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Turkey Economic Outlook

4Q18

October 2018

Creating Opportunities

Key messages

- The global expansion remains at a steady pace, but more moderated and less synchronized. Risks now cumulate on protectionism, normalization of the Fed, tensions in emerging countries, greater uncertainty in Europe
- Turkey's firm policy response to the financial shocks helped to restore confidence in financial assets. The economic adjustment is now underway
- Recent financial shocks and necessary tightening policies to restore confidence will result in a faster rebalancing of the economy. We expect GDP growth to decelerate to 3% in 2018 and 1% in 2019
- The sharp depreciation of the exchange rate during the summer triggered excessive inflation pressures. We estimate the year-end inflation to remain high and start to moderate from 2Q19 onwards
- Both monetary and fiscal policies included in the New Economic Program (NEP) are now more adequate to restore confidence and rebalance the economy
- The current account deficit will correct much faster than initially expected

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01

Global Economy: Still Global Positive Outlook, although risks are intensifying

Positive global inertia continues, although risks are intensifying

The global expansion remains at a steady pace, but more moderated and less synchronized

The strength of the US economy contrasts with moderation in China and Europe

Divergent monetary policy between the US and Europe from 2019

The Fed ends the cycle of increases, while the ECB initiates the increases and prepares the withdrawal of liquidity

Greater financial tensions in emerging markets

With evident differentiation between countries, the most financially vulnerable face sudden adjustments of their economies

Intensification of the commercial war between the US and China

Impact still limited, but could increase if new measures are taken. At the moment, the conflict between the US and other areas decrease

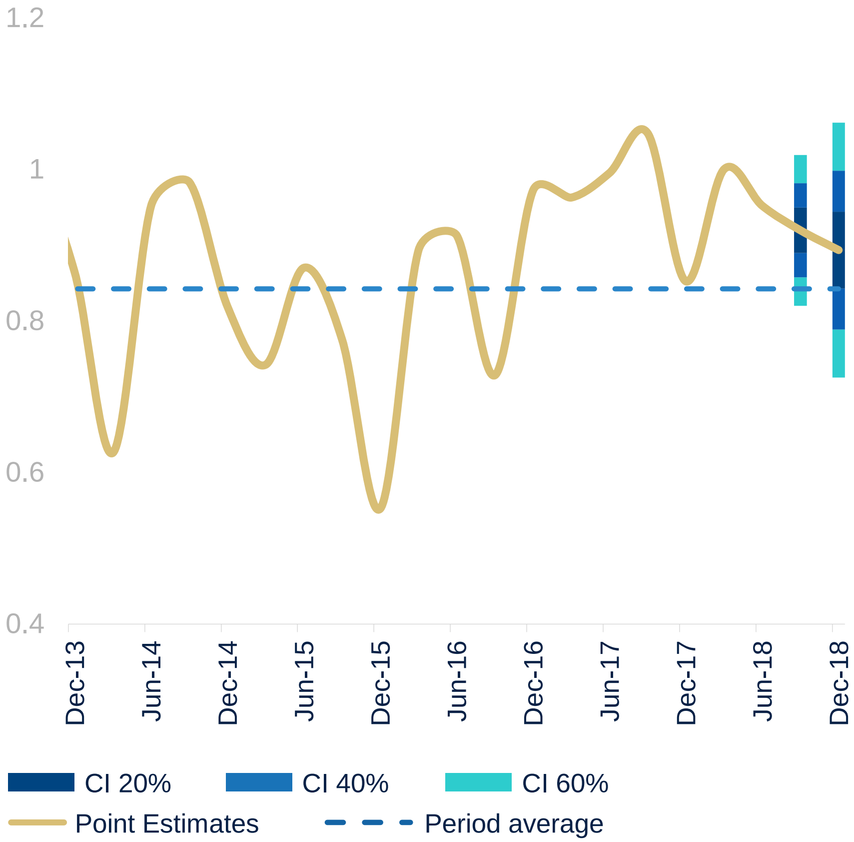
Global risks intensify

Protectionism and the normalization of the Fed are joined by the increase in tensions in emerging countries, and the greater uncertainty in Europe

