TURKISH CONTAGION RISKS: ITALY, EUROZONE, EMERGING MARKETS?

Berenberg Macro Flash

Turkey is no small fry. It contributes 1% to global GDP. Beyond the obvious geopolitical concerns, a major Turkish recession would pose a significant challenge for financial markets and for other economies. Remembering the tremors which Turkey’s smaller neighbour Greece once sent through European and global markets, investors are understandably nervous. As emphasised before, the noise from Turkey could delay the rebound in Eurozone business confidence and growth for a few more months despite the easing of US-EU trade tensions, see Eurozone: beyond the rocky summer (13 August 2018). As long as frightened markets stay in risk-off mode, for a while, the euro, equities and bond yields can remain lower than underlying fundamentals would otherwise suggest. As a result, we shave our end-2018 calls for the euro to $1.17 from $1.21, for the CHF to €1.16 from €1.18 and for 10-year Bund yields to 0.6% from 0.7%, see Forecasts at a Glance (17 August 2018). Still, despite the heightened risks, we need to put Turkish issues into perspective.

ITALY IS NOT TURKEY

- Turkey is in trouble partly because its central bank’s independence is undermined by the country’s autocratic president Recep Tayyip Erdogan. The Turkish central bank cannot credibly commit to its 5% inflation target as long as its president rails against the necessary rise in interest rates. The European Central Bank setting monetary policy for Italy – because of its multinational structure – is more independent of national political pressure than any other central bank in the world.
- Turkey suffers the fallout from a credit binge that has gone too far. Italy, for all its banking issues, has problems that largely reflect low trend growth stemming from an insufficiently reformed supply side.
- Turkey has a ballooning current account deficit (so far on course for 6.5% of its GDP) that it needs to finance through capital inflows; Italy runs a solid current account surplus of 2.8% of GDP.

Of course, as the Turkish crisis nurtures risk aversion and safe haven flows, it leads to some spread widening within the Eurozone. Wrong fiscal policies and reform reversals may turn Italy into an accident waiting to happen, as emphasised before, see Italy: heading for an even hotter September. But whether or not Italy falls into a debt crisis soon depends almost exclusively on the policy choices it makes upon preparing its 2019 budget due by 15 October. At the margin, the tragic Genoa bridge disaster makes it even more likely that Italy will breach EU fiscal rules in its draft budget for 2019. Still, that should not be a major surprise anymore. Our base case remains that Italy, while flouting the rules, will not do so to such an extent to spark an immediate debt crisis this autumn. Instead, occasional surges in bond yields can serve to rein in some of the tax–cut and spending plans of the radical parties that form the Italian government. Italy’s deficit may rise to c.2.5% of GDP next year but will likely stay below the 3% threshold. Otherwise, all bets would be off. But that is an Italian issue that has little to do with any fallout from Turkey.

IMPACT ON THE EUROZONE? VERY LIMITED

- **Exports**: The Eurozone earns 0.55% of its GDP by selling goods to Turkey. Even a 20% fall in exports to Turkey would not subtract more than 0.1ppt from annual Eurozone GDP growth. As global demand remains healthy, Eurozone firms could likely contain the damage further by switching to other markets for some of these affected goods with only modest reductions in their selling prices.
- **Financial linkages**: Spain, France and Italy are the most exposed Eurozone countries to Turkey. According to BIS data, the exposure to Turkey of banks domiciled in these countries stands at $61bn for Spain, $35bn for France and $18bn for Italy. A major part of this consists of equity stakes in Turkish banks rather than in more dangerous intra-company loans or direct credit exposure. Turkish losses may well affect individual institutions in the Eurozone to a significant degree. Still, Eurozone banks are in much better shape than they were during the 2011-2012 euro crisis which had come right in the wake
of the 2008/2009 mega-recession. The risk that the exposure of some banks to Turkey could turn into a systemic problem for the Eurozone and/or cause a tightening of credit conditions in Spain, Italy or France remains remote (see Does Turkey matter for the Eurozone?).

- **Confidence effect:** The real risk stems from the level of noise. Confidence and hence the readiness to spend and invest often drives the business cycle. As confidence is currently fickle with no established trend, even small but highly visible problems can nourish the feeling that the world is a dangerous place rather than full of exciting opportunities. We therefore see a clear risk that any noisy crisis - such as the Turkish turmoil - could take some toll on the Eurozone and retard the upturn in markets and business sentiment for a while.

