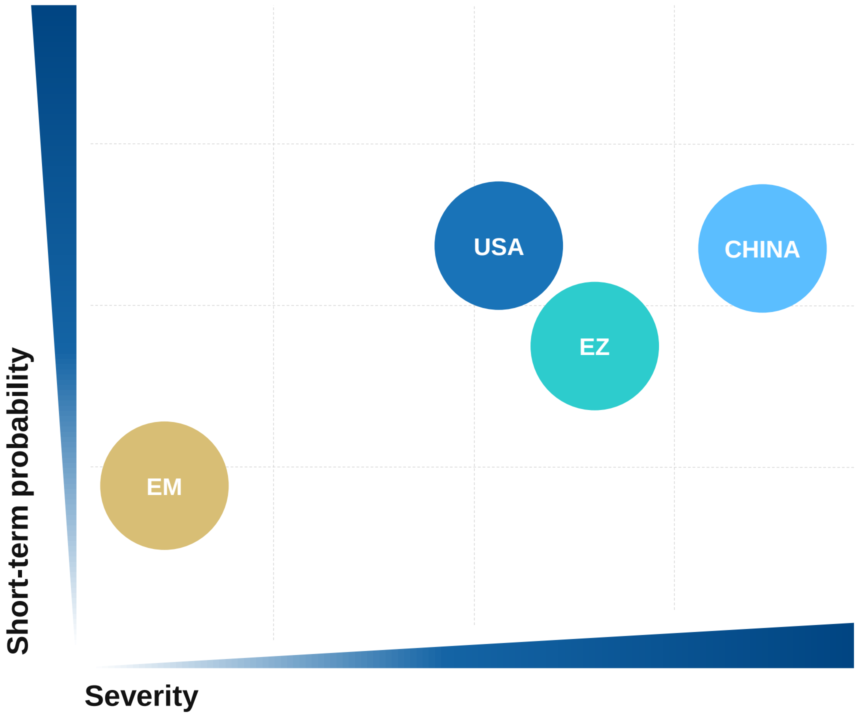
Up

Unchanged

Down

Source: BBVA Research

Global risks: the main one is a trade war, but those associated with emerging economies and Europe are increasing



CHINA

- High indebtedness: more contained but still high
- Protectionism: upwards (retaliation) with possible impact on domestic policies (financial stability, reforms)

USA

- Protectionism: upwards
- The Fed exit strategy: high. Aggressive rate hikes in the face of a temporary increase in inflation
- Signs of over-valuation of certain financial assets

EUROZONE

- Political uncertainty: on the upswing, led by Italy. Brexit: risk of a rough departure
- Protectionism: on the upside with a focus on the auto sector
- Exit strategy by the ECB: on the downside (delay of rate hikes)

EMERGING ECONOMIES

- Upward. Global risks and domestic vulnerabilities in some countries are raising the risk of a systemic crisis

Source: BBVA Research

02

Turkey:
Navigating a Soft Landing

Challenging times ahead to be tackled with policy determination

01

Turkish financial assets remain under stress

Concerns over increasing protectionism in global markets maintain the EM sell-off pressures. Idiosyncratic factors also weigh

02

Rebalancing is already underway

The level and the duration of adjustment in the economy will depend on the policy reactions in the short term, which should focus on engineering a soft landing

03

Inflation reached high levels

Consumer prices reached alarming levels on last year´s loose policies, high inertia and second round effects from exchange the rate depreciation

04

Monetary policy needs to be tighter

Monetary policy will be maintained tight to fight inflation, anchor increasing expectations and restore credibility. Cooling down the overheating is urgent

05

Fiscal policy should complement Monetary Policy

Anti-inflation strategy should be comprehensive and balanced. Both fiscal policy and monetary policy should complement each other to fight inflation

