Turkey Economic Outlook

2nd QUARTER 2017 | TURKISH UNIT

Contents

1. Editorial

Global economic activity accelerated during the first quarter of the year as signalled by the overall improvement in confidence indicators, along with the advance of global trade. The performance of the advanced economies continues to be particularly positive thanks to the US recovery consolidating and Europe growing at rates that are above potential. **The improved global behavior is accompanied by some clarification regarding the course of US economic policy, where expectations of rapid reflation have been limited, or at least the timing of measures to support changes in that direction has been delayed. The financial markets have remained calm in recent months, recording low volatility in spite of the high uncertainty.**

After contracting in the 3rd quarter, **Turkish economic activity posted a "V"-shaped, faster than expected recovery in the last quarter of 2016 (3.5% YoY), thanks to solid private consumption supported by tax reductions and the strong recovery of credit growth.** The preliminary indicators signal that GDP growth momentum prevailed in 1Q17 thanks to the impact lag of the fiscal stimulus and solid export demand from the EU. **Faster than initially expected recovery momentum leads us to upgrade our 2017 GDP growth forecast from 2.5% to 3%.**

Consumer prices tended to rise, as we anticipated, on the back of mounting cost push pressures due to a sizable exchange rate pass-through and unfavourable base effects on food and energy inflation. We expect inflation to peak in May and then moderate during the last quarter of the year.

As inflation accelerated and the Turkish lira suffered due to electoral uncertainty, the Central Bank (CBRT) strengthened its monetary tightening by increasing the average funding rate significantly at the start of the year. The CBRT's sizable tightening helped to stabilise the exchange rate but it is still far from reining in inflation expectations. Our inflation forecast forces us to expect the CBRT to keep its tight monetary policy stance and continue to use the extraordinary late liquidity window facility as a regular policy tool for at least the near future. **The CBRT may find a window of opportunity to start to ease monetary conditions gradually by the end of the last quarter,** if global financial conditions remain supportive and headline inflation recedes towards single digits as we forecast. **The monetary policy easing should be matched with a more restrictive tone in the macro-prudential stimulus.**

The Government's counter-cyclical measures **will generate an increase in the budget deficit to GDP ratio to 2.5% in 2017 from 1.1% in 2016.** Even if we pencil in some deterioration in budget performance, **both the expected budget deficit and public indebtedness will remain below international standards, such as the Maastricht criteria**. While supporting fiscal policy measures was somewhat desirable given the magnitude of the slowdown in the economy, the public authorities should also balance the positive effects of maintaining sound fiscal balances for financial assets. **In this sense, fiscal expansion should prove to be a temporary phenomenon in 2017 and the public accounts should strengthen next year and beyond.**

The overall risks are balanced. On the one hand, **the end of electoral uncertainties after the referendum on constitutional change and the current momentum of economic recovery provide the Government with a window of opportunity for focusing on economic policies and reforms**. On the other, some economic and geopolitical uncertainties will continue.

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2. Global outlook

Global environment: global growth consolidates but there are still risks

Gradual acceleration and more restrained extreme scenarios

During the second half of 2016, the global **GDP growth rate stood at 0.9% QoQ**, and the most recent data point to similar rates for the beginning of 2017, which compare positively with the 0.8% recorded on average since 2011. The overall improvement in confidence indicators and the advance of global trade are behind this acceleration in activity. **The performance of the advanced economies continues to be particularly positive** thanks to the US recovery consolidating and Europe growing at rates that are above potential. On the downside, Latin America will emerge from recession this year, but with only moderate growth.

The improved global behaviour is accompanied by some **clarification regarding the course of the economic policy in the USA,** where expectations of rapid reflation have been limited, or at least the timing of measures to support changes in that direction has been delayed. Therefore, the government appears to be considering moderate proposals for a possible renegotiation of NAFTA, while it continues to face obstacles in pursuing its policies to restrict immigration. Nontheless, the difficulty of pushing forward with the reform of the health care system has also revealed problems with getting other measures approved, such as those linked with tax cuts and the infrastructure expenditure plan, which eliminates the likelihood of a strong fiscal impulse in the short term.

The financial markets have remained calm in recent months, recording low volatility in spite of the high uncertainty. Financial tensions have relaxed, especially in the emerging economies, which were more negatively affected at the end of last year due to the uncertainty after the US elections. **Europe is an exception to this trend**, as the uncertainty about the elections in France has widened the debt spread in France and the periphery.

Moving towards monetary policy normalisation

The combination of a cyclical upturn, the reversal of inflation from negative rates and, above all, the moderation or disappearance of deflationary risks have provided the basis for the central banks to leave ultra-expansionary policies behind. **The Fed, which leads this process, has brought forward its third rate increase to March**. The rise in rates has not caused any adverse effects on the financial markets, fundamentally because it is broadly in line with the progress made by the economy, which is nearing full employment, and also because the Fed is maintaining its gradual exit message. In addition, the Federal Reserve is discussing how to approach the third phase of the exit strategy, i.e., the reduction of the balance sheet (once the -QE- bonds purchase programme is completed and interest rate increases are consolidated). But it is something that will probably not happen until next year and will be put in place passively.

The ECB also is more optimistic about growth but still not very confident about inflation reaching its medium term target. Therefore, the announced QE recalibration has been taking place since April, with monthly purchases of public and private debt falling from 80 to 60 billion euros. This reduction in purchases and some changes in the ECB`s communications are a first step in the exit strategy. In this regard, the monetary authority is expected to change its forward guidance to prepare the market for the timing and order that will follow. According to our scenario, we expect the ECB to continue reducing its bond purchases during the first part of 2018 and not to extend them beyond the summer, so as to start the upward cycle of rates at the end of the same year.

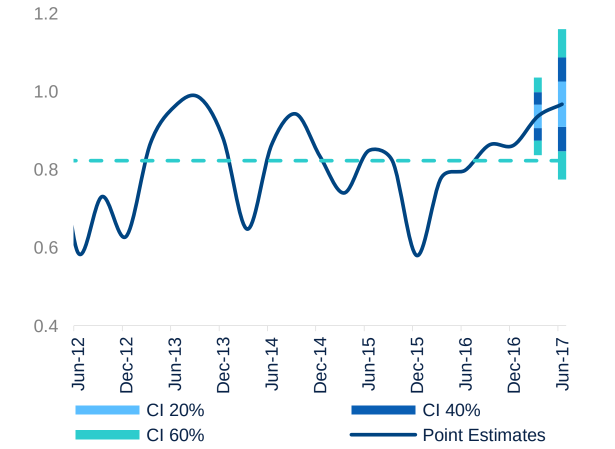
In short, we are facing a normalisation process in monetary policies, which, until now, were very accommodating. Therefore, an increase in financing costs can be expected at the global level on the projected horizon. The communication policy will be the key to this process, to prevent mistakes like the famous “taper tantrum” (overreaction in 2013 by the bonds market to the withdrawal of stimuli) in the USA. The tightening of financing conditions not only depends on the intervention rates set by the central banks but also on long term interest rates. In this case, there are factors that continue to pin down the long end of the curve, such as elevated uncertainty, the lack of safe-haven assets and certain regulatory features.

