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MACRO UPDATE: ITALY, TURKEY AND EMERGING MARKETS

Berenberg Macro Flash

Italy: The renewed volatility in Italian bond markets highlights the risks from the upcoming budget discussions. A higher-than-expected projection for the 2019 budget deficit could lead to a clash with Brussels and increase the risk of an Italexit. Three people are key in the on-going budget negotiations: Finance Minister Giovanni Tria and the two leaders of the governing populist parties, Matteo Salvini and Luigi Di Maio. FM Tria is the most sensible of the three, he targets a budget deficit of just below 2% of GDP. This would likely be accepted by the EU. However, right-wing Lega leader Salvini demanded last week a budget deficit of c.2.9% of GDP in order to implement his elections promises (e.g. the flat income tax and reversing the pension reform). This led to an increase in the Italian sovereign bond risk spreads (c. 15bps). Yesterday, he seemed to have changed his mind following the warning from the markets. Salvini pledged that he will try to respect EU fiscal rules and honour pre-existing budget commitments. If Salvini is serious about this pledge and the budget deficit remains close to 2%, that would be a step into the right direction. But we still have not seen a change of heart from the influential left-wing 5Stars leader Di Maio. He announced last week that the budget deficit could exceed the EU's ceiling of 3% of GDP. Di Maio wants his expensive citizens income and tax cuts implemented already in 2019. Assuming that the VAT will not be hiked, the pension reform partly reversed and that the flat tax and citizens income will be introduced in stages, we expect a budget deficit target of c.2.6% of GDP in 2019 - see: "Heading for an even hotter September".

Turkey: Turkey's economy overheated for a while, similar to Greece in 2000-2007 (Table 3). Both countries had an unsustainable credit-driven consumption and investment boom. In the process Turkey has accumulated a large stock of foreign currency denominated debt. Turkey's troubles are multiplied by the fact that: a) in theory it has, but in practice it doesn't have an independent central bank, and b) its leader, President Recep Tayyip Erdogan seems set on stoking political tensions with the US (this could lead to painful economic sanctions). That makes Turkey's currency very vulnerable in "risk off" periods as seen in early August.

Yesterday the Turkish central bank pledged to tackle its elevated inflation level. In August CPI jumped by c.19% yoy, only very slightly below the average weighted Turkish central bank interest rate of currently 19.25% Even though the central bank pledge is a step into the right direction, this set high expectations for a significant raise in the interest rate during its next meeting on 13 September. International investors would like to see an increase of the interest rate corridor of between 500bps-1000bps. But due to the constrains of the central bank caused by President Erdogan, who does not like high interest rates, the central bank will likely hike less than what investors demand which could lead to further disappointment. We discussed in our latest "Chart of the week – Turkey: How bad can inflation get" the big challenge the Turkish central bank faces. The Turkish consumer price level will likely increase by c.50% (or by c.22% annualised) over the next 18-24 months if the Turkish Lira remains at the current level. Far away from the 5% yearly inflation target by the central bank.

The latest Turkish sentiment readings (Turkish PMI and the industrial sector confidence index) indicate that GDP growth slows quickly and that the country heads towards a recession. 5-year credit-default swap levels of c580bps signal a roughly 1/3 chance that Turkey will default on its debt over the next 5 years.

Emerging Markets (EM) contagion: Besides Turkey, Argentina looks the most vulnerable among larger EM countries (Table 1). Argentina has similar problems to Turkey, high inflation and large twin deficit as a % of

GDP (current account and government budget deficit), but at least its central bank is ready to tackle the problem and the government asked for IMF help. South Africa and Brazil are vulnerable to negative sentiment towards EMs as well. Additionally South Africa is weakened by an unclear land reform programme while Brazil suffers from the fear of a less economically sensible party winning the upcoming presidential election. But importantly, most of the other large EM look fine. In particular China, India and Central Eastern European countries look stable (Table 2). Please see "Turkish contagion risks" for more details.