Moderation of global growth

World GDP growth

(Forecasts based on BBVA-GAIN, % QoQ)



Source: BBVA Research

- Slight moderation of global growth towards rates slightly below 1% QoQ in 2H18
- Activity remains strong, but have lost momentum, since protectionism growth weighs on confidence, trade and investment
- Beyond volatility, world trade has improved and stabilized after the slowdown at the beginning of the year

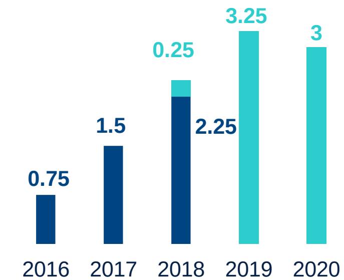
Monetary policy continues to normalize and will diverge between the Fed and the ECB from 2019

Balance

Interest rates

Continues the reduction of the balance (450mM dollars in 2018)

More rate hikes in 2019, but the cycle ends (natural interest rate)

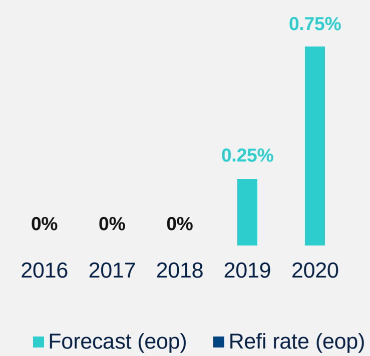


End of QE (December 2018)

Total reinvestment at least until December 2020

Repayment of TLTROs from June 2020

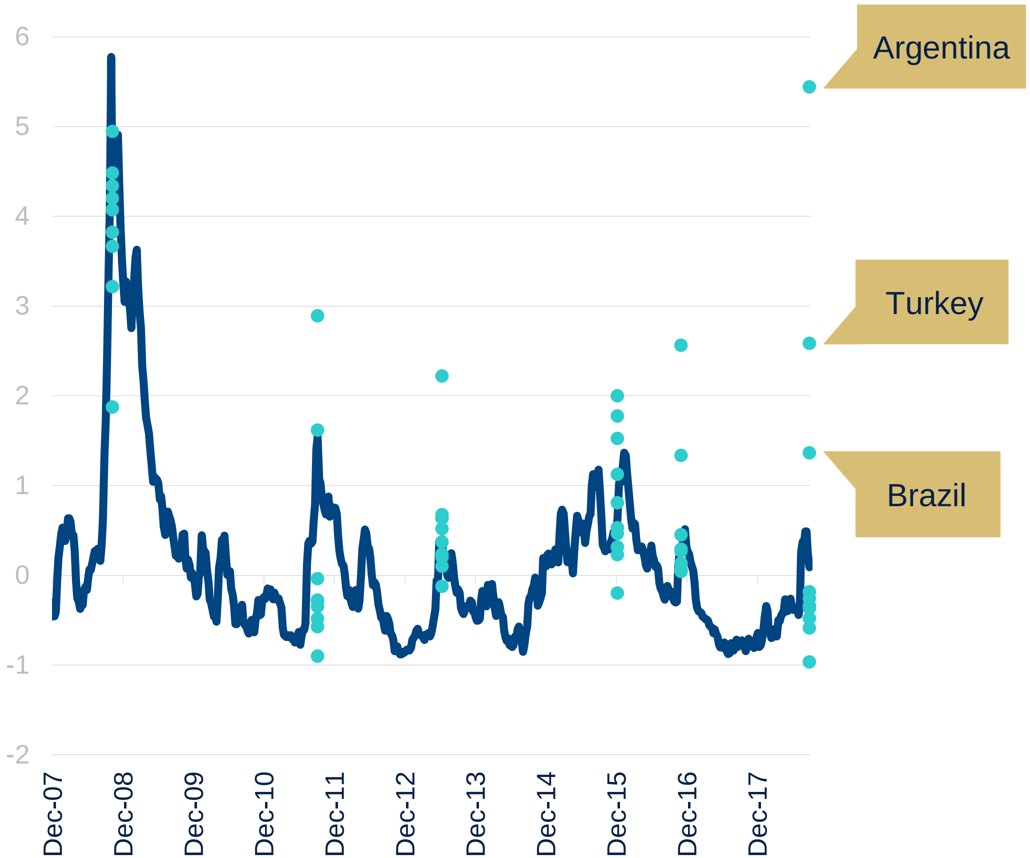
Anchored expectations of low rates for a prolonged period. **No increases are expected until September 2019**