Slightly upward revision of growth but still with risks of a downturn

Overall, growth forecasts for 2017-18 are only marginally revised. The positive start for the year moves them up for the Eurozone and especially China, while for the Latin American countries they are rather more negative this year (with the notable exception of Mexico). As a result, expected global growth is **3.3% for 2017 and 3.4% for 2018**, which, in both cases, is 0.1pp higher than our previous forecasts.

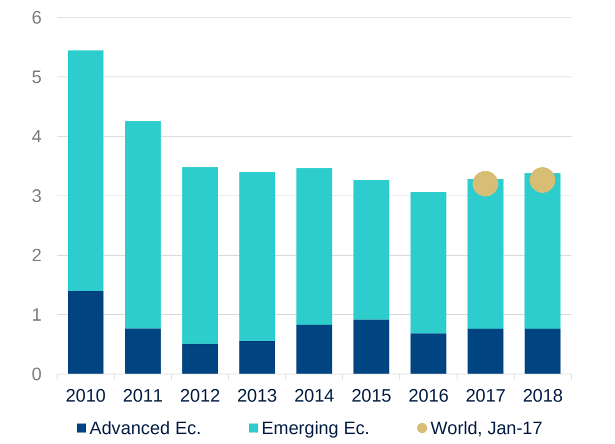
In spite of the above, perceived risk events, if they occur, would mostly reduce growth. In particular, in addition to the uncertainty that is still associated with the **measures about to be approved in the USA**, there are doubts centred around the election **results in France and Italy,** due to the highly negative impact that they could have on Eurozone stability in the (unlikely) event of a victory for the strongly anti-European ellements. There is also the **risk associated with the Chinese economy,** where the recent strength of investment may slow down the imbalance reduction process. Other significant elements that remain uncertain and which it will be important to consider in the coming months include the evolution of the Brexit negotiations, the multiple open geopolitical events and the risks associated with the normalisation of monetary policy, especially in the USA.

Figure 2.1 Global GDP growth Forecasts based on BBVA-GAIN (%, QoQ)



Source: Haver and BBVA Research

Figure 2.2 Global growth by region (%, year-on-year)



Source: BBVA Research

3. Turkey Economic Outlook

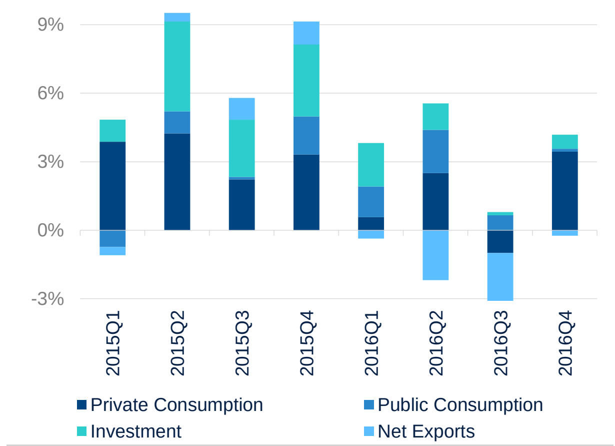
A V-shaped recovery after the third quarter slump

After contracting in the 3rd quarter, **economic activity posted a faster than expected recovery in the last quarter of 2016.** Turkish GDP finally contracted 1.3% in 3Q (revised from the previously estimated -1.8%) while the economy registered economic growth of 3.5% YoY, thanks to private consumption's being supported by tax reductions and the strong recovery of private credit. **The performance of the last quarter and the significant revision of the previous quarters of 2016 led the economy to grow by 2.9% in 2016.**

Despite the significant moderation from the 6.1% growth in 2015, GDP growth of 2.9% was a positive surprise (our expectation was 2.3%) and it continues to demonstrate the resilience of the economy despite the political and geopolitical circumstances of last year. The intensified fiscal stimulus and counter-cyclical macro-prudential measures to boost private consumption have worked to avoid a recession and resulted in a V-shaped economic recovery.

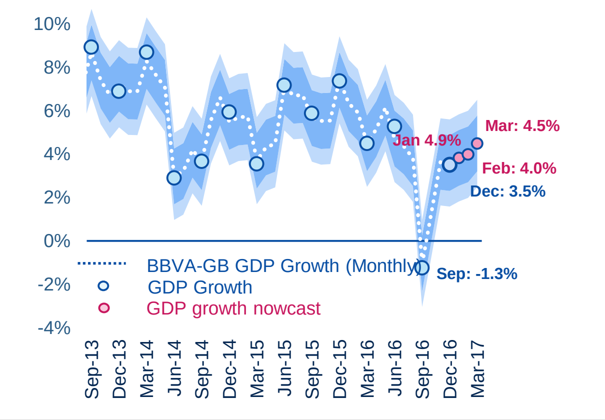
Despite a poor performance by industrial production during the first months of the year, we expect GDP growth momentum to prevail in 1Q17 thanks to the impact lag of fiscal stimulus and solid export demand from the EU. **Our monthly GDP indicator also indicates 4.5% growth in the first quarter of the year.**

Figure 3.1 Turkey: Contributions to Growth (YoY)



Source: Turkstat, BBVA Research, Garanti Research

Figure 3.2 Turkey: BBVA-GB Research Monthly GDP (YoY)



Source: BBVA-Garanti Research Monthly GDP Model, Turkstat

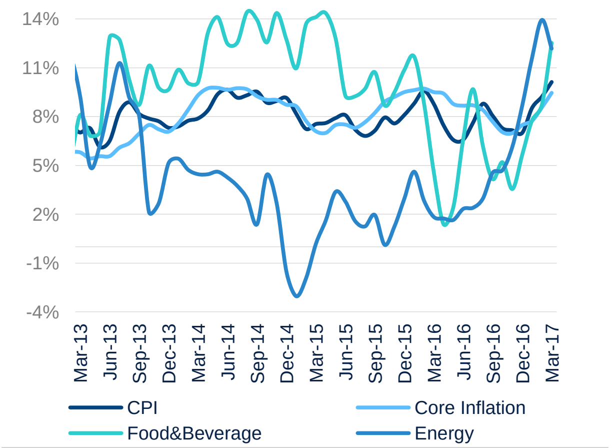
However, the deterioration in the labour market continued with rising participation rates and less job creation. A sizable increase in the unemployment rate was registered in the last quarter, reaching 12.1% and taking the overall 2016 level up to 10.9%, the highest level since 2010. The unemployment rate reached 13% in January. **A usual lagging indicator, the unemployment rate is likely to begin to retreat gradually starting from 2Q, as the impact of the government's employment campaign becomes felt and economic activity gains further traction.**

Inflation outlook worsens significantly in 1Q17

Consumer prices maintained their increasing trend and annual inflation reached 11.3% in March, up from 8.5% at the end of 2016. The second round effects on core prices stemming from the exchange rate pass-through and the unfavourable base impact on food and energy inflation were the main drivers behind the surge. The impact of these factors was even greater for domestic producer prices, which jumped to 16.1% from the lows of 1.8% in September 2016 and 9.9% at 2016 year-end, signalling continuing cost push pressures in the short term.

