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TURKEY'S CRISIS: DOES IT MATTER FOR THE EUROZONE?

Berenberg Macro Flash

Turkey is in deep trouble: After a credit-driven boom, the surge in Turkish inflation, bond yields and the even more dramatic plunge in Turkey's exchange rate in 2018 suggest that the country could now be in danger of heading for a bust. Beyond the obvious risks to Turkey itself, this raises the question of how much the Eurozone economy would be affected. In our view, the impact on Eurozone GDP growth would be small. Even if Eurozone goods exports to Turkey were to fall by, say, 20%, this would subtract no more than 0.1ppt from growth in the big Eurozone.

Turkey's economy has been running hot over the last quarters. A large pre-election fiscal stimulus programme, elevated credit growth and bad policy decisions have caused a major rise in inflation (15.8% yoy in July 2018 vs. 9.8% in July 2017) and a dangerous widening of the current account deficit (to c6.5% of GDP in 2018). In addition, direct pressure from President Recip Tayyib Erdogan on the central bank to keep interest rates low has further undermined investor confidence.

The pressure on the Lira and Turkish bond yields increased dramatically over the last four weeks due to the recently announced US sanctions and fears of a further escalation to tit-for-tat between Turkey and the US. An apparent lack of urgency by the Turkish government to react to the many economic dangers has not helped. Over the last 12 months, the Turkish Lira fell by c33% vs. the EUR and the 2-year local benchmark bond yield nearly doubled to 22% over the same period. The credit default swap level reached a 9-year high of 368bps this week.

Turkey's economic scenario: So far, Turkish sentiment indicators (such as the consumer confidence index) held up surprisingly well. Turkey also proved in the past for instance in Q4 2016, that it is ready to step up spending dramatically to prevent a recession such as in H2 2016. But this time borrowing costs are much higher. This makes a government rescue via a massive stimulus programme such as in late 2016 more difficult. The decline in the Turkish Lira and rising borrowing costs cause a big headache for many Turkish companies, as they have borrowed in foreign currency despite receiving revenues in local currency. The credit-fuelled consumption boom of the past is unlikely to continue due to sky high inflation, high debt levels and high borrowing costs. In our view, a temporary decline in GDP in late 2018 or early 2019 looks quite likely if the authorities do not restore confidence soon. Even a recession and a debt crisis that would force Turkey to implement capital controls and ask for an IMF bailout cannot be ruled out anymore. Turkey now has much less room to kick the can down the road than before.

POTENTIAL REPERCUSSIONS ON THE EUROZONE ECONOMY

Size matters: Turkey's economy grew by c60% in real terms since 2009 and its annual GDP is c€750bn, equivalent to c6.5% of Eurozone GDP. Meanwhile, Turkey's GDP is four times larger than that of Greece, but less than half the size of the Italian economy (despite Turkey's larger population of c80 million vs. c60 million for Italy).

Trade with Turkey: The Eurozone runs a goods trade surplus with Turkey. Last year, the Eurozone exported €63bn of goods to Turkey. Goods imports from Turkey reached €50bn last year. Furthermore, Eurozone exports to Turkey jumped by 80% since 2009, while imports accelerated even faster, by 88%, during the same period. However, Eurozone export to Turkey has declined since 2012 relative to Eurozone GDP and fell to 0.57% in 2017 vs. 0.61% in 2012 (see chart).

Lessons from previous crises: Turkey has suffered two major economic crises in the last 20 years. In November 2000, the IMF had to bailout Turkey after a boom had turned to bust. In 2001, Turkey's economy contracted by 6% with Eurozone exports to Turkey plunging by 30%. In 2009, Turkish GDP fell by 5% in response to the fallout of the global financial crisis. At the same time, Eurozone exports to Turkey declined by c20%. If Turkey were to fall into a comparable crisis again, which is not impossible but is not our base case, a drop in Eurozone exports to Turkey by 20% or 30% could directly deduct c0.1 ppts to 0.15 ppts from annual Eurozone GDP growth. However, as seen in previous external setbacks such as the 2014 sanctions imposed on Russia, Eurozone companies are pretty quick in identifying and switching to new markets. Selling more elsewhere would offset some of the hypothetical decline in Eurozone exports to Turkey. The total damage from a Turkish recession would be smaller than 0.1 ppts to the Eurozone economy. Once the Turkish crisis is over, exports to Turkey could recover fast. Already one year after the 2009 recession, Eurozone exports to Turkey surpassed the previous 2008 peak. After the 2001 crisis, it took only 2 years for Eurozone exports to Turkey to reach previous highs.