Source: BBVA Research

Financial tensions rebound in emerging markets, but less synchronized than in previous episodes

BBVA index of financial stress in emerging markets
(Standardized index)

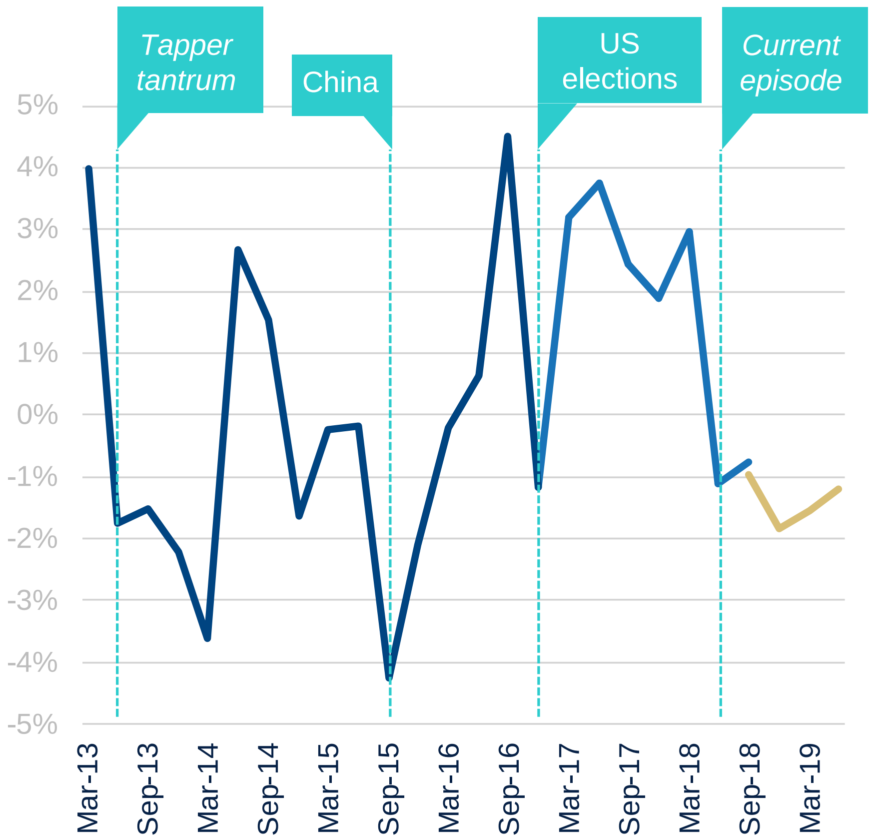


Source: BBVA Research

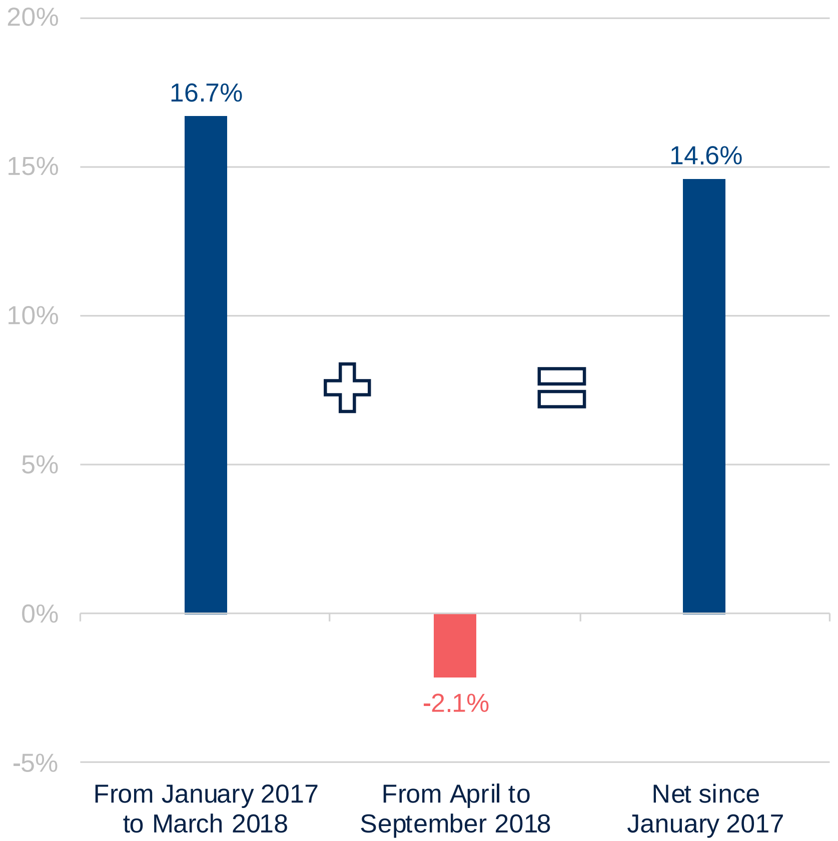
- The emerging markets are being subjected to greater stress which results in a depreciation of their currencies and an increase in their risk premium