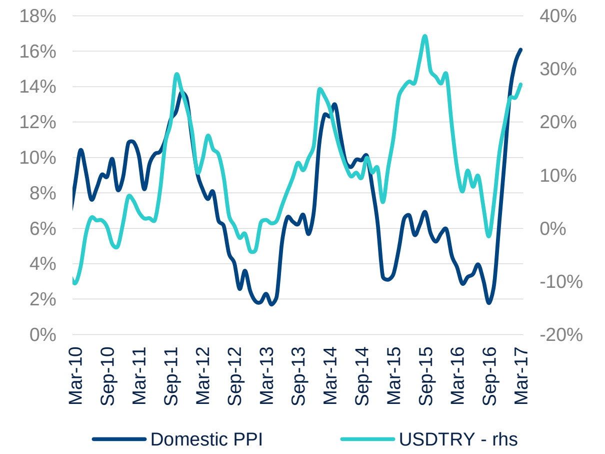
Besides the exchange rate pass-through, food inflation was the main amplifier, as its annual rate rose to 12.8% in March from the year-end 5.4%. This was mainly the result of an unfavourable base effect and a higher seasonal average. The other prominent factor was core prices, as annual core inflation advanced to 9.5% from 7.5% in the first 3 months of the year, reflecting the second round impacts of exchange rate depreciation and the lack of a disinflationary impact on demand conditions, thanks to the Government's substantial fiscal support. Energy inflation has also contributed to the headline, by rising to 12.2% from 8.7% in annual terms. **In line with our expectations, inflation continued to increase in 1Q17 as cost push impacts were coupled with unfavorable base effects and deteriorating inflation expectations.**

Figure 3.3 Turkey: Annual CPI by Components



Source: TURKSTAT, BBVA Research and Garanti Research

Figure 3.4 Turkey: Annual Domestic PPI & USD/TL (YoY)



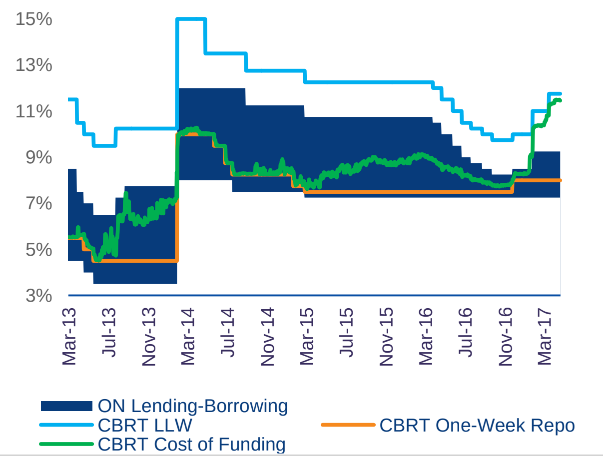
Source: BBVA-Garanti Research Monthly GDP Model, Turkstat

Central Bank strengthened tightening against FX and inflationary pressures

As inflation accelerated and the Turkish lira suffered from electoral uncertainty, the Central Bank (CBRT) decided to tighten monetary policy in January. In March and April, the CBRT raised the late liquidity window (LLW) interest rate by 75bps and 50bps, respectively, following the increase of 100bps at the start of the year, to 12.25%. Since the third week in January, the CBRT has been funding the markets through a combination of O/N lending and the Late Liquidity Window, interrupting the normalisation process (the end of the corridor) initiated last year.

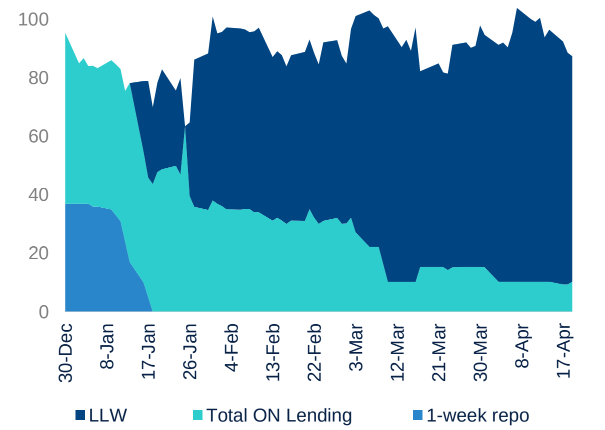
The CBRT has tightened liquidity conditions further by allocating almost 90% of the funding to the LLW facility. This has made the LLW, once an extraordinary monetary policy tool, the most relevant interest rate in the Central Bank's monetary policy framework. **So far this year, the CBRT has raised the average funding rate by 320 basis points, from 8.3% at the start of the year to 11.50% as of April.**

Figure 3.5 Turkey: CBRT Interest Rate Corridor



Source: CBRT, BIST, BBVA Research and Garanti Research

Figure 3.6 Turkey: CBRT Funding Composition, bn TL

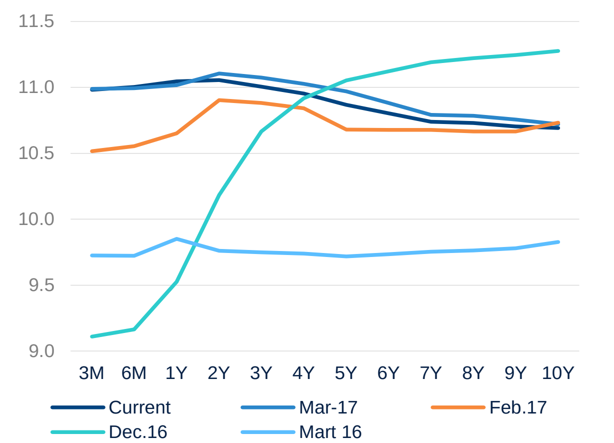


Source: CBRT, BBVA Research and Garanti Research

As a result, the CBRT contributed to stabilising the extreme volatile period at the start the year, when security concerns, political uncertainties and geopolitical risks triggered a sharp reaction in the financial markets. So, the Central Bank's 320bps tightening, although still not successful in improving inflation by containing inflation expectations, was effective in taming currency depreciation and preventing a speculative self-fullfiling dynamic.