However, three recent examples suggest that Eurozone confidence should not be badly affected by a Turkish crisis for long.

- First, the Eurozone economy continued to expand solidly in 2010 and early 2011 while the **first Greek crisis** was in full swing. Only when a policy mistake, a decision to restructure Greek bonds without adequate contagion controls, sparked massive capital flight out of Spain and Italy did the Eurozone economy budge.
- Second, Eurozone confidence and bank lending improved though out the **second Greek crisis** in H1 2016 triggered by the ascent of Tsipras/Varoufakis to power.
- Third, after the **failed coup d'etat** against the current president in July 2016, the Turkish economy contracted by 2.5% qoq in Q3 2016. Nonetheless, Eurozone confidence remained unchanged in Q3 2016 vs. Q2 2016 while credit growth rose during the same period. Of course, Turkey's current economic calamity looks much worse than the 2016 dip.

Eurozone economic fundamentals look better now than during these three periods. As confidence levels are still well above average, the Eurozone can withstand a further modest dent in confidence.

**CONTAGION TO OTHER EMERGING MARKETS: NOT WIDESPREAD**
As part of the same basket of investments, emerging markets are more vulnerable than developed markets to financial contagion from Turkey. In particular those emerging markets with problems and imbalances similar to those of Turkey are at risk.

We need to watch countries that suffer from:

- **High twin deficits as % of GDP** (current account plus government budget deficit): South Africa, Argentina, Brazil and Colombia are prominent among them.
- **High foreign currency debt as % of GDP:** Outside Europe, Argentina and Chile have the highest exposure to foreign-currency debt (around 50% of their GDP according to the IIF).
- **Dovish national central banks** that have a track record of not tightening monetary policy enough to reach their inflation target (e.g. Argentina).
- **Political disputes with the US** and are threatened by a potential escalation of tit-for-tat tariffs and sanctions (China and Russia).

We expect a number of country-specific problems to be accentuated by the fallout from Turkey. However, we do not look for wide-spread and dangerous contagion to a large number of other emerging markets. The direct exposure of other emerging markets to Turkey via trade or the banking sector is very small. A stronger USD and, in some cases, the risk of US sanctions, remain serious concerns for the most exposed countries. Big current account deficits coupled with high levels of foreign currency debt can be a recipe for a crisis. However, thanks to strong economic growth since the great financial crisis of 2008/2009, many emerging markets benefit from improved private sector balance sheets and elevated FX reserves. This should help most of them to withstand the Turkish tremors with little damage.
Some Central Eastern European (CEE) countries have - compared to other emerging markets - relatively high amounts of external debt as a % of GDP - e.g. **Poland** at 72% - or a high percentage of government bonds owned by foreign investors. These factors can make them vulnerable in times of risk-off sentiment. However, CEE countries are, on average, much more advanced economically and have much better credit ratings than most other emerging markets. Tied closely into Western European production chains, they depend much more on what happens in the Eurozone than on the fate of other emerging markets.

**Which emerging markets suffered the most from the Turkey crisis so far?** A sharp decline in the currency or a sharp increase in credit default swaps (CDS) signals potential trouble. **Argentina** stands out as the most affected country, followed, by a significant distance, by **South Africa, Russia** and **Brazil**. Since the beginning of August, **Turkey**’s 5-year CDS climbed by 1150bps to 470bps (Chart 1). This reflects a roughly one in three chance of Turkey defaulting on its debt over the next 5 years (assuming a recovery rate after default of 30%). **Argentina**’s CDS increased only slightly less by 1120bps to 540bps. The CDS level of other large EM countries did not change much. **Russia, South Africa** and **Brazil** CDS levels increased by only 20-40bps during the same period.

The **Turkish Lira** lost around 15% vs. the USD this month, followed by the **South African Rand** (10%), the **Argentinian Peso** (8%) and the **Russian Ruble** (7%). Most other emerging market currencies lost less than 5% vs. the USD (Chart 2). For them, the fall-out is very modest.

**Chart 1: 5-year credit default swap price change this month (in bps)**

As of 17 August 7:30am. Source: Bloomberg
Chart 2: FX change vs. USD this month (in %)

As of 17 August 720am. Source: Bloomberg

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