- There is heterogeneity: tensions have concentrated especially on the most vulnerable economies. We are not facing a systemic crisis
- The adoption of economic policy measures (monetary and fiscal) are allowing some stabilization

The outflows of emerging economies are still persistent, but we are far from a typical episode of sudden-stop

Portfolio flows to emerging economies
(% of total assets, monthly data)



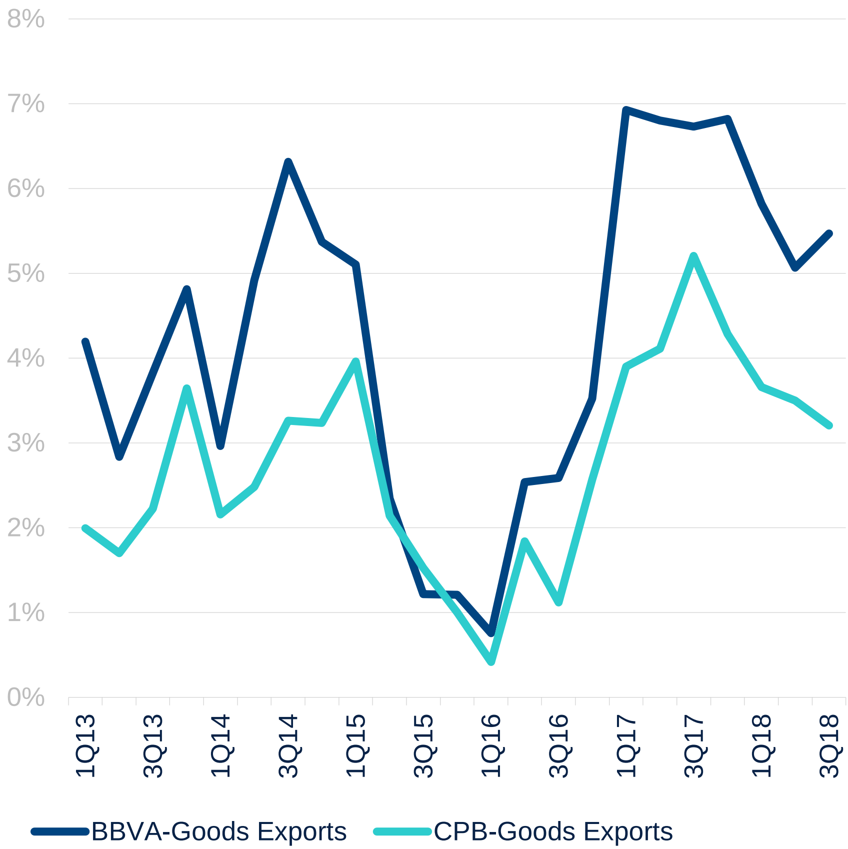
Accumulation of flows in the last 5 quarters
(% of accumulated since January 2017)