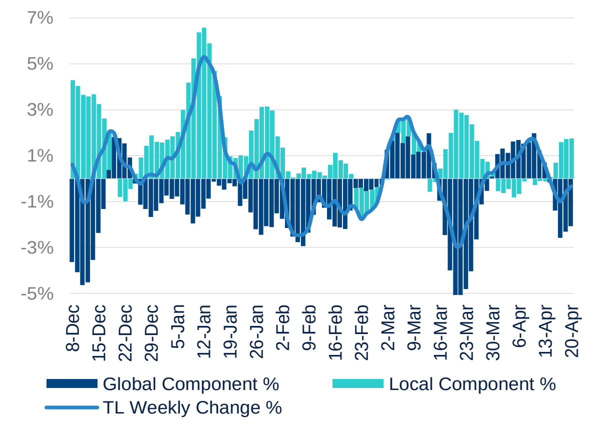
The global emerging markets' positive risk mood was also a supportive factor. The positive performance of the Chinese economy and the move of the FED to adopt a gradualist approach renewed optimism regarding EM assets. The yield curve shifted upwards at the short-end to belly on higher than expected inflation and the CBRT's monetary tightening. Although inflation breached 11% in March, the upward shift at the long-end was comparatively limited, with the decline in risk premiums associated with the optimism in global financial markets.

Figure 3.7 Turkey: Yield Curve (%)



Source: CBRT, BIST, BBVA Research and Garanti Research

Figure 3.8 Turkey: Exchange rate Global vs Local factors*



Source: CBRT, BBVA Research and Garanti Research.

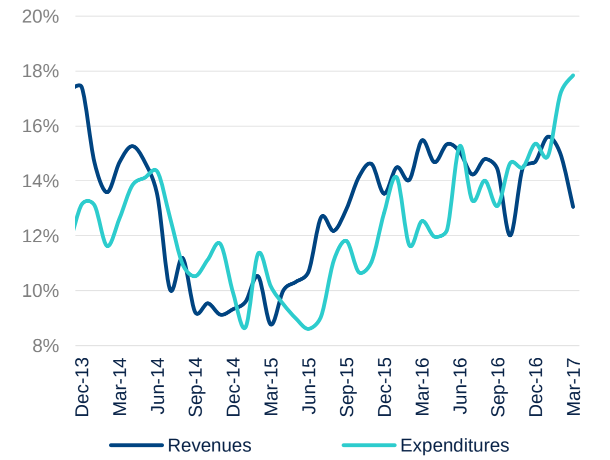
Budget deficit increased in 1Q17 as a result of fiscal expansion

The government intensified its fiscal stimulus by accelerating its non-interest expenditures in 1Q17, while revenue generation performance was weaker due to tax cuts and still moderate domestic demand. According to our calculations, the budget deficit to GDP ratio increased to 1.7% by March from 1.1% at the end of 2016, while the primary surplus to GDP ratio declined to 0.3% of GDP from 0.8% at the end of last year.

Despite the ongoing tax amnesty the tax revenue growth rate was barely able to catch up with annual inflation due to revenue collection year-to-date, tax cuts on durable goods and furniture and domestic demand lagging behind its potential level. In addition, one-off revenues (mostly privatization) were lower compared to the same period of the previous year.

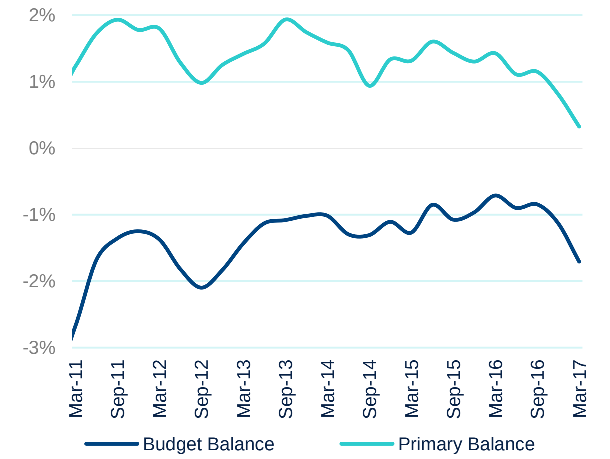
Tax and total revenue growth were 12% and 10% YoY respectively in 1Q17. On the expenditures side, non-interest expenditures accelerated to 22% growth, mostly due to the current transfers. These include the deficit financing of the Social Security Institution due to delays in insurance premiums, household and other transfers in order to boost domestic demand. Similarly, investment expenditure and the government's goods and services procurement increased sizably, signalling a remarkably higher public contribution to the growth rate in 1Q17. **All in all, total expenditure grew by 21% in 1Q17.**

Figure 3.9 Turkey: Budget Revenues & Expenditures (12 months cumulative, YoY)



Source: Ministry of Finance, Garanti Research

Figure 3.10 Turkey: Budget & Primary Balance (% of GDP)



Source: Ministry of Finance, TURKSTAT, Garanti Research

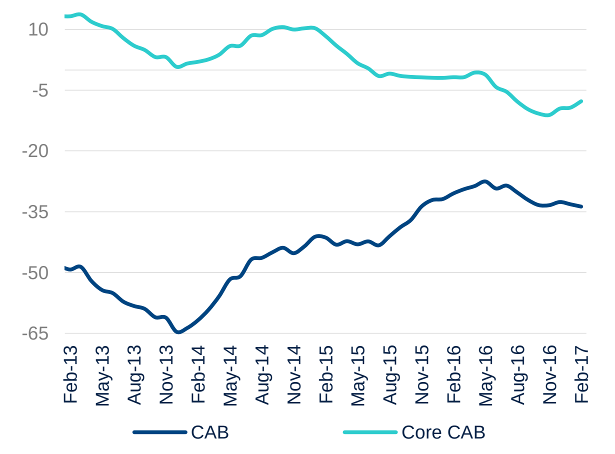
The current account deficit increased during the first months of the year

The current account deficit (CAD) increased to around USD 35bn by March from USD 32.6bn at the end of 2016 (to 4.1% of GDP from 3.8%). While the increase was mainly due to higher oil prices, improving export performance thanks to solid demand from the EU and the gradual withdrawal of the highly negative impact of the tourism sector were positive factors for the current account balance.