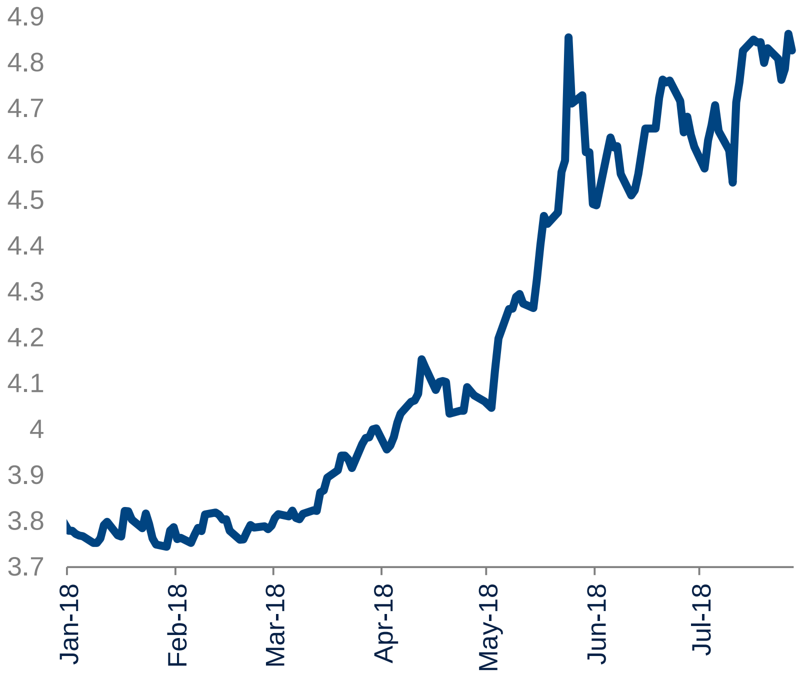
06

Current account deficit will benefit from the adjustment in the economy

The current account adjustment will become more obvious from 2019 onwards

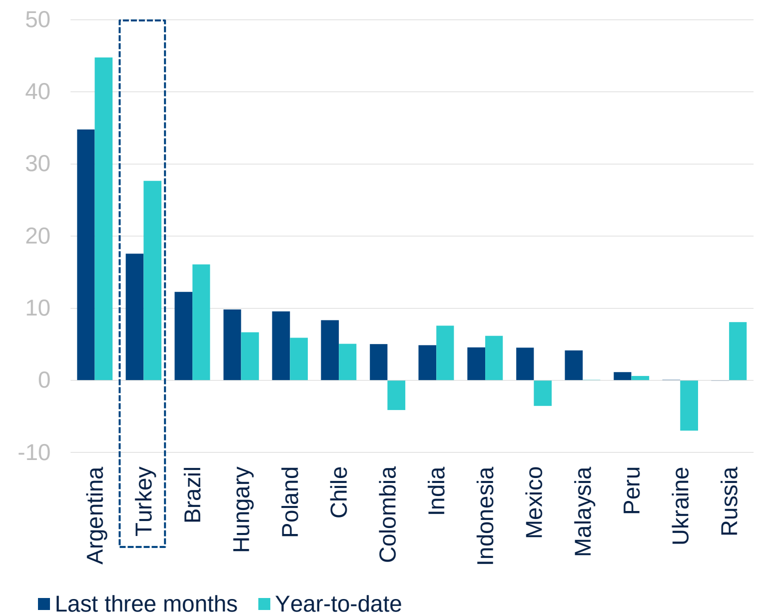
Emerging Markets woes, macroeconomic imbalances and uncertainty about policies lead to sharp reaction of Turkish financial assets

Turkish Lira vs USD
(Level)



Source: BBVA Research

Currency depreciation in emerging countries (*)
(percentage change)



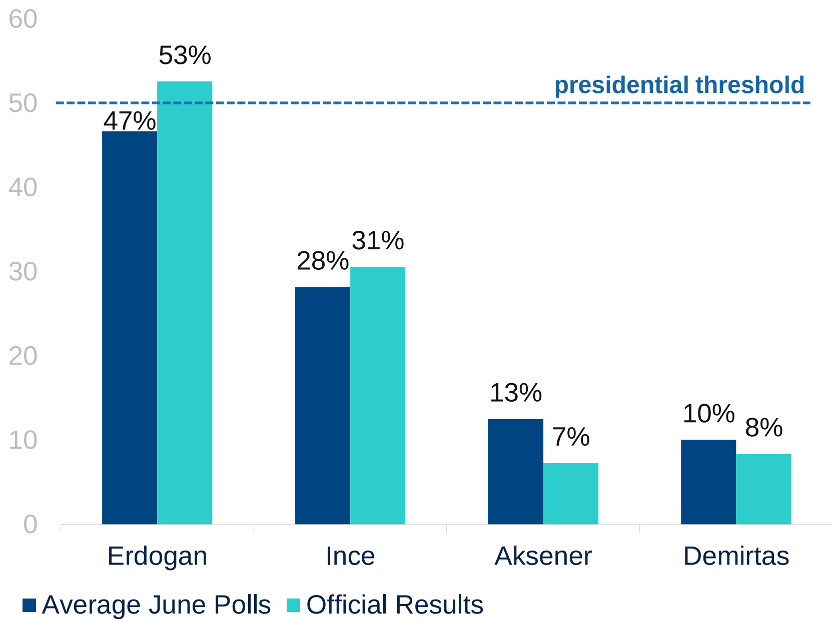
(*) A positive value indicates a depreciation of the local currency
Source: Bloomberg

Turkish financial assets remain under pressure, waiting for clearer signals on the new direction of policies to correct double-digit inflation and a high current account deficit

The Turkish Lira has become one of the worst performers among EM currencies since March, depreciating 28% since then. The sell-off pressure over EM assets pose special risks as Turkish financial assets show a higher "beta"

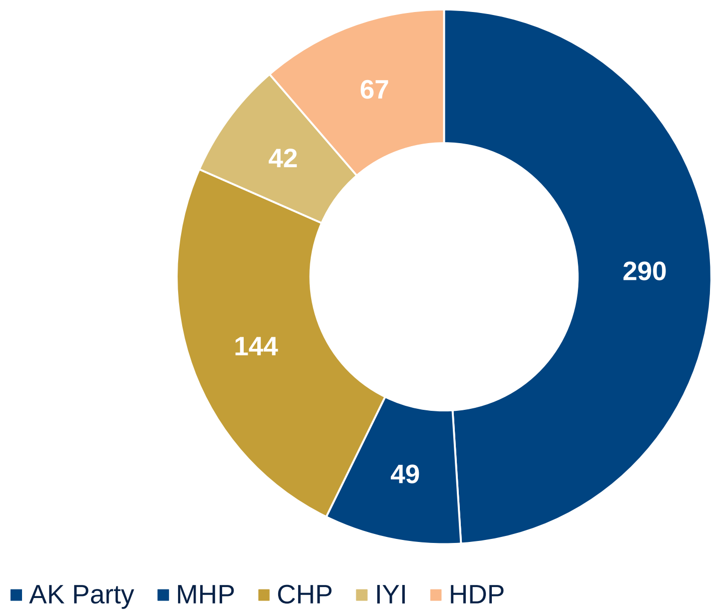
Turkey's Elections: President Erdogan and Government Coalition won the elections

Turkey: Presidential Elections
(% Total votes)



Source: BBVA Research

Turkey: MPs Distribution in Parliament*
(seats)



*People's Alliance: AK Party and MHP – 344 MPs.
*Nation's Alliance: CHP, IYI, SP – 189 MPs.