Source: BBVA Research

Trade loses momentum after the strength of 2017, but will continue to support global growth

Global export of goods
(% QoQ, constant prices)



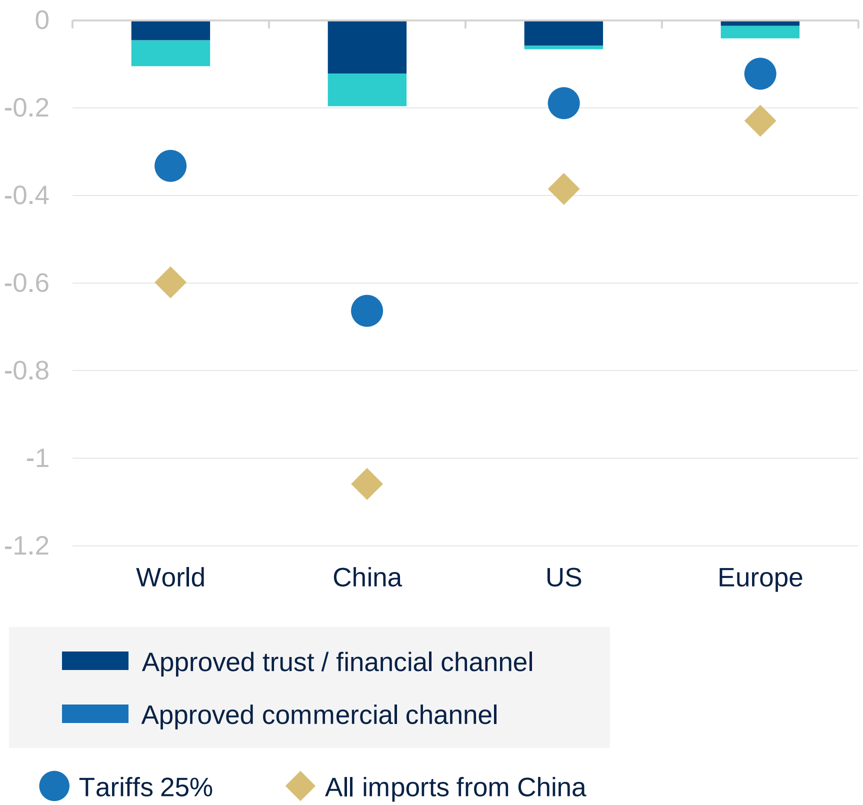
Source: BBVA Research based on CPB World Trade Monitor

- So far, the trade war has had a limited impact. Export flows may be ahead of the possibility of a worse scenario
- Increases the volatility of trade flows as a result of uncertainty…
- ... due to commercial tensions, the political situation and the depreciation of the currencies of emerging economies

USA and China have announced higher tariffs, but with an estimated effect on limited global GDP

Effect on GDP growth of US tariff increases and the response of other countries

(2018-20, pp)