Excluding net energy and gold, the deficit improved to USD 7.7bn from roughly USD 10bn by February, reflecting the effect of both improving external demand and modest domestic demand. On the financing side, net FDI, portfolio flows, deposits and external credit lines comprised 26%, 26%, 11% and 6% respectively of the financing on a 12-

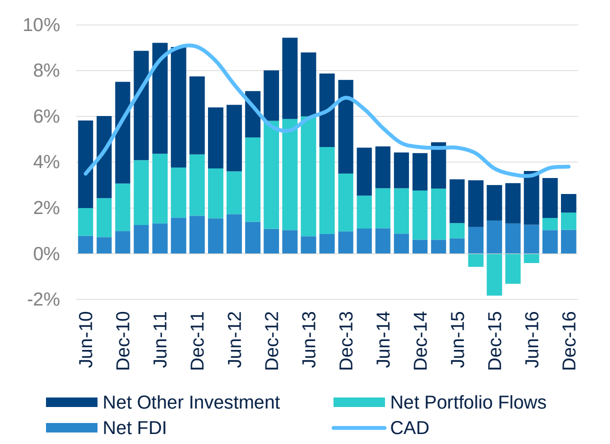
month cumulative basis. Net errors and omissions were positive with a 27% share, while the reserve drain also contributed by taking a 4% share in the same period. Portfolio flows have become more important as both the banking sector and the real sector have been reducing their long term external borrowing rollovers to under 100%.

Figure 3.11 Turkey: Current Account Balance (12 months cumulative, bn USD)



Source: BBVA Research and Garanti Research

Figure 3.12 Turkey: CAB Funding Composition (12 months cumulative,% of GDP)



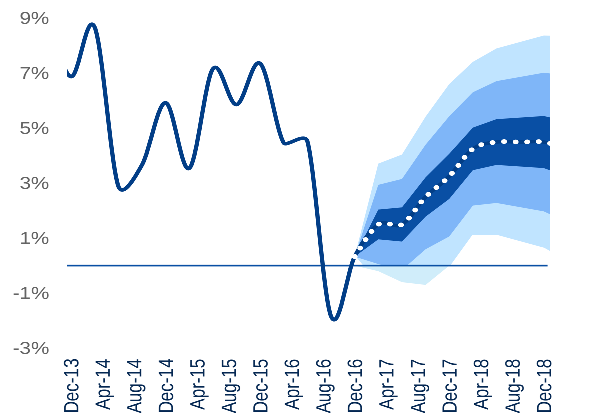
Source: CBRT, BBVA Research and Garanti Research

We increased our 2017 growth forecast to 3.0%

Our monthly GDP indicator signals 4.5% growth for the first quarter of the year, mainly on the back of improving confidence indicators and export performance. However, industrial production and retail sales point to a somewhat more gradual recovery, although they have recently tended to fall short of their respective components under the new GDP series.

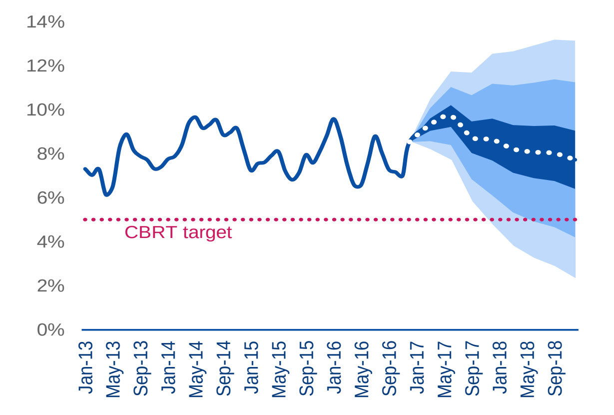
Although we expect the tight monetary policy to continue, the expansionary macroprudential and fiscal policy will support the gradual recovery of the economy. The intensified fiscal stimulus and rapidly recovering credit growth thanks to the Credit Guarantee Fund and macro-prudential easing will limit the negative impact of monetary tightening on agregate demand, while the end of election uncertainty may support private investment. Additionally, the depreciation of the exchange rate and the steady demand from the EU economies will reduce the negative contribution of foreign trade. Given these factors and the better than expected performance of economic activity during the first months of the year **we upgraded our GDP forecast for 2017 from 2.5% to 3.0%.**

Figure 3.13 Turkey: GDP Forecasts (YoY)



Source: BBVA Research and Garanti Research

Figure 3.14 Turkey: Inflation Forecasts (YoY)



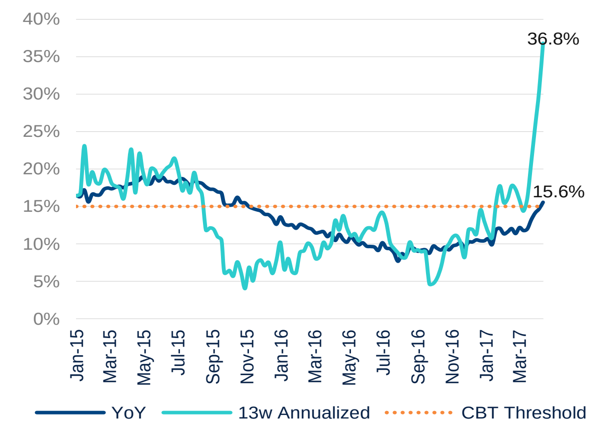
Source: CBRT, BBVA Research and Garanti Research

Inflation will peak in May but stay high until December

According to our forecasts, mounting cost push pressures and unfavourable base effects on food prices will keep consumer inflation above double digits until the last quarter of the year. Despite the Central Bank's monetary tightening, financial conditions remain broadly accommodating, helping the government efforts to boost bank credits. An improvement in the output gap will limit the disinflationary impact of demand conditions. The improvement in domestic demand conditions, the recovery of credit growth and the lagged effects of cost push factors stemming from the depreciation of exchange rates will keep core inflation at around 10% and the headline at 12% in April-May period, moderating after that.

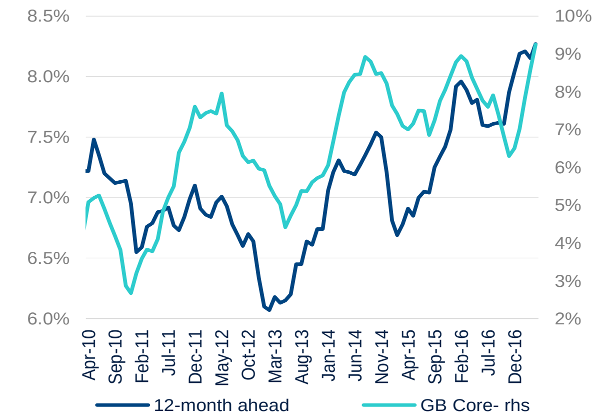
We increased our 2017 year-end inflation forecast to 9.0% from the previous 8.5%. Our risks are balanced: the potential actions that could be taken by the Food Committee bring some downside risks while the recovery in the tourism sector and improving food exports to Russia and Iraq and a further depreciation of the exchange rate would add upside risks to our inflation forecast.