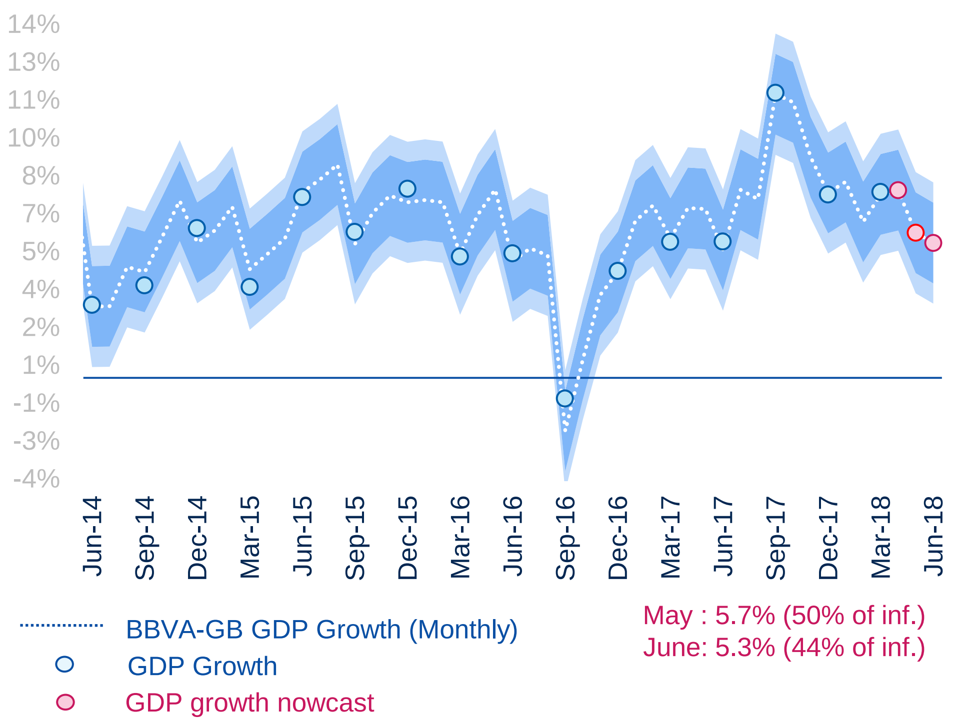
President Erdogan surprised in the Presidential election obtaining the majority in the first round. He will become an Executive President for the next five years

The Government`s Party coalition (AKP+MHP) obtained the majority in the Assembly. They would need some forces from the opposition to call a referendum (360 MPs) or approve directly Constitutional reforms (400 MPs)

The economic activity soft landing is already underway and will accelerate in the second part of the year

Turkey: GDP Monthly Indicator

(%YoY mov. Avg. 3m)

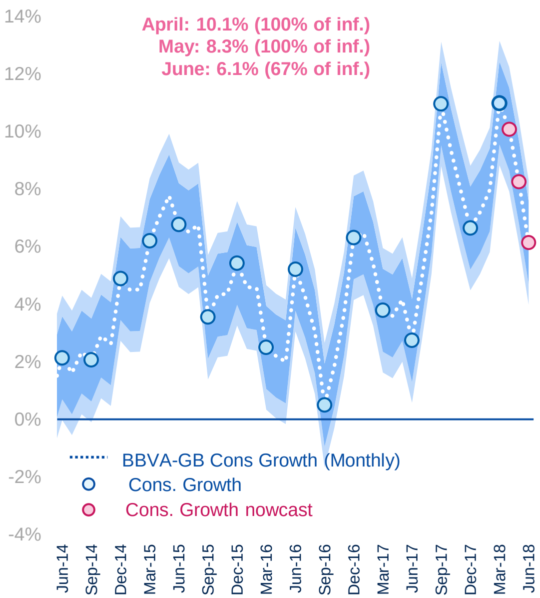


- Soft data (confidence) and first hard data releases from the second half of the year (imports and electricity production) signal that economic adjustment is accelerating
- The cool-down in economic activity could become much clearer from now onwards. The high base effect and lagged response to the tightening of financial conditions will affect domestic demand
- The level and the duration of adjustment in the economy will depend on the policy decisions taken in the short term and global financial conditions

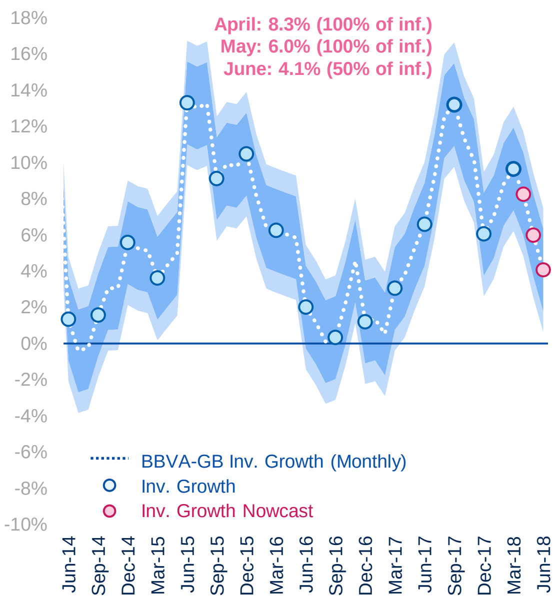
Source: CBRT, TURKSTAT, BBVA-Research Turkey

Consumption and Investment are already adjusting with external demand providing some buffer

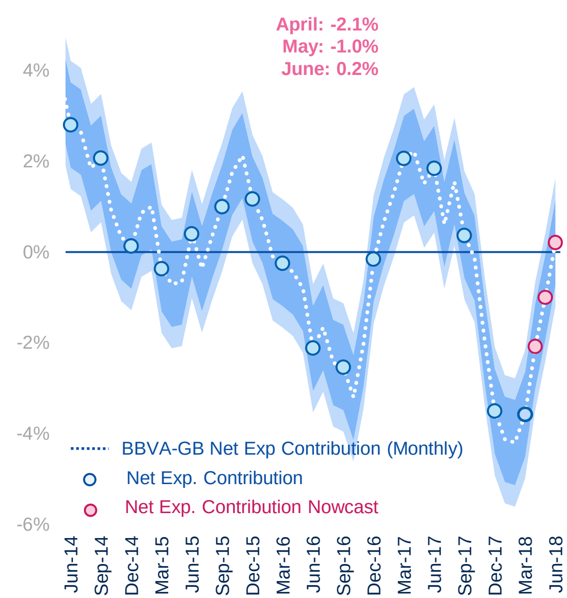
Turkey: Private Consumption
(%YoY, mov. Avg. 3m)



