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BANK

ECONOMIC SITUATION AND STRATEGY

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Turkey Crisis: A Storm Cloud over Other Emerging Economies?

The Turkish lira has been under immense pressure since early August with losses peaking at some 30 percent against the US dollar and euro. By now the Turkish lira has devalued almost 40 percent relative to the greenback this year. In line with the currency crumble Turkish share prices and bonds also took a nosedive. The yield on Turkish government bonds with residual maturities of ten years increased from 11.4 percent to 20.6 percent most recently corresponding to a price plunge in excess of 25 percent calculated in Turkish lire. Turkish stocks did not fare any better. The index of the 100 largest companies listed on the Istanbul stock exchange has lost over 20 percent since the beginning of this year corresponding to about 50 percent loss for euro investors.

There are both economic and political reasons for this development. Turkey has long had a very high current account deficit relative to other countries. Although government debt is low at just below 30 percent of GDP, but Turkish enterprises are deeply in debt due to a credit boom fostered by the Erdogan administration. Private households, too, took the low-interest environment of the past few years as an opportunity to borrow.

This puts a different spin on Turkey‘s impressive growth rates averaging almost 6 percent per year over the past five years. Foreign investment largely financed this strong growth and while returns on these investments were healthy for a long time, investors now wonder how sustainable these returns are as they realize that the country has been living beyond its means for years on a leveraged economic miracle.

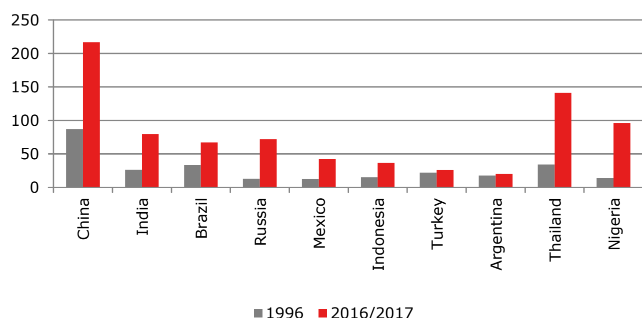
Political problems are additionally complicating the economic turmoil. After the 2017 referendum and the parliamentary elections this past June President Erdogan has been moving toward autocratic rule. There is ever more government intervention in the Turkish economy and the Central Bank of the Republic of Turkey (CBRT) does not seem as independent anymore as it once was. With inflation running wild near 16 percent, the CBRT should raise interest rates substantially to bring it back down toward its target of five percent. However, President Erdogan publically declared to oppose high interest rates and the CBRT obliged cancelling the generally expected rate hike in July. As a result the Turkish lira went into a tailspin. Escalating political tension with the US further aggravated the economic pressure. After a US pastor was arrested in Turkey, President Trump put trade sanctions on Turkey that will further weaken the Turkish economy.

High inflation, current account deficit, increasing foreign debt, low foreign currency reserves, and political problems are all well-known triggers for currency crises. Its high foreign-currency-denominated debt in particular makes the country vulnerable. As the Turkish lira devaluates it becomes ever harder for the country to

service this debt. Moreover, as Turkey has to serve this foreign debt its foreign currency reserves are depleting. This can turn into a vicious cycle where companies can no longer pay their dollar and euro denominated debt rendering them insolvent or at least forcing them to reduce their capital spending. Either one is bad for economic growth prompting investors to further withdraw money from Turkey and the lira to devalue more.

What can Turkey do to stabilize its currency and regain market trust? Higher interest rates and a more frugal government budget policy are the most obvious path to take but neither one seems to be on the horizon just yet. Instead the CBRT announced an action plan to protect Turkish banks and enterprises this week. Moreover, the CBRT is providing additional liquidity for the financial market by lowering the minimum reserve requirements for Turkish lira and foreign exchange transactions. Furthermore, the CBRT has tightened requirements for foreign exchange swaps to limit speculation against the lira. This measure has indeed stopped the lira's nosedive for now but such measures may only be deemed temporary. There is currently no resolution of this crisis in the offing.