Impact on Eurozone economic confidence and credit growth: Sentiment is a fickle thing. However, two recent examples suggest that Eurozone confidence and bank lending are unlikely to be negatively impacted by a Turkish crisis. First, confidence and lending improved in H1 2015 although Greek tensions reached a peak at that time. Second, after the failed coup d'etat against the current president in July 2016, the Turkish economy contracted by 2.5% qoq in Q3 2016; however, Eurozone confidence remained unchanged in Q3 2016 vs. Q2 2016, while credit growth rose during the same period.

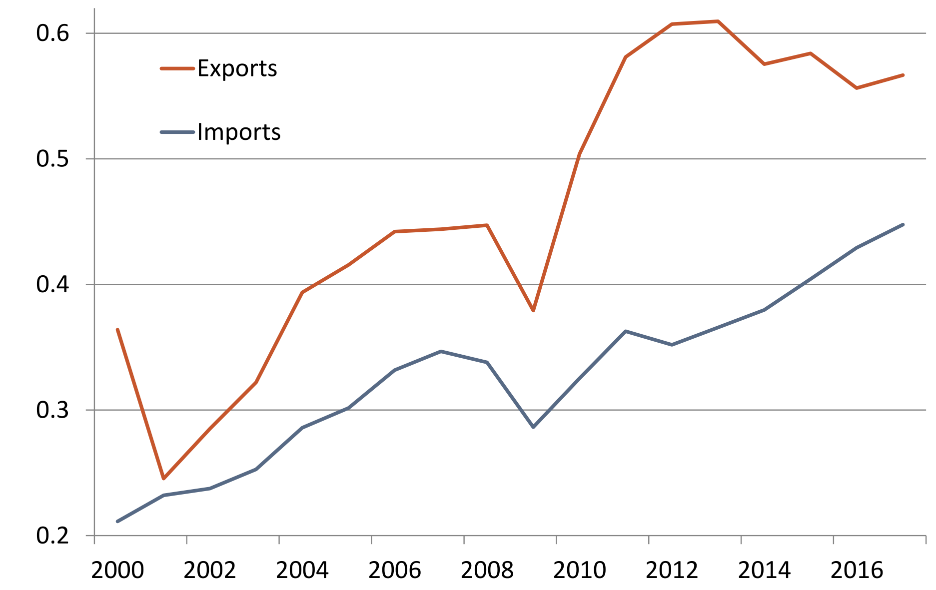
Turkish banking crisis contagion risks: Of course, a full blown Turkish banking crisis would have some negative repercussions on Eurozone banks that have large credit exposure to Turkey or own Turkish banks. But overall, the Eurozone banking exposure seems too small to cause a significant Eurozone crisis. The total exposure of banks in the three Eurozone countries with the largest claims in Turkey is c$135bn (Spain c$81bn, France c$35bn and Italy c$19bn) according to the BIS. This reflects c12.2% of the banks total equity in Spain, France and Italy together and equals c6% of their total exposure to Eurozone countries. But even if we are wrong and a potential meltdown of the Turkish banking sector would cause serious trouble for some Eurozone banks, bank supervisors in the Eurozone would have sufficient tools at their disposal to contain the damage. That the fallout from Turkey could cause any credit crunch in any part of the Eurozone seems highly unlikely.

POTENTIAL POLITICAL FALLOUT

Migration: A deep Turkish recession could lead to more migrants leaving Turkey for the EU. Currently more than three million Syrian refugees are living in Turkey. A large increase in migrant arrivals in the EU could strengthen support for right-wing radical parties in the EU. Despite disputes between Turkey and the EU on many issues, the EU has a strong interest in a stable Turkey.

Economic policies: At the margin, the Turkish crisis could discredit unorthodox economic policies in Europe and elsewhere. The Turkish example shows that bad or unconventional economic policies have long-term negative consequences and make a country more dependent on the political goodwill of others. Whether or not policy makers elsewhere will heed such a lesson is a separate question, though.

Chart: Eurozone trade with Turkey, in % of Eurozone GDP



Trade in goods. Source: Eurostat, Berenberg.

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