Figure 3.15 Turkey: FX Adjusted Loan Growth



Source: BBVA Research and Garanti Research

Figure 3.16 Turkey: Inflation Expectations and GB Core Inflation



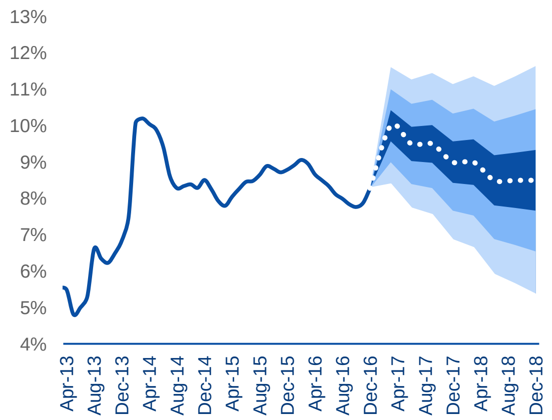
Source: BBVA Research and Garanti Research

…which will maintain a challenging environment for monetary policy

As we expect annual inflation to stay above double digits for the most of the year and inflation expectations to remain far from anchored, **we expect the CBRT to keep its tight monetary policy stance and to continue to use the extraordinary late liquidity window facility as a regular policy tool for some time in the near future.**

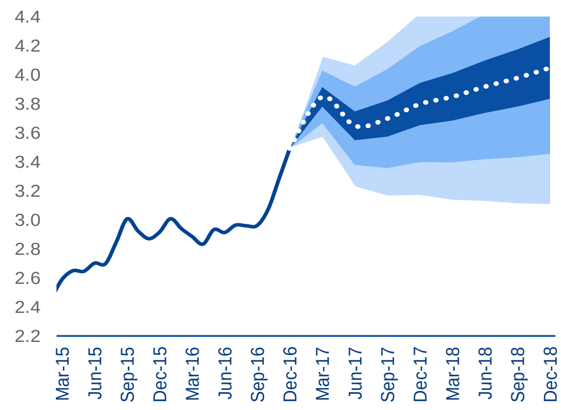
Our inflation forecast would require an average funding rate close to 12% in the short term, taking into consideration the CBRT's recent strategy of providing a slightly positive ex-post real interest rate. **We expect the CBRT to start to ease monetary conditions gradually by the end of the last quarter,** if global financial conditions remain supportive and headline inflation recedes towards a single digit as we forecast.

Figure 3.17 Turkey: Official Interest Rate Forecasts (%, CBRT average funding cost)



Source: BBVA Research and Garanti Research

Figure 3.18 Turkey: Exchange Rate vs USD (USD/TRY)



Source: BBVA Research and Garanti Research

The budget deficit will increase due to intensified fiscal stimulus

The Government's strengthened countercyclical measures will generate an increase in the budget deficit to GDP ratio to 2.5% in 2017 from 1.1% in 2016. This will also lead to an rise in the EU defined public sector debt to GDP ratio to 30% from 28% in 2016. Even if we pencil in some deterioration in budget performance, both the expected budget deficit and public indebtedness will remain significantly below international standards, such as the Maastricht criteria.

Stepped up public investment and procurement spending, postponing social security insurance premium collection and household transfers will figure in this year's budget as deficit items. Potential contingent liabilities stemming from the Credit Guarantee Fund (up to TL 20bn), Sovereign Wealth Fund (SWF) and other Private Public Parnership projects (PPPs) will be mostly reflected in the budget figures for 2018 and the following years.

So far in 1Q17, the increased budget deficit has been creating an additional borrowing need for the Treasury, where its debt rollover ratio rose to over 100% for the first time since 2009. The Treasury's rollover ratio target for 2017 is

98%, with their own assumption of a 1.6% budget deficit to GDP ratio. **Assuming our own deficit scenario, we forecast a rollover ratio of above 100% for the rest of the year, the extent of which will be important for market risk-free interest rate pricing.**

While supporting cyclical and structural fiscal policy measures is understandable given the recent deterioration in the economy, the public authorities should also balance the positive effects of maintaining a sound fiscal balance for financial assets. In this sense, the public accounts should be strengthened next year and beyond.

The current account deficit is expected to widen but to a limited extent

While higher than initially expected oil prices and recovering domestic demand growth will widen the external balance, a potential recovery in tourism revenues will partly compensate. **We forecast a rise in the current account deficit from USD 32.6bn (3.8% of GDP) in 2016 to USD 37.5bn (4.8% of GDP) in 2017**, bringing the CAD/GDP ratio above the structural current account deficit (4%, according to our estimations). The risks remain balanced with lower than initially expected oil prices and a potential improvement of tourism revenues posing some risks on the downside while a faster than expected recovery in domestic demand and higher credit growth could widen the external gap beyond our baseline forecast.

Table 3.1. Baseline Scenario: Forecast

	Variation 2015 / 2018			
	2015	**2016**	**2017**	**2018**
GDP (%, y/y)	6.1	2.9	3.0	4.5
Inflation (%, average)	7.7	7.8	10.3	7.6
Inflation (%, end of period)	8.8	8.5	9.0	7.5
Official Interest Rate (%, average)	8.4	8.4	10.3	8.5
Official Interest Rate (%, end of period)	8.8	8.3	9.5	8.5
Exchange Rate vs USD (average)	2.72	3.02	3.74	3.93
Exchange Rate vs USD (end of period)	2.92	3.52	3.80	4.05
Current Account Balance (% of GDP)	-4.5	-3.8	-4.8	-5.3
Fiscal Balance (% of GDP)	-1.0	-1.1	-2.5	-2.0

Source: BBVA Research and Garanti Research

4. Balance of Risks

Global market stress has eased but some uncertainty remains

The overall balance of risks is neutral. The close victory of the “Yes” vote will put an end to election uncertainty and the Government should now concentrate on economic policies and reforms. If implemented, economic growth could surprise on the upside as economic confidence will release part of the postponed consumption and investment decisions in the second half of the year.

The improvement in the investment climate will also depend on the outlook for Turkey’s relations with its key allies, including the EU, where the majority of foreign direct investment inflows to Turkey originate. The tensions in EU-Turkey relations escalated in the run up to the referendum. Whether both the Turkish and the EU authorities will take the necessary steps towards easing the existing tensions will be key.