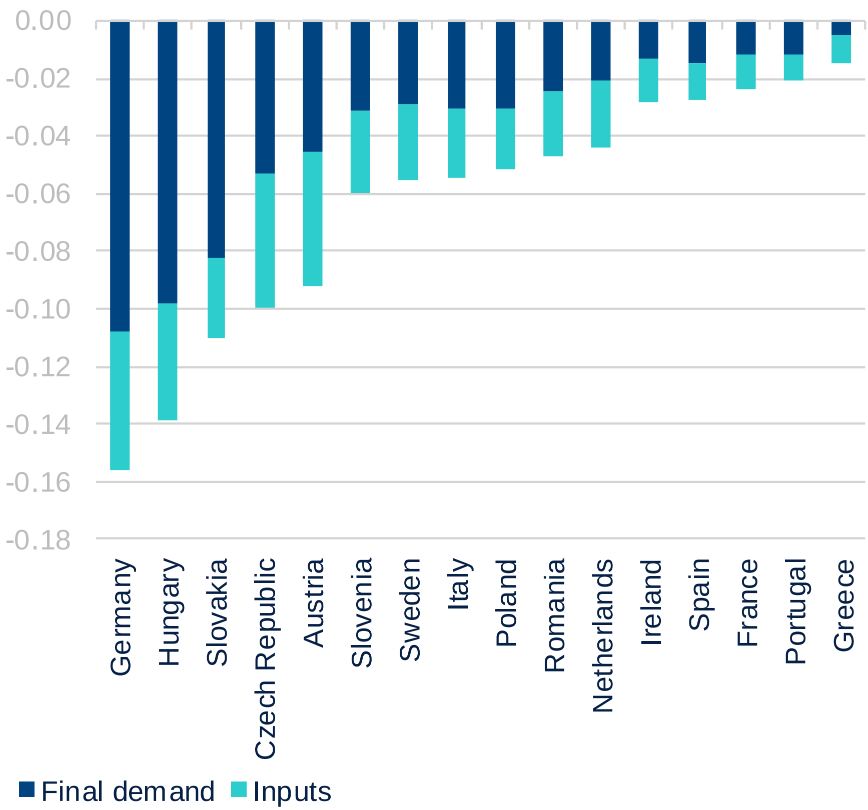
Approved tariff increase: USA (25% steel, 10% aluminum, 25% Chinese imports worth 50,000 million dollars and 10% worth 200,000 million); China (25% to US imports worth 50,000 million dollars and 10% to 60,000 million).
Source: BBVA Research

- The impact on growth of the measures approved so far through the commercial channel could be limited, but the indirect effects could be considerable, especially for China and emerging economies
- The signature of the USMCA reduces the uncertainty with Mexico and Canada
- In Europe, the increase of tariffs on cars is currently frozen, although it will be negotiated again from November

The risk of an increase in US tariffs to the European automotive sector continues, with a limited and different effect per country