Turkey: Total Investment
(%YoY mov. Avg. 3m)



Turkey: Net Exports*
(%Contribution to GDP Growth)



Source: BBVA Research

*June Nowcast uses internal estimates for trade balance and BOP

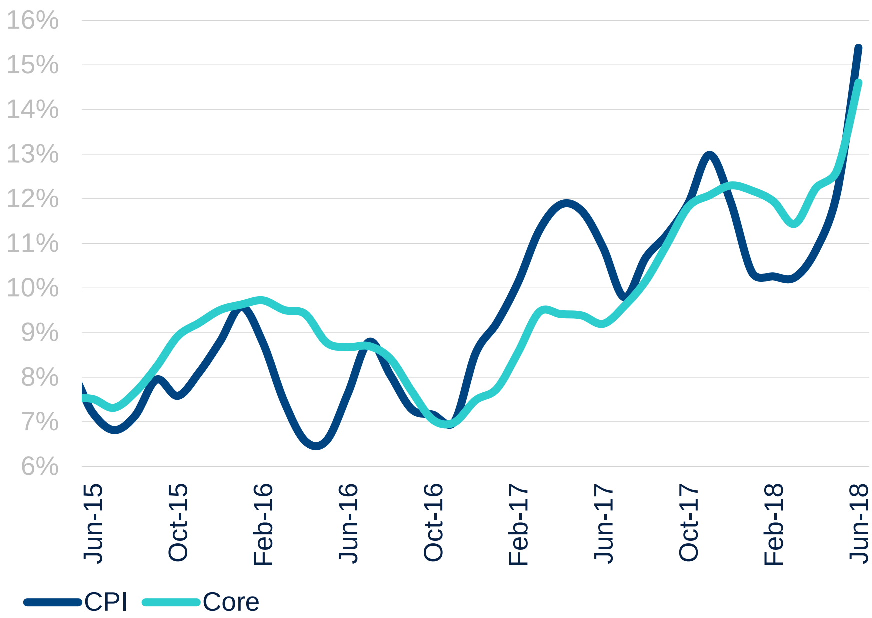
Growth in private consumption remained solid in 2Q but the first signs of slowdown have been clearer since May

The adjustment in investment is much more apparent with risks clearly on the downside in the short term

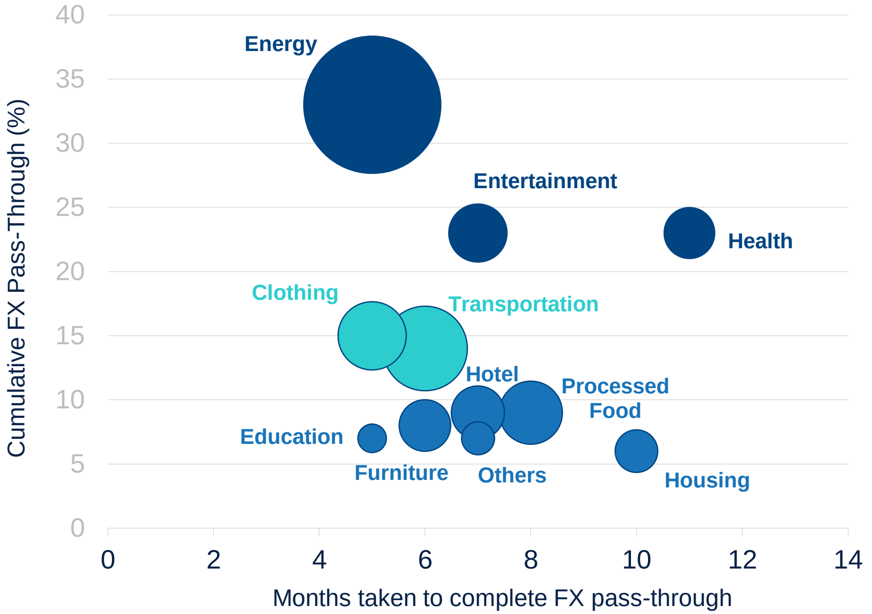
The adjustment in imports and some recovery in exports will provide some cushion from the external demand

Inflation has reached alarming levels.The pass-through from the exchange rate is broad-based but uneven

Turkey: CPI and Core Inflation
(YoY)



Turkey: FX Pass-through on CPI Items*



*Bubble size corresponds to the weight of each item in FX pass-through to CPI

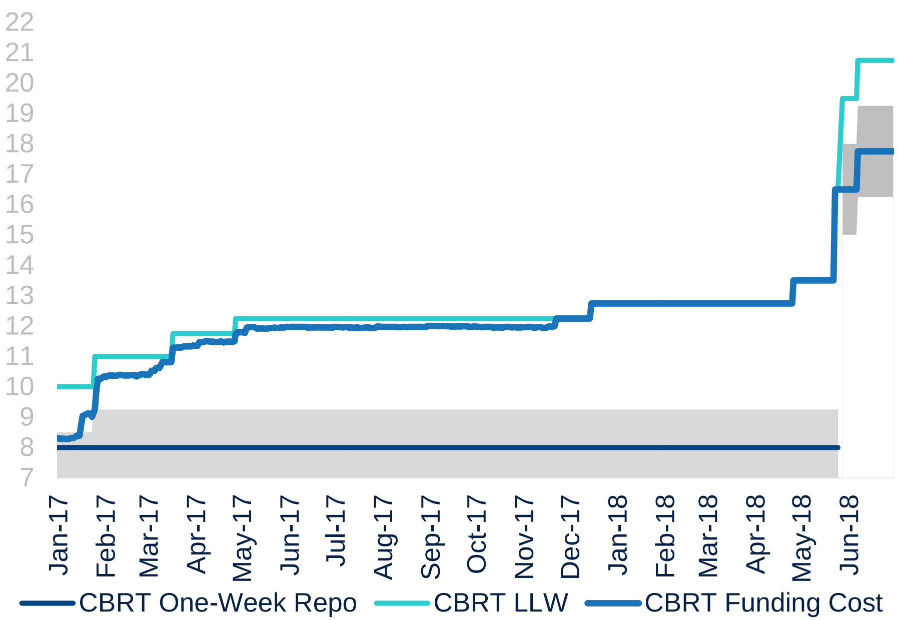
Headline and Core inflation are reaching alarming levels due to both demand and supply factors. There is an urgent need to design a comprehensive strategy to break this price spiral