In the global markets sphere, the EMs financial markets have remained calm in recent months. This was thanks to the Fed’s gradualist approach to monetary policy normalisation and some clarification regarding the course of the economic policy in the USA, where expectations of rapid reflation have been limited, or at least the timing of measures to support changes in that direction has been delayed. Nevertheless, there is ongoing uncertainty regarding the new US economic policy and its impact on world growth, inflation and monetary policy response and it is still a potential source of financial market volatility.

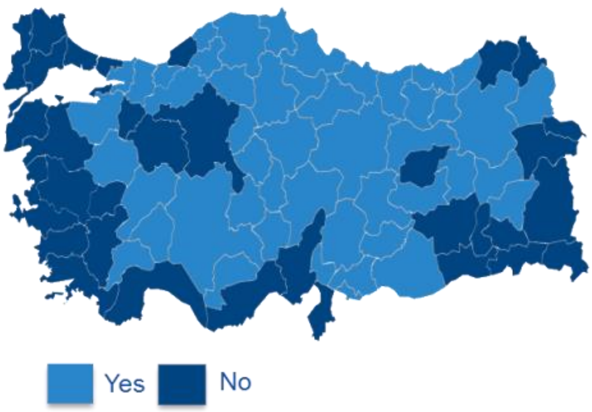
The end of electoral uncertainty, at least for now

Finally, the uncertainty about the referendum came to an end and the Turkish people voted “Yes” for the constitutional amendments by a slim margin (YES: 51.4%; NO: 48.6%). The results were contested by the CHP but the irregularities claimed by the opposition were not finally accepted by the Supreme Electoral Council (YSK). As a result, the transition phase to the new system will start, although it will not fully materialize until the next Legislative and Presidential elections, to be held on the same day in November 2019, or before then in the case of snap elections (see Box).

The close victory shows the fragmentation of Turkish society over the constitutional changes. While the big cities (Istanbul, Ankara and Izmir), the Aegean coast and part of the Kurdish populated provinces supported “No”, the Anatolian interior and the Black Sea provinces supported “Yes”. Both President Erdogan and Prime Minister Yildirim sent a conciliatory message to “friends and allies” although some “tensions” with the EU arose after the comments on the possibility of reinstating the death penalty, which was not welcomed by the EU Authorities, especially the Council of Europe. On April 25th, the Parliamentary Assembly of the Council of Europe put Turkey back into the monitoring list, from which it was removed in 2004.

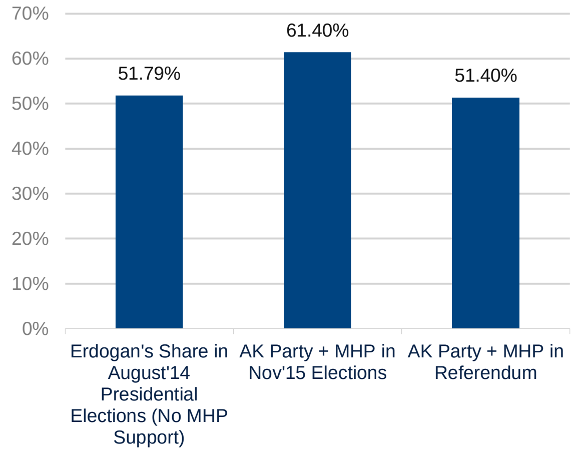
The financial markets reacted positively to the end of the political uncertainty and the lira recovered the ground lost in the week prior to the referendum. We expect the markets to focus now on policies and reforms rather than politicians. Our expectations are for the Government to continue with announcements of economic policies and reforms. These measures, the relationship of the Turkish Authorities with key Allies such as the EU and the potential division in some of the opposition parties will dominate the political outlook in the medium term.

Figure 4.1 Turkey: Referendum Results by Province



Source: Turkish Media

Figure 4.2 Turkey: Elections and Referendum Results



Source: Turkish Media, BBVA Research

Electoral noise affected foreign affairs with the European Union despite being mutually beneficial

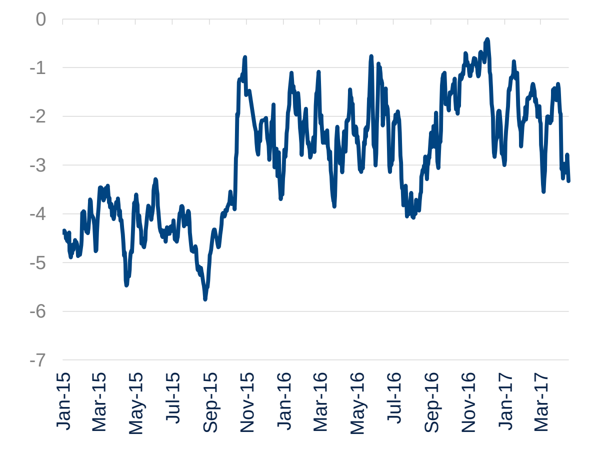
Tensions betweenTurkey and the EU escalated in the run up to the referendum. The EU countries' stance against AK Party officials' plans to hold rallies in Germany and Netherlands, where there is a significant Turkish population, caused a worsening in the tone of EU-Turkey relations. Later on, President Erdogan's comments on reinstating the death penalty in Turkish law could reopen frictions in the relationship.

Beyond these frictions, EU officials raised the issue of a potential upgrade to the Customs Union Agreement that was first signed in 1995. The truth is that the Refugee Deal signed between Turkey and the EU remains as an anchor to prevent futher worsening of the relations. This and continuing talks on Cyprus between the EU and Turkey lead us to think there will be some easing in diplomatic relations in the wake of the referendum, and we consider the relationship to be mutually beneficial.

The search for a new balance of power in the Middle East with new US involvement creates complications in Turkey's area of interest

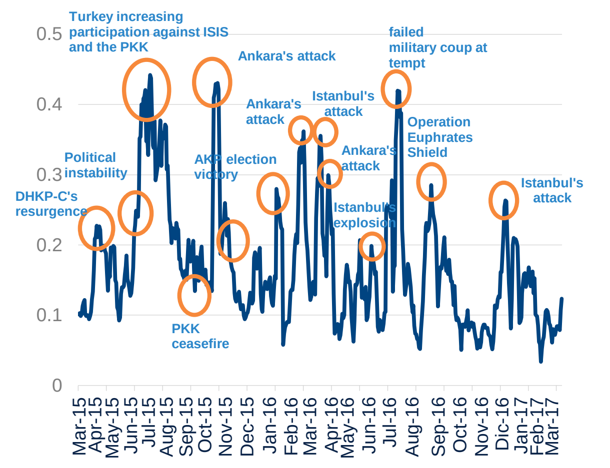
Geopolitical and foreign policy issues will continue to be important and some uncertainties remain in the geopolitical arena:

Figure 4.3 Media sentiment on Turkey–EU relationship (Lower values indicate a deterioration of tone)



Source: www.gdelt.org, BBVA Research and Garanti Research

Figure 4.4 Turkey: BBVA Conflict Intensity Index (2015 - 16) (Conflict events / Total Events)



Source: www.gdelt.org, BBVA Research and Garanti Research

- **US Foreign Policy in the Middle East is shifting but with mixed signals.** As the new US administration takes office, Washington's Middle East policy seems to be differing from the Obama administration's. Indeed, the Trump administration is more eager to contain Iran and its allies in the region. In addition, the Trump administration could give more significant support to its traditional allies (Israel and the Sunni Gulf States) than the Obama administration did. Also, the new administration is taking a more hawkish stance against Iran and its regional aspirations. Potentially, the crisis between Iran and the US could escalate and when the US needed allies to prevent Iran from dominating the region, Turkey and the Sunni Gulf countries, including Saudi Arabia, would have closer relations with Washington.