Effect on GDP growth of US tariff increases to the European automotive sector

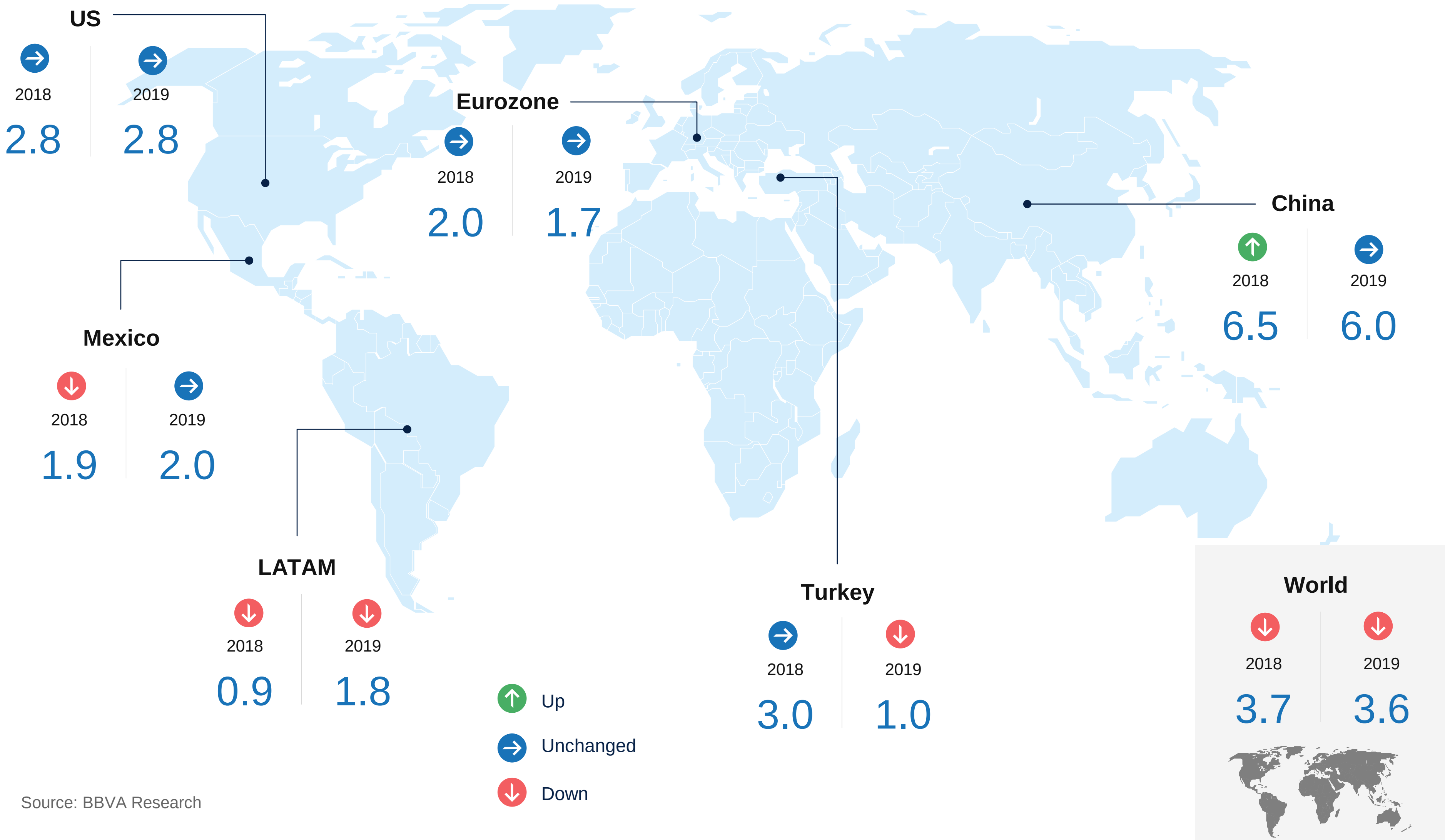
(2018-20, pp)



Simulation: increase of tariffs to 20% to the European automotive sector, Japan and Korea in addition to the measures approved so far.
Source: BBVA Research