Exchange rate pass-through has been broad-based but uneven. The maximum impact is reached about seven months after depreciation, so there are still extra effects to come before year-end correction

The Central Bank (CBRT) stayed on hold in July despite market expectations of tightening (100 bps). We expect the CBRT to tight later, depending on the degree of fiscal consolidation and currency volatility

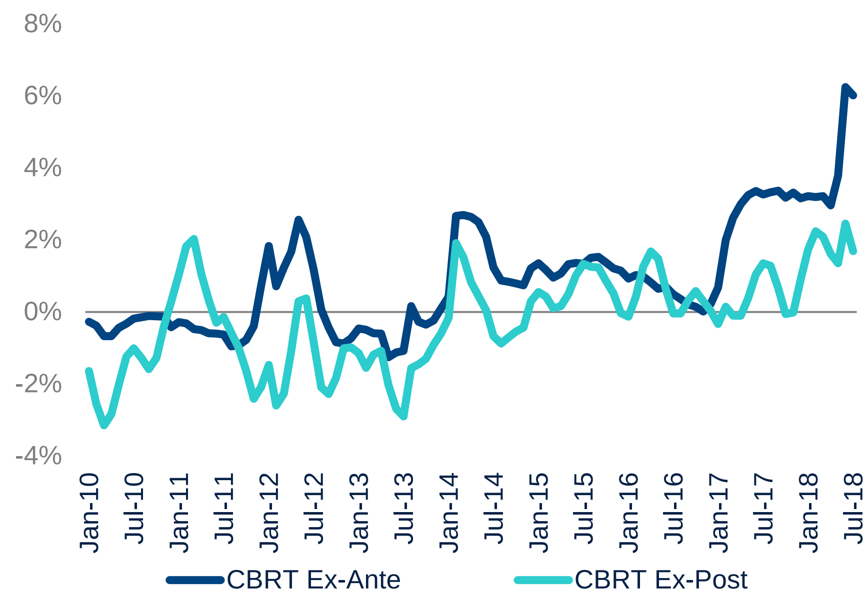
CBRT Interest Rates

(Annual Level, %)



Real Policy Rates

(ex-ante with 12m ahead exp. & ex-post with current inflation)



Source: CBRT and BBVA Research Turkey

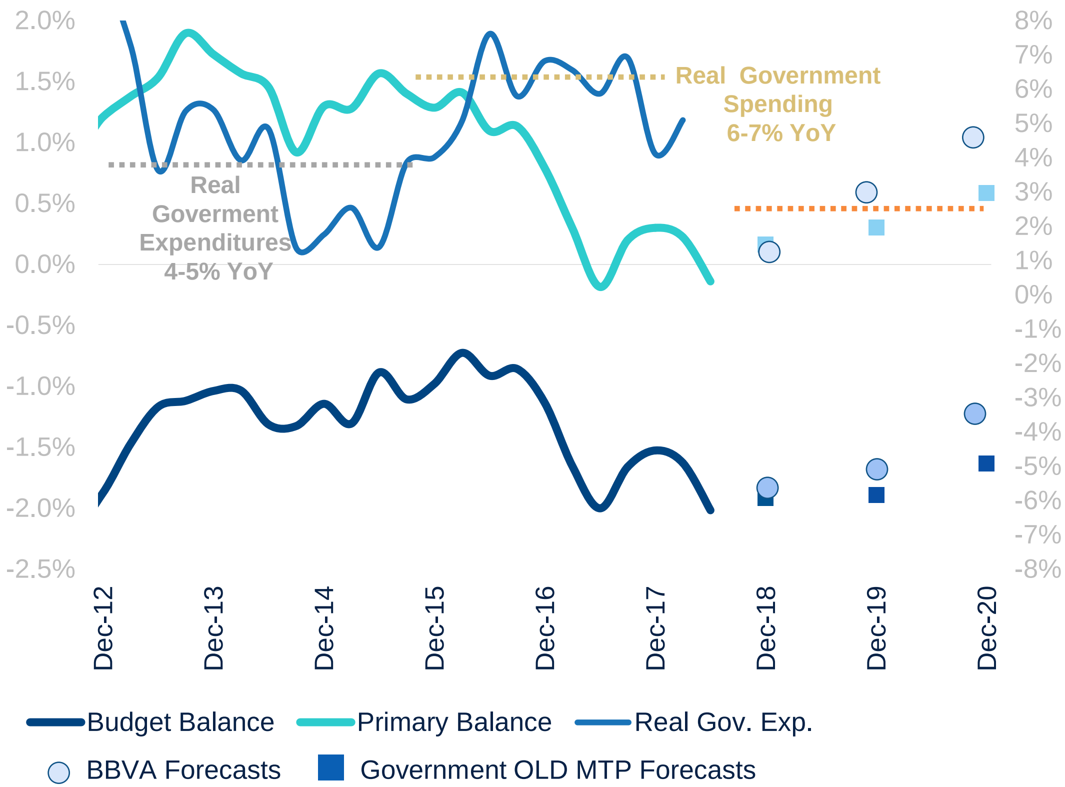
The CBRT has increased its funding rate by 500 bps to 17.75%, simplified its policy framework and provided some supporting liquidity measures since its March meeting

Real interest rates (ex ante) are now more appropriate for coping with the inflation problem. They should be maintained tight until inflation turns back to single digits and inflation expectations start to move to more reasonable levels

A fiscal consolidation strategy should lead Budget Balance to return to the traditional 1% deficit of GDP