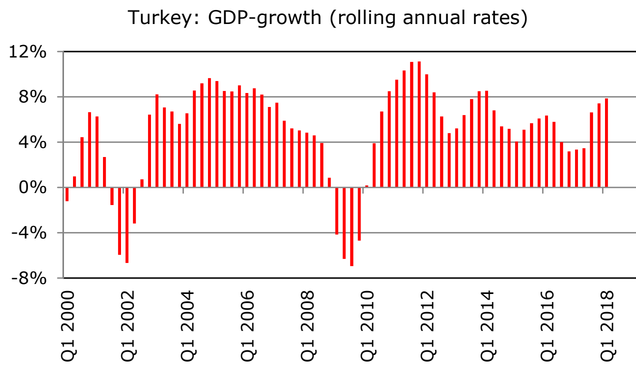
In the past, emerging economies in dire straits tended to seek help from the International Monetary Fund (IMF). However, IMF loans always come with strict conditions to rebuild the trust of private investors. It does not currently look as if President Erdogan will apply for IMF help. The IMF is also mostly US funded and the US may well veto a help application from Turkey considering the political tensions between the two countries. As such, Turkey's way out of the crisis would entail a political about-face of the Erdogan administration. Even if the worst case scenario of Turkey's default can be averted, the country will experience a severe slow-down of economic growth if not outright recession.

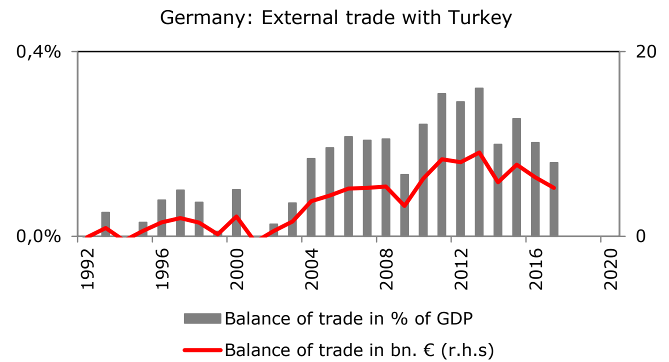


The current Turkish situation is somewhat reminiscent of the Asian crisis in 1997/98. It started in Thailand and then spread to other emerging economies growing into a broad-based currency, finance, and economic crisis. At the time, Thailand's problems spread because of high foreign debt that emerging markets accumulated due to persistent current account deficits and insufficient foreign exchange reserves. And that is where the difference lies. Even though many other emerging economies have suffered from the turmoil in Turkey in the past few weeks, we consider most of them fundamentally more stable than Turkey.

Of the ten largest emerging economies (China, India, Brazil, Russia, Mexico, Indonesia, Turkey, Saudi Arabia, Argentina, and Poland) only Argentina's current account deficit is about as high as Turkey's (4.8 vs. 5.5 percent). By contrast China, Russia, Saudi Arabia, and Poland even have current account surpluses while the other countries are running deficits of no more than two percent. So, the current account deficits of almost all countries and regions have come down since 1997. The emerging economies have overall basically balanced current accounts today while there were some severe imbalances in the lead-up to the 1997/98 Asian crisis. Most of the major emerging economies also have much higher foreign currency reserves relative to their GDPs and foreign debt now – except Turkey. Prime examples are Russia, Brazil, India, and Mexico but Argentina and Poland, too, have higher reserves now than in 1997. This implies better resilience to crises, which is particularly important considering the US dollar rally and higher US interest rates. All this makes the Turkey crisis unlikely to spark a wild fire across the emerging economies.

Even though we do not expect an economic meltdown across the emerging economies we wonder what effects the Turkey crisis will have on the global market place and the financial world. There will probably not be much: Last year, Turkey's economic performance totaling USD 826 billion made it the world's 17th-largest economy contributing about one percent to global value added. That makes Turkey's economic significance relatively marginal. Assuming that Turkey will undergo a recession next year that is on par with 2001 or 2009 (when its real GDP declined five to six percent) and not, as the IMF has previously expected, generate four percent growth, this would only curb global GDP by 0.1 percentage points. In other words, the global economy would grow only 3.8 percent instead 3.9 percent in 2019 unless the crisis spills over to other economies after all.





Turkey accounts for less than two percent of German exports and is therefore not a key trading partner. German exports to Turkey totaled just over EUR 21 billion last year and imports EUR 16 billion. The EUR 5 billion trade surplus corresponds to some 0.15 percent of German GDP. Only three sectors accounted for more than 50 percent of German exports to Turkey in 2017. The by far most prominent German exports to Turkey are German cars (EUR 4.7 billion or 22 percent), machinery (EUR 4.6 billion or also about 22 percent), and white goods (EUR 2.2 billion or about 10 percent) followed by plastics (EUR 1.4 billion or 6 percent), optical goods (EUR 1.1 billion or 5 percent), and pharmaceuticals (EUR 0.7 billion or 3 percent). The automotive and mechanical engineering sectors thus account for the lion's share of Germany's trade surplus with Turkey. However, only 1.2 percent of Germany's car and machinery exports go to Turkey leaving these industries only tangentially affected by the crisis.