- **Syria continues to be a complex problem.** ISIS is losing ground in Syria but with fierce fighting. Its stronghold, Raqqa, could be besieged by US backed forces. These forces mainly consist of the PKK affiliate YPG, which led Turkey to manifest serious objections to Washington's close relations with the YPG. Turkey's own proposal to the US to seize Raqqa with other local sources has not been accepted by the US administration. In the meantime, Russia and Iran's military and diplomatic support for the Assad regime continues, complicating the overall situation. The recent chemical attack in Syria's Idlib province, believed to be conducted by the Assad regime, led to US missile strikes against a regime airbase. Both Russia and Iran used harsh rhetoric against the US action but the situation did not escalate further.

- **Turkey's cross border operations could increase.** After successfully cleansing an area of around 2000 sq kms of ISIS, Turkey announced that Operation Euphrates Shield has been completed. According to President Erdogan, new operations are on the way. These are presumably a military operation targeting PKK terrorists in northern Iraq and another operation to destroy the YPG's attempts to create a corridor in northern Syria. Although the US and Russia are against an escalation of Turkey's military operations in Syria, Ankara is promoting diplomatic talks to initiate its operations or at least to persuade Moscow and Washington to withdraw their support for the YPG.

Box1

Turkey's Referendum

Main implications of the referendum

According to preliminary unofficial results of the referendum held on April 16th, 51.4% of voters overall voted in favour of an executive presidency, giving a close victory to the President and the ruling AK Party. Among the 18 proposed constitutional ammendments, three of them will be immediately effective after the official declaration of the results and during the transition phase, while the implementation phase of the President's executive powers will only come into effect after the next parliamentary and presidential elections, which for the moment are scheduled for 3 November 2019.

1. The changes in the transition phase:

- After the official announcement of the referendum results, President Erdogan could become a member of his AK Party at any time, which was not allowed under the old Constitution. This will happen in the short term. According to Prime Minister Yildirim's announcement, the AK Party will have a leadership congress in late 2018. At this congress, President Erdogan could be elected as the AK Party's Chair.
- In the next 30 days the Supreme Board of Judges and Prosecutors will be reshaped. Four members will be appointed by the President and seven of them will be appointed by Parliament. Military courts will be abolished. In the next six months laws will be written to adopt new constitutional amendments.

2. The changes after the elections:

- The President will assume executive powers after the next Legislative and Presidential Elections. These will be held as late as November 2019. There will also be Local elections in March 2019, which can be merged with the other elections.
- After the elections, the post of Prime Minister will be abolished and the President will become the Head of State and Government at the same time. He/she will appoint and dismiss top public executives, including ministers and vice presidents. The President will issue decrees, submit the budget and may declare a state of emergency.
- Parliament will lose its direct control over the cabinet as the "no-confidence vote" will be abolished. Also, Cabinet members will not be dismissed through parliamentary checks and balances.
- Elections for the Parliament and President will be held on the same day every five years. The President will have a maximum of two terms but he/she could run for a third term if Parliament decides to hold snap elections during the President's second term. The President will have to win the Presidential elections by a simple majority (50%) and if this is not reached in the first round, a second round will be held between the two candidates who earn the highest number of votes.

Political scenarios are open to new uncertainties even beyond the referendum.

Given the slim results of the referendum, the possibility of snap elections has diminished. A potential right-wing coalition between the AKP and the MHP could have reduced the latter's support in this referendum by nearly 10% (from the 60% total they gained in the 2015 elections) as some MHP supporters did not vote Yes. There is also a risk of an split in the MHP party, which could complicate the political arithmetic.

We therefore think that the AK Party will focus on restoring confidence, as a small portion of AK Party supporters and a significant portion of MHP supporters voted No. To regain the support of the big cities, economic measures and reforms will play a key role in the coming months.

Lastly, President Erdogan won some support in the Kurdish populated provinces, which could open the door to a new scenario in the eastern part of the country.

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5. Tables

Table 5.1 Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2014	2015	2016	2017	2018
United States	2.4	2.6	1.6	2.3	2.4
Eurozone	1.2	1.9	1.7	1.7	1.7
Germany	1.6	1.5	1.8	1.7	1.6
France	0.7	1.2	1.1	1.4	1.5
Italy	0.2	0.6	1.0	1.0	1.2
Spain	1.4	3.2	3.2	3.0	2.7
UK	3.1	2.2	1.8	1.7	1.3
Latin America *	0.8	-0.3	-1.5	1.1	1.8
Mexico	2.3	2.6	2.1	1.6	2.0
Brazil	0.5	-3.8	-3.6	0.9	1.8
Eagles **	5.4	4.7	4.8	4.9	5.0
Turkey	5.2	6.1	2.9	3.0	4.5
Asia Pacific	5.6	5.6	5.5	5.2	5.1
Japan	0.2	1.2	1.0	0.8	0.9
Asia (exc. China)	7.3	6.9	6.7	6.3	5.8
World	4.2	4.5	4.5	4.2	4.5
United States	3.5	3.3	3.1	3.3	3.4

(f): forecast
* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 31 July 2015.
Source: BBVA Research and IMF

Table 5.2 Macroeconomic Forecasts: 10-year government bond yield

(Annual average, %)	2014	2015	2016	2017	2018
United States	2.53	2.13	1.84	2.60	2.84
Germany	1.22	0.52	0.13	0.58	1.21

(f): forecast
Forecast closing date: 31 July 2015.
Source: BBVA Research and IMF

Table 5.3 Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2014	2015	2016	2017	2018
USD-EUR	0.75	0.90	0.90	0.93	0.88
EUR-USD	1.33	1.11	1.11	1.07	1.13
USD-CNY	6.14	6.23	6.64	7.01	7.50

Source: BBVA Research and IMF

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