CG Budget Balance and MTP Forecasts

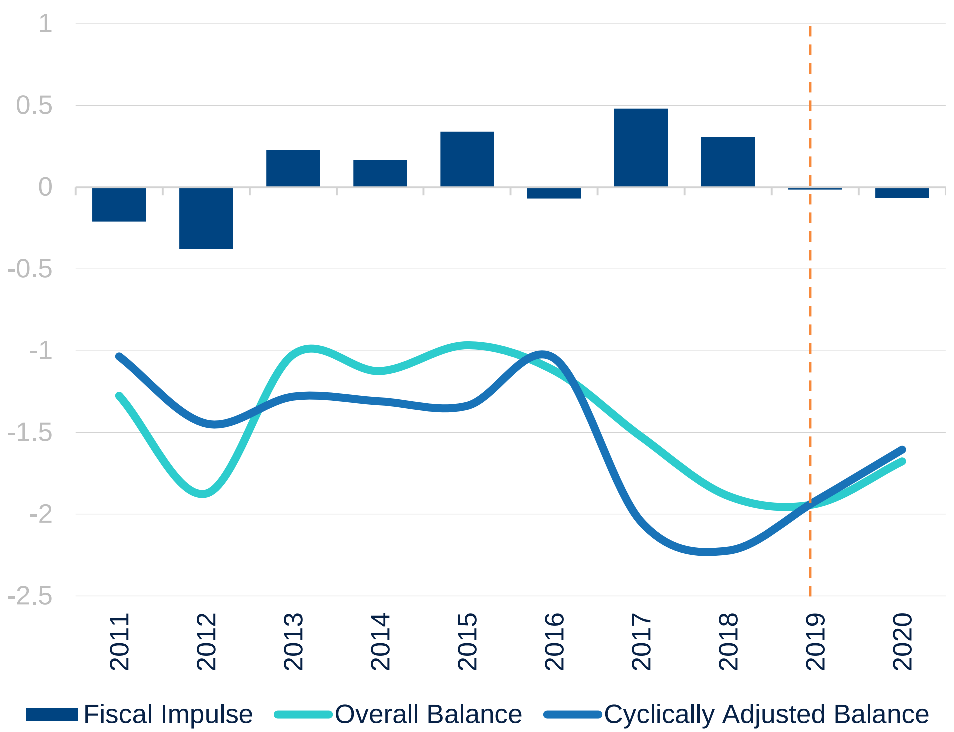
Balance in % of GDP (LHS) & Real Government Spending YoY (RHS)



- Financial markets' doubts about fiscal policy pose additional risks to the economy
- High real government spending, pre-election transfers and extra defence spending have contributed to a deterioration of the fiscal balance to 2% of GDP and a decrease in the primary balance to negative
- Given the increase in interest payments in the coming period, the authorities should design a strategy to correct the primary component of the budget balance
- The strategy should aim to contribute to the rebalancing in the economy

The new medium-term plan should be designed to help to rebalance the economy and initiate a path to disinflation

Central Government Balance
(% GDP)

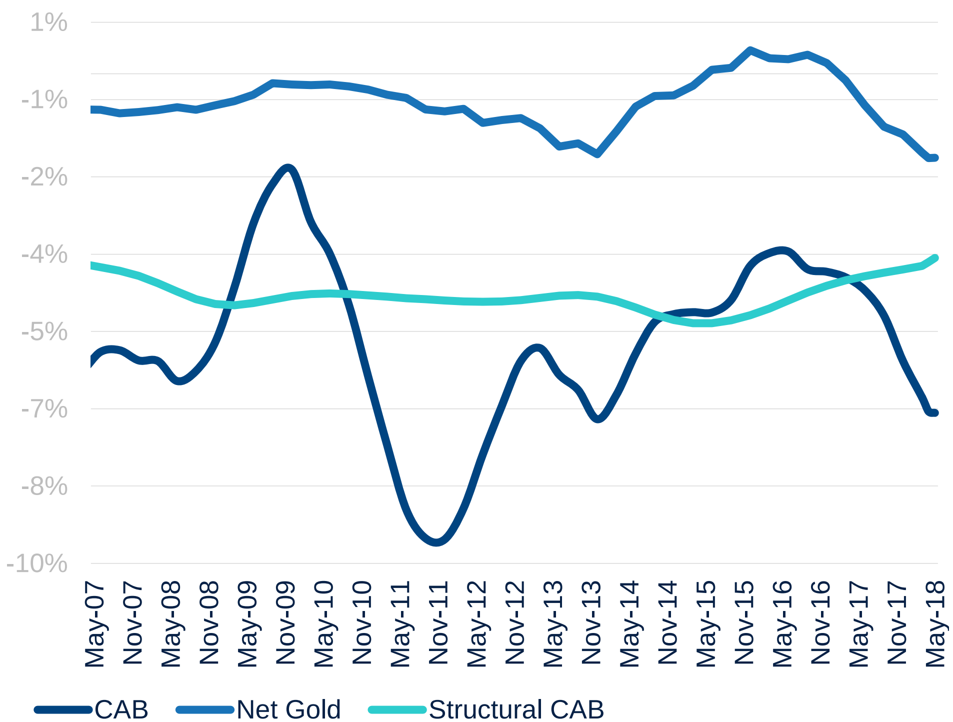


- The deterioration of the public balance has been structural rather than cyclical (i.e. the balance has deteriorated despite extraordinarily high growth and inflation)
- The fiscal consolidation strategy should aim to increase structural primary balance and contribute to more balanced growth (investment rather than consumption) :
- Spending: Current spending should be adjusted, while some public investment could be postponed. This could be offset by changing tax incentives in favor of private investment
- Revenues: Direct taxes and transfers should be adjusted accordingly as indirect taxes would hit inflation. Structural measures to increase the tax base (i.e. reducing the size of the “informal” economy)

The CA deficit ballooned again on the cyclical boost. The soft landing will contribute to adjustment, but the problem of structurally low savings remains