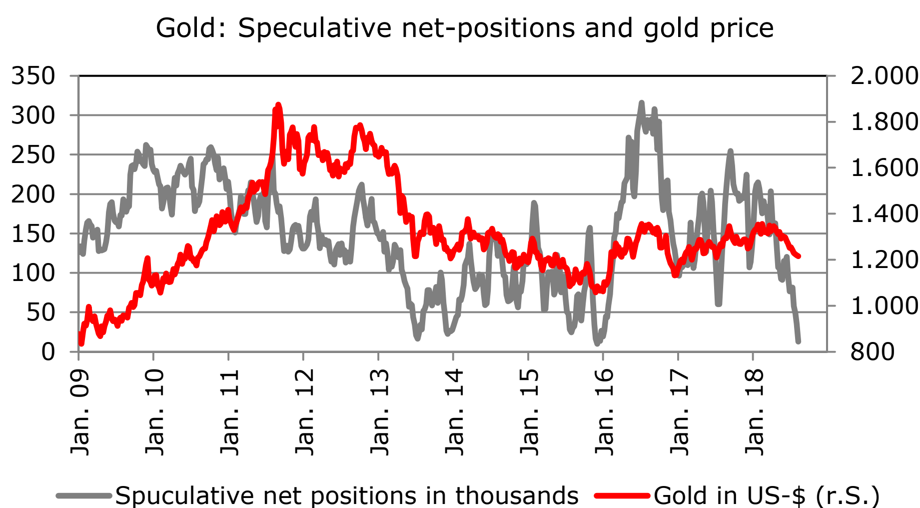
All in all, we do not really believe that Turkey has the potential for sparking an economic wild fire in the emerging economies considering that it is an exception both politically and economically. Most of the other emerging economies are also economically much more stable. One may consider Turkey a largely isolated case because the Turkish lira and yields on Turkish bonds are developing relatively independently of the currency and yields of other emerging economies. We thus reiterate our recommendation from last year to stay away from Turkish bonds and stocks until the country significantly changes its economic policy. We still think that investments in emerging economies are attractive but the coast is not yet clear. It is a good idea to wait with new investment until the situation has settled down. One should also keep a close eye on US trade policy going forward as this can cause much greater trouble for emerging economies than anything going on in Turkey.

Weekly outlook for August 20-24, 2018

	Mar	Apr	May	June	July	Aug	Release
DE: Producer prices, m/m	0.1%	0.5%	0.5%	0.3%	0.2%		August, 20
DE: Producer prices, y/y	1.9%	2.0%	2.7%	3.0%	3.0%		August, 20
DE: PMI manufacturing, flash	58.2	58.1	56.9	55.9	56.9	56.7	August, 23
DE: PMI services, flash	53.9	53.0	52.1	54.5	54.1	54.2	August, 23
EUR-19: Consumer confidence, flash	0.1	0.3	0.2	-0.6	-0.6	-0.5	August, 23
EUR-19: PMI manufacturing, flash	56.6	56.2	55.5	54.9	55.1	55.2	August, 23
EUR-19: PMI services, flash	54.9	54.7	53.8	55.2	54.2	54.3	August, 23

MMWB estimates in red

Chart of the Week: Crisis of the crisis currency?



The gold price has dropped nearly 10 percent in the past three months. In light of increasing global risks from trade conflicts and the Turkey crisis one should think that gold would assume its role as crisis currency and gain in value. There are then presumably other factors that keep these uncertainties from affecting the gold price. Prominently among these factors are certainly rising interest rates in the US. The higher interest rate level makes gold less attractive as an asset class since it does not produce income. Even risk shy investors find it more interesting to invest in US bonds. The US dollar's revaluation to below EUR 1.14/ USD is evidence of this. With probably two further rate hikes coming this year and more in 2019, gold should become rather less attractive in the future. It thus comes as no surprise that speculators have amassed vast short positions in gold. The number of short positions relative to long positions is currently at its highest since these statistics are being published. There is one more thing eating away at the gold price of late. As Turkey's currency crisis is making it ever more difficult for the country to finance its current account deficit the country seems to have taken to selling part of its (substantial) gold reserves and thus putting pressure on the gold price. This may continue. Investors not prone to apocalyptic thinking may at least think carefully before investing into gold.

