



Dark times: Turkey's economy is vulnerable to international risk

## TURKEY'S RISK OF OVERHEATING

*Amid rumours that Turkey's president Recep Tayyip Erdogan may be bringing elections forward to mid-2018, observers fear a pumped-up 'campaign economy' will overheat. Tom Stevenson reports.*

**T**urkey's economy has experienced a rapid return to growth over the past year, but the recovery has also brought high inflation and a deepening current account deficit as the government prepares for national elections slated for 2019.

Having suffered a disastrous period in 2015 and 2016, when an economic crisis coincided with a failed coup attempt and war, both in Turkey's restive south-eastern provinces and across its borders in Syria and Iraq, Turkey's economy experienced a remarkable rally in 2017.

In 2017, Turkey achieved gross domestic product (GDP) growth of about 7%, outperforming almost all emerging markets, according to estimates from the International Monetary Fund (IMF), ratings agencies and the Turkish government.

It was a recovery built on an unprecedented government-run fiscal stimulus programme designed to make 2017 what

Turkey's prime minister Binali Yildirim called "a year of salvation".

The biggest contributor was the TL250bn (\$66bn) Credit Guarantee Fund (CGF) mechanism that saw the state back bank lending (see separate article on the Turkish banking sector on page 38), along with a temporary VAT cut. According to some estimates, these measures pushed unemployment figures down by 3 percentage points to about 10%.

While the government has decided to keep the CGF programme going, albeit at a more modest level, there are many challenges ahead for Turkey's economy.

### CONSTRUCTION WOES

Stubbornly high inflation, a volatile currency and deteriorating relations with both the US and Turkey's main trading partner, the EU, are compounded by a widespread international perception of increasing centralisation and authoritarianism on the part of presi-

dent Recep Tayyip Erdogan's government.

"It is well-documented that this credited regime has managed to achieve high growth rates mainly by stimulating the construction sector, without regard for the high social and ecological costs of projects," says Fikret Adaman, professor of economics at Istanbul's Bogazici University.

Mr Adaman points to Mr Erdogan's recent green-lighting of the Kanal Istanbul project, a plan to build an artificial sea-level waterway to connect the Black Sea and the Sea of Marmara, as typical of a trend towards growth through construction, regardless of external costs, that does little to address problems such as the high levels of informal employment.

Now the CGF programme is being extended in a more limited form into 2018, one key concern is Turkey's increasing dependence on short-term foreign capital, according to Mr Adaman. "The country's dependence on a steady stream of capital inflows has always been its Achilles' heel," he says. "But provided that the current account deficit problem is kept under the red line, there is no reason to think that the economy will get onto a radically different path."

Turkey's public finances have begun to show signs of stress. The current account deficit widened to an estimated 5.3% of GDP in 2017, from 3.8% in 2016. However, debt to GDP was estimated at 28.4% at the end of 2017, a stronger position than in most of Turkey's emerging market peers.

After the highs of 2017, international rating agencies (all of which have downgraded Turkey's sovereign rating to 'junk' status) predict the economy will grow at a more modest rate of between 3.5% and 4.1% in 2018, below the Turkish government's target of 5.5%.

### CORPORATE DEBT

In the corporate sector, there is little sign of a slowdown. The stock market is booming. Turkey's main stock market index, the BIST 100, was up 28.5% in the 12 months from the start of March 2017 to the end of February 2018.

However, Turkish corporates are now sitting on a record \$326bn of foreign currency debt, which risks becoming more expensive if the lira weakens. On January 21, Borsa Istanbul chairman Himmert Karadag told Bloomberg: "The indebtedness of companies is no longer sustainable."

With the prospect of the country's banks having less room to lend, Turkish companies are seeking to cut debt and capitalise on high demand for emerging market equity through initial public offerings

(IPOs). Istanbul-based brokerages have predicted a carnival of IPOs for 2018 with about a dozen companies looking to list at a total value of up to \$4bn.

Changes made in January to the Istanbul Stock Exchange listing requirements have made it easier for firms to qualify by reducing the proportion of shares that need to be sold to domestic investors to as low as 10%.

However, the initial signs have been disappointing. In the first week of February, electricity company Enerjisa Enerji and hospital operator Saglik Hizmetleri attracted interest at the lower end of their proposed valuations. Saglik Hizmetleri was forced to cut its asking price by more than 20%.