Current Account Balance

12M sum, % GDP



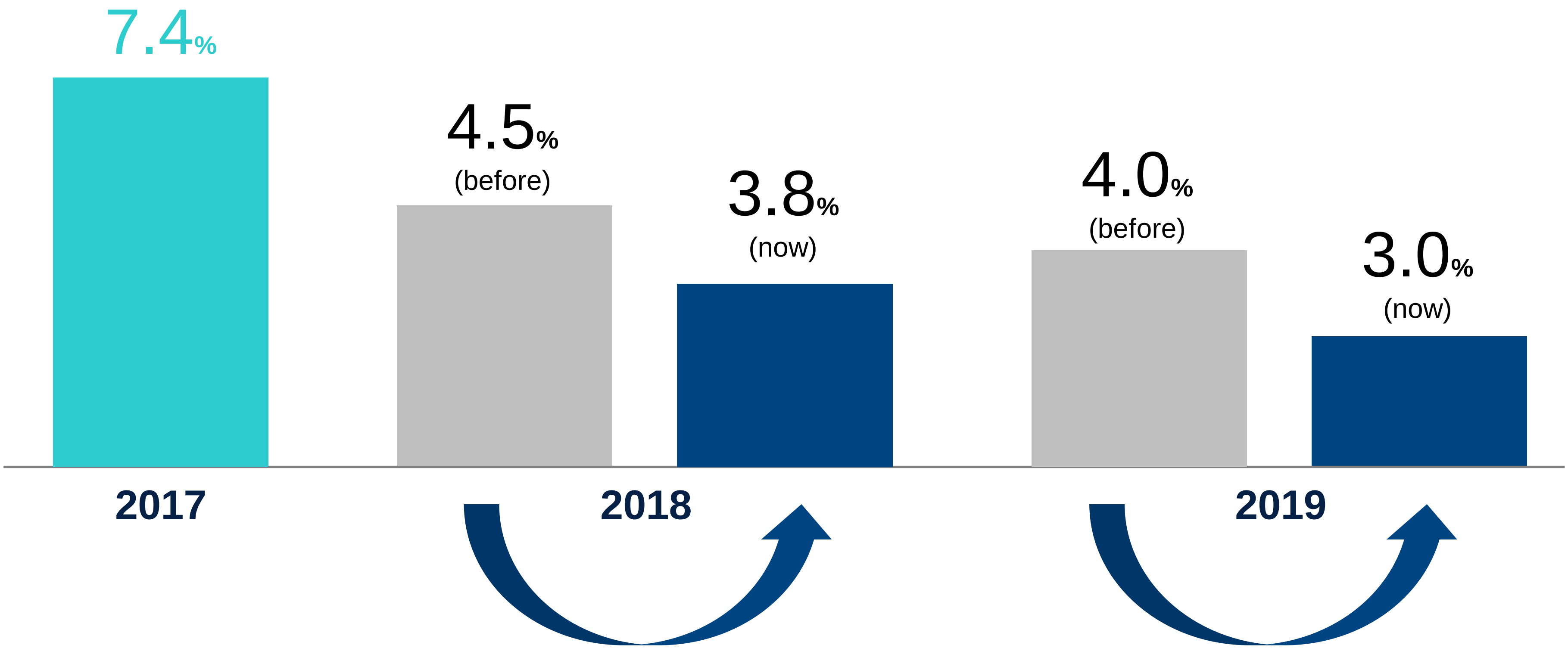
Source: CBRT, Turkstat and BBVA Research Turkey

- Current account deficit (CAD) reached 6.6% of GDP in May, the highest figure since March 2014. We believe that it will start to correct as soon as domestic demand adjusts
- The recent deterioration is mostly cyclical, as the structural balance remains at around 4%. However, it has contributed to exacerbating the structural problem of the balance of payments
- The problem of low savings remains, and explains most of the structural external imbalance
- Adjustment of the low rate of savings will come from structural measures to enhance private savings (quantities) or higher real interest rates (prices)

03

Turkey Baseline Scenario: Navigating the necessary Soft Landing

Tighter global financial conditions, monetary policy tightening and the expected consolidation plan will lead the economy to a soft landing

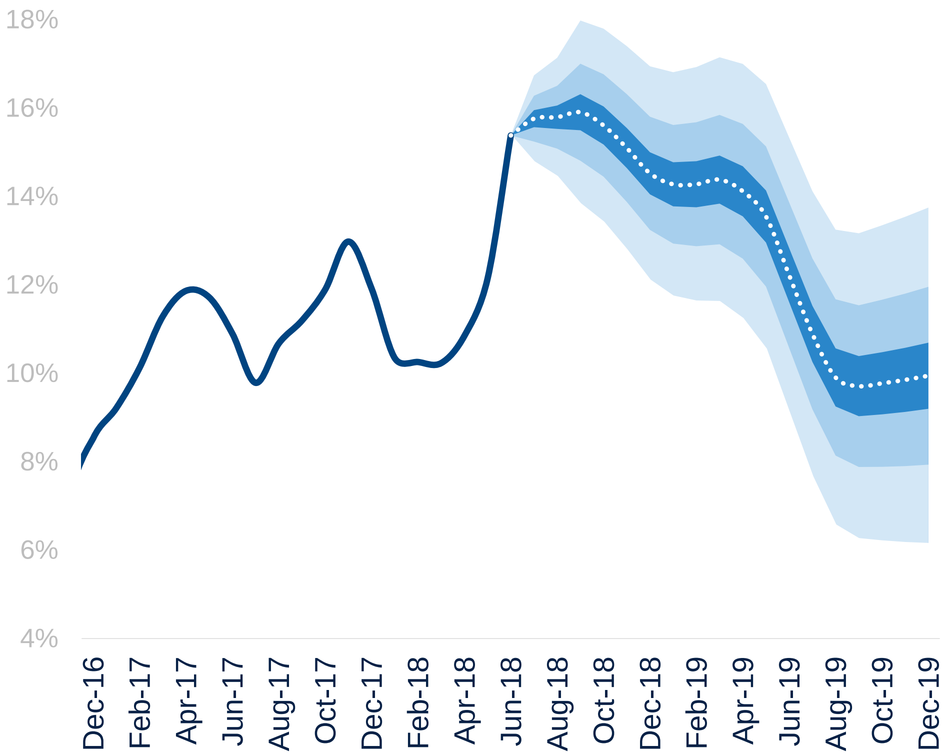


The cool-down in economic activity will become much clearer in the second half of this year prompted by a large statistical base effect and the tightening of external and local conditions