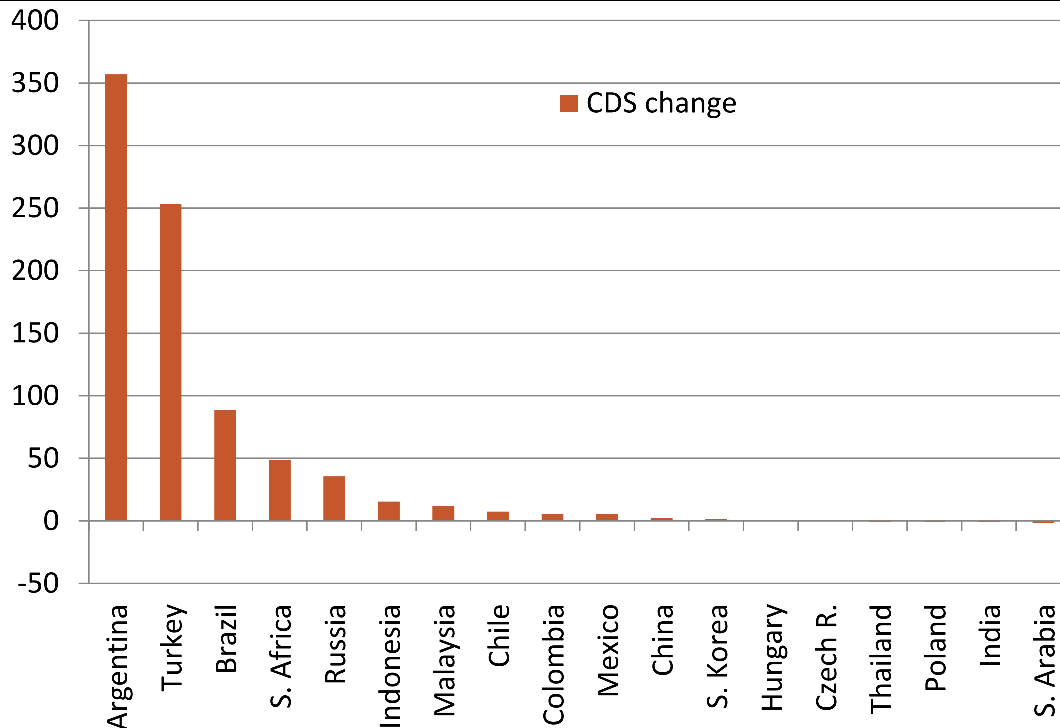
Will the external pressure on vulnerable EM increase much further? We don't think so: The vulnerable Emerging Markets mainly suffered from the US trade war threat which caused a risk-off mode in markets and which led to money flows out of EMs and a stronger US dollar. We expect the trade war threat to fade which should encourage investors to leave the safe haven off the US as they return to a more risk-on mode. If this is combined with the local authorities in Turkey, Argentina, Brazil and South Africa taking the right measures to fight the economic imbalances, then the pressure on vulnerable EMs should calm down as a result.

Table 1: EM heat-map: Besides Turkey, Argentina, Brazil and S. Africa look most vulnerable

	Budget[1]	Current account[1]	FX debt[1]	5-year CDS[2]	Debt to GDP	GDP	Gross reserves[1]	CPI[3]
Turkey	-2.3	-5.6	70	576	28.5	7.3	12.7	15.8
Argentina	-6.5	-4.9	52	775	52.6	2.9	8.6	31.2
Brazil	-7.8	-0.5	26	303	84	1	18.2	4.5
S. Africa	-4.5	-2.5	34	230	52.7	1.3	14.5	5.2
Russia	-1.5	2.6	27	168	17.4	1.6	27.4	2.4
Indonesia	-2.5	-1.7	24	127	28.9	5.1	12.8	3.2
Mexico	-1.1	-1.7	27	120	54.2	2.3	15	4.8
Colombia	-3.1	-3.3	33	112	49.4	1.8	15.1	3.1
India	-6.9	-1.9	15	85	70.2	6.7	15.9	4.1
S. Arabia	-9.3	2.2	21	83	17.3	-0.9	72.3	2.3
Poland	-1.7	0.2	53	63	51.4	4.6	21.6	2.2
China	-4	1.3	14	60	47.8	6.9	26.4	1.8
Chile	-2.7	-1.5	50	56	23.6	1.5	14	2.7
S. Korea	1.9	5.1	44	42	39.8	3.1	25.4	1.5

[1] As a % of GDP. [2] CDS level as of 31 August 2018. [3] as of July 2018 Source: National Statistical Institutes, IIF IMF, Bloomberg

Table 2: Most EM did not suffer from an increase in 5-year CDS levels in August (in bps)



[1] As of 31 August. Source: Bloomberg

Table 3: Greece and Turkey? Overheating signals compared – Annual average growth rates

	Greece 2000-2007	Turkey 2010-2017
Loans to private sector (real)	15.7%	17.2%
M2	10.9%	16.3%
Central bank rate (real)	-0.1%	0.3%
Credit to private sector in % of GDP [1]	101.8%	84.9%
Bank loans to deposit ratio [1]	82.4%	126.6%
Inflation (CPI)	3.3%	8.4%
GDP per capita	3.7%	5.6%
GDP per capita (in 2010 US dollars) [1]	30.2k	15.2k
Investment (GFCF)	6.1%	10.9%
Investment in % of GDP [1]	27.1%	30.9%
Private consumption	3.7%	6.6%
Current account balance in % of GDP	-8.7%	-5.6%
Budget balance in % of GDP	-6.4%	-1.6%
Government debt-to-GDP ratio [1]	123.8%	28.2%
Interest payments in % of GDP [1]	4.5%	1.9%

[1] End of period. Source: National Statistical Institutes, BIS, Eurostat

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