With the prospect of credit flowing less freely and a corporate tax rate hike of 2 percentage points already in place, businesses are set to feel the squeeze.

#### A CAMPAIGN ECONOMY?

With elections slated for 2019, and amid rumours that Mr Erdogan may bring the vote forward to mid-2018, the authorities are unlikely to turn off the spigot all at once.

In fact, government planning may be pointing to a campaign economy, according to Sebnem Kalemli-Ozcan, professor of economics at the University of Maryland. "Of course the coming elections are affecting economic planning. The Turkish authorities, as is common in emerging markets, have always been in this economic-political cycle where they pump up the economy before elections," she says.

The active fiscal policies the Turkish government has pursued over the past year have had wide benefits for the country's creditworthiness, but while growth has been impressive, Turkey has experienced rampant inflation.

Ms Kalemli-Ozcan says there is a risk of even worse inflation figures to come. "The only force that kept inflation from going completely out of whack has been low oil prices," she says. "With any increase in oil prices, inflation will shoot up and the lira will depreciate even more, unless monetary policy takes an active role to combat it."

Turkey's central bank has sought to curb inflation by raising interest rates, but Mr Erdogan is strongly against high rates and has put pressure on the central bank to moderate rate hikes.

#### RUNNING A TEMPERATURE

Signs that the Turkish government may be looking to pump up the economy ahead of elections have some external observers worried. In February, the IMF sounded an alarm



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that Turkey's economy may be running hot.

"Such has been the strength of the recovery that the economy faces signs of overheating: a positive output gap, inflation well above target, and a wider current account deficit," the IMF wrote in its latest assessment.

Kristin Lindow, a senior vice-president at Moody's Investor Service, agrees that there is a real risk of overheating in Turkey's economy and that the risk will rise further, "should the government adopt any additional stimulus measures while inflation remains high and the current account deficit is widening".

Ms Lindow adds that Turkey's seemingly resilient growth must be weighed against the economy's vulnerability to international risk, and especially domestic political risk. "The lira's volatility has been detrimental to investment, given the high pass-through from the exchange rate to domestic inflation and the high import content of investment spending," she says. "Investors view the central bank's response as ineffective given the persistence of above-target inflation amid significant political pressure on the central bank to lower rates."

#### TOURISM BOOM

Turkish government officials acknowledge the risks and say they are planning for them. Deputy prime minister Mehmet Simsek, Mr Erdogan's chief economic planner, has said Turkey will "prioritise lowering inflation to single digits" and keeping the current account deficit under control.

One area where the omens are more positive is the tourism sector. Turkey is expecting a return to growth in tourism in 2018 as the security situation improves following a stream of violent attacks on civilians in major cities and a failed coup attempt that shook the country in 2016.

In February, European tour operators TUI and Thomas Cook both said summer bookings to Turkey looked set to recover markedly in 2018. In 2017, Turkey collected \$26bn in tourism revenues, an increase of 18.9% on the lows of 2016, in a partial rally led by Russian travel companies re-establishing business in the country.

Turkish government officials are predicting a far greater improvement for 2018 as European airlines add capacity for travellers to Turkey. "There is a 70% increase in the number of bookings from foreign travel agencies for this year and we expect record in numbers in 2018," minister for tourism Numan Kurtulmus said in January.

#### KEEPING CAPITAL FLOWING

However, Turkey's relations with Europe are currently at a low ebb. Disagreements between Turkey and the European Parliament over human rights abuses and a recent diplomatic spat that resulted in the withdrawal of the Dutch ambassador from Ankara have coincided with a dispute between Turkey and Cyprus over natural gas exploration in the eastern Mediterranean.

Given its large external financing requirements, Turkey will need to keep a careful eye on how its disagreements with Europe affect capital inflows. In November 2017, tensions with its Western allies almost halted inflows altogether.

Turkey and the EU remain key trading partners and there is every chance the situation will stabilise, according to Inan Demir, senior emerging Europe, Middle East and Africa economist at Nomura.

"Being a savings-short economy, Turkey is always in need of foreign capital inflows to fund its growth and resulting current account deficit," he says. "If capital inflows slow or reverse due to a deterioration in global sentiment or Turkey-specific factors, then the downside risks to growth would become much more prominent." **IB**