We forecast 2018 GDP growth to be slightly below 4% in 2018 and 3% in 2019. The economy will subsequently recover to its potential levels

We revise our inflation estimate upwards to 14% for 2018 year-end and expect it to stay very near to two digits during the next year

Inflation Forecast
(3m YoY)

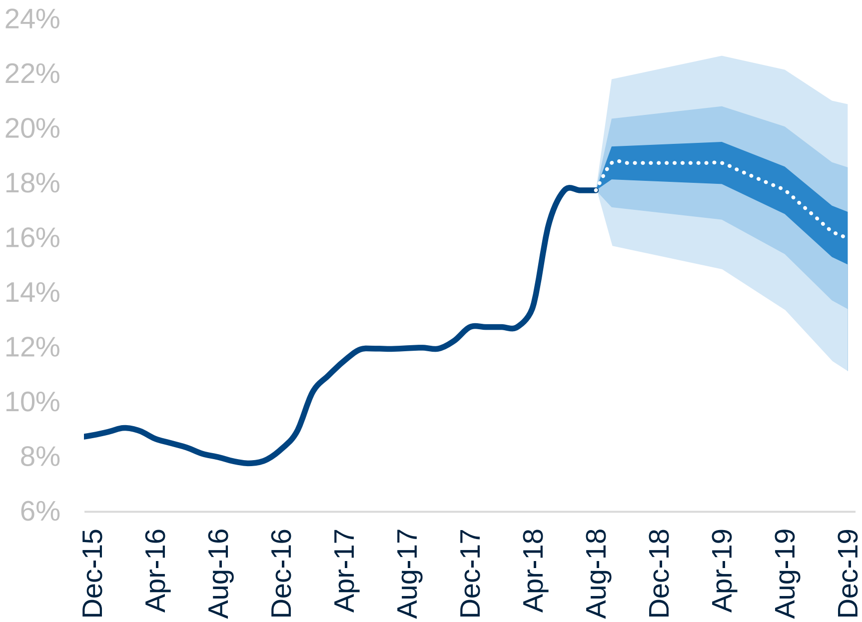


- Annual headline inflation adjusted from exchange rate pass-thru is now close to 11%, compared to the levels fluctuating around 6% in 2011-2016
- Continued deterioration in pricing behavior seems to strengthen inertia via second round price effects, cost push factors and expectations in the last couple of years
- This unhealthy trend requires fiscal and monetary policies to act accordingly to fight against inflation

Monetary policy will be "tight", reacting to inflation realizations, expectations and exchange rate deviations from the expected path

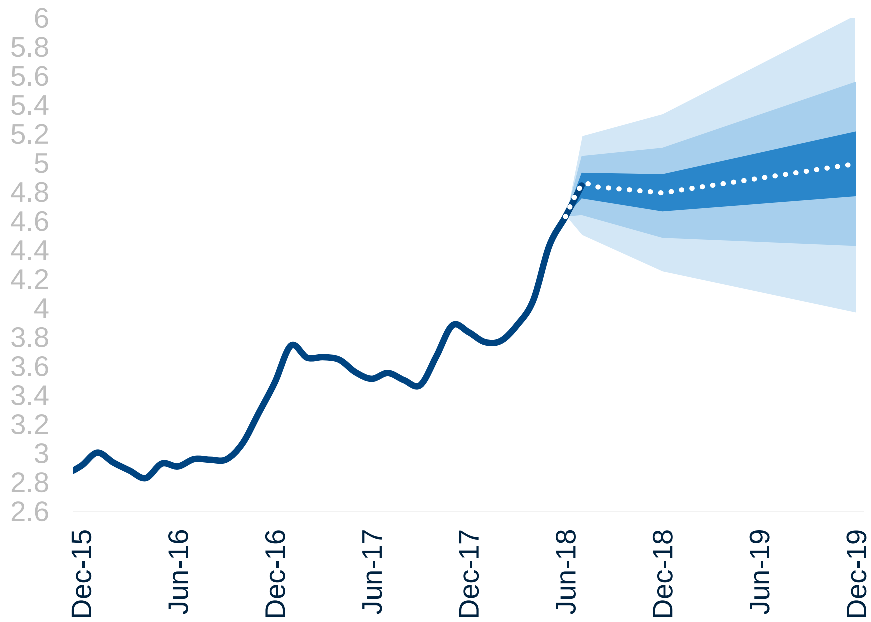
Monetary Policy Forecasts

% CBRT Funding Cost



Exchange Rate Forecasts

USDTRY Level



Monetary policy will remain tight, with upside risks depending on fresh bad news on inflation, continuing deteriorating expectations or further supply shocks from exchange rate depreciation

We expect the exchange rate to remain at current levels at the end of this year. Although the lira remains undervalued, ongoing high inflation and unsupportive global environment will limit the correction

04

Turkey:
Forecast table

Turkey Baseline Scenario

	2016	2017	2018 (f)	2019 (f)
GDP (%)	3.2	7.4	3.8	3.0
Private consumption (%)	3.7	6.1	4.3	2.5
Public consumption (%)	9.5	5.0	2.6	2.0
Investment in fixed capital (%)	2.2	7.3	2.1	2.5
Exports (%)	-1.9	12.0	5.0	5.5
Imports (%)	3.7	10.3	4.4	3.1
Unemployment rate (average)	10.9	10.9	10.3	10.9
Inflation (end of period, YoY %)	8.5	11.9	14.0	10.0
CBRT funding rate (end of period, YoY %)	8.31	12.75	18.75	16.0
Exchange rate (USDTRY, end of period)	3.52	3.77	4.80	5.0
Current account balance (% of GDP)	-3.8	-5.5	-6.6	-5.4
Central government budget balance (% of GDP)	-1.1	-1.5	-1.9	-2.0

(f) Forecast.

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