Market data overview

	As of	Change versus				
	17.08.2018	10.08.2018	16.07.2018	16.05.2018	16.08.2017	29.12.2017
Stock marktes	15:33	-1 week	-1 month	-3 months	-1 year	YTD
Dow Jones	25547	0,9%	1,9%	3,1%	16,0%	3,3%
S&P 500	2841	0,3%	1,5%	4,3%	15,1%	6,2%
Nasdaq	7807	-0,4%	0,0%	5,5%	23,0%	13,1%
DAX	12153	-2,2%	-3,2%	-6,5%	-0,9%	-5,9%
MDAX	26242	-1,6%	-0,9%	-1,4%	5,1%	0,2%
TecDAX	2875	-1,7%	1,2%	3,3%	26,8%	13,7%
EuroStoxx 50	3359	-2,0%	-2,6%	-5,7%	-3,6%	-4,1%
Stoxx 50	3048	-1,7%	-0,8%	-3,3%	-1,1%	-4,1%
SMI (Swiss Market Index)	8971	-0,7%	1,4%	0,0%	-0,7%	-4,4%
Nikkei 225	22270	-0,1%	-1,4%	-2,0%	12,9%	-2,2%
Brasilien BOVESPA	76167	-0,5%	-0,6%	-12,0%	11,0%	-0,3%
Russland RTS	1055	-0,2%	-10,7%	-11,4%	2,4%	-8,6%
Indien BSE 30	37948	0,2%	4,5%	7,2%	19,4%	11,4%
China Shanghai Composite	2669	-4,5%	-5,2%	-15,8%	-17,8%	-19,3%
MSCI Welt (in €)	2131	0,0%	2,7%	3,7%	11,9%	6,5%
MSCI Emerging Markets (in €)	1022	-3,4%	-1,9%	-8,6%	-1,1%	-7,3%
Bond markets						
Bund-Future	163,14	-20	67	496	-61	146
Bobl-Future	132,53	17	50	166	-9	92
Schatz-Future	112,07	3	6	17	-10	9
3 Monats Euribor	-0,32	0	0	1	1	1
3M Euribor Future, Dec 2017	-0,29	-2	1	1	-11	0
3 Monats $ Libor	2,32	0	-1	0	101	63
Fed Funds Future, Dec 2017	2,22	2	0	-1	78	0
10 year US Treasuries	2,86	-1	0	-26	63	45
10 year Bunds	0,30	-2	-1	-31	-7	-12
10 year JGB	0,10	-1	6	4	5	5
10 year Swiss Government	-0,12	-1	-9	-24	-4	1
US Treas 10Y Performance	564,50	-0,1%	-0,1%	2,3%	-3,6%	-2,9%
Bund 10Y Performance	622,38	0,1%	0,6%	3,6%	2,8%	2,5%
REX Performance Index	486,63	0,2%	0,2%	1,7%	0,9%	1,2%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,66	0	-9	-20	-7	-2
IBOXX BBB, €	1,57	4	0	4	29	33
ML US High Yield	6,55	0	-5	3	44	40
JPM EMBI+, Index	783	0,3%	-2,1%	-1,2%	-5,6%	-6,4%
Convertible Bonds, Exane 25	7352	0,0%	-0,4%	-1,7%	2,5%	-0,6%
Commodities						
CRB Spot Index	413,84	-1,9%	-4,4%	-6,7%	-5,6%	-4,3%
MG Base Metal Index	302,19	-4,0%	-4,3%	-14,0%	-7,8%	-15,8%
Crude oil Brent	72,34	-0,7%	-0,4%	-7,6%	42,1%	8,6%
Gold	1179,54	-2,9%	-4,8%	-8,5%	-7,4%	-9,5%
Silver	14,79	-3,5%	-6,2%	-9,4%	-12,8%	-13,1%
Aluminium	2022,25	-3,1%	-4,0%	-13,5%	-3,7%	-10,4%
Copper	5901,00	-4,2%	-4,3%	-13,2%	-9,2%	-18,1%
Iron ore	67,59	-1,4%	6,7%	0,4%	-7,9%	-5,2%
Freight rates Baltic Dry Index	1720	1,7%	1,5%	22,6%	42,5%	25,9%
Currencies						
EUR/ USD	1,1408	-0,4%	-2,7%	-3,2%	-2,6%	-4,9%
EUR/ GBP	0,8961	0,1%	1,3%	2,5%	-1,5%	1,0%
EUR/ JPY	125,99	-0,8%	-4,3%	-3,0%	-2,9%	-6,7%
EUR/ CHF	1,1345	-0,4%	-3,0%	-3,8%	-0,5%	-3,1%
USD/ CNY	6,8740	0,4%	2,7%	7,9%	2,7%	5,7%
USD/ JPY	110,90	0,0%	-1,2%	0,5%	0,6%	-1,6%
USD/ GBP	0,79	0,4%	3,9%	5,9%	1,1%	6,3%

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