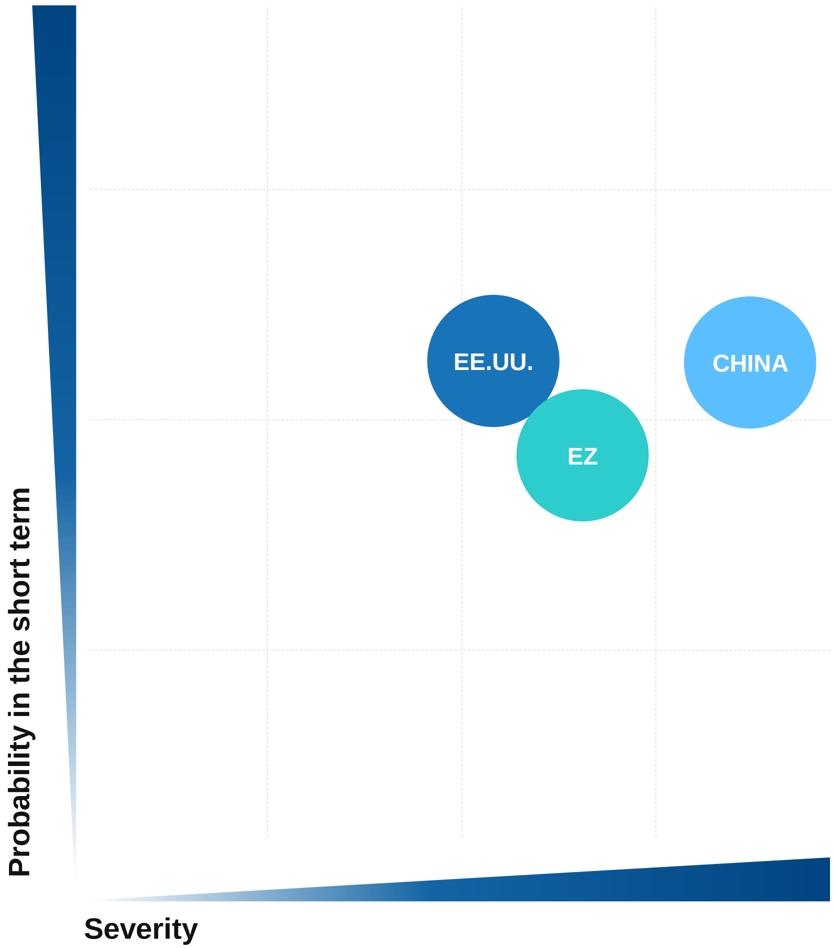
- An increase of the tariff to the European automotive sector up to 20% (current 2.5%) could subtract between one and two tenths of the growth of Germany and the northern European countries
- Greater impact in Korea and Japan, but also in the US
- There is uncertainty about the effect of the hardening the amount of inputs produced in North America (75%) in the USMCA by European car companies, but the impact should be smaller

The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019



Source: BBVA Research

Global risks: Protectionism and the exit of the Fed remain the most relevant, but political uncertainty in Europe increases



Source: BBVA Research

CHINA

- Protectionism: upward (new tariffs and reprisals) with an impact on domestic policies (financial stability, reforms)
- High indebtedness: more content in the short-term, but higher in the medium term (private debt continues to rise)

USA

- Fed exit: rises of higher than expected rates
    - Differential impact on emerging markets
- Protectionism: upward and concentrated in China
- Economic recession: low probability, but rising
- Signs of financial instability in some assets

EUROZONE

- Political uncertainty: upwards, led by **tensions in Italy** and Brexit
- Protectionism: more restrained with focus on the automotive sector
- ECB's exit: downward

Tensions in emerging economies can amplify the impacts of the aforementioned global risks (effects of "second round" on global growth)

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02

Turkey: Right policy steps restore confidence in Turkish financial assets. The rebalancing is underway

Challenging times ahead to be tackled with policy determination

Turkish financial assets stabilize after firm economic policies

The change in economic policy direction and the ease of geopolitical tension with the US triggered the stabilization and recovery of Turkish financial assets

The rebalancing of the economy is already underway

A fast domestic demand adjustment is being compensated with the reversal of external demand. The current account deficit will correct rapidly

Inflation will remain the key concern in the short term and should reduce gradually next year

Inflation will stay high in the short term as the exchange rate pass-thru is still well alive. A gradual disinflation path will start in 2019

Monetary policy needs to be tighter

Monetary policy should be maintained tight to fight inflation and re-anchor inflation expectations. Monetary policy credibility will continue to be key for the coming months

New Economic Program (NEP) suggests an aggresive fiscal consolidation plan in the short term

The Government has presented a more realistic plan including a sizeable fiscal adjustment in 2019. The policy mix is now more adequate to fight inflation

Foreign affairs with the US improved, eliminating some uncertainty in the Market

The ease of tensions with the US after the Reverend Brunson release might facilitate agreements on other issues. This could help to eliminate uncertainty in the market

The change in policy direction and easing tensions with the US supported the stabilization and improvement in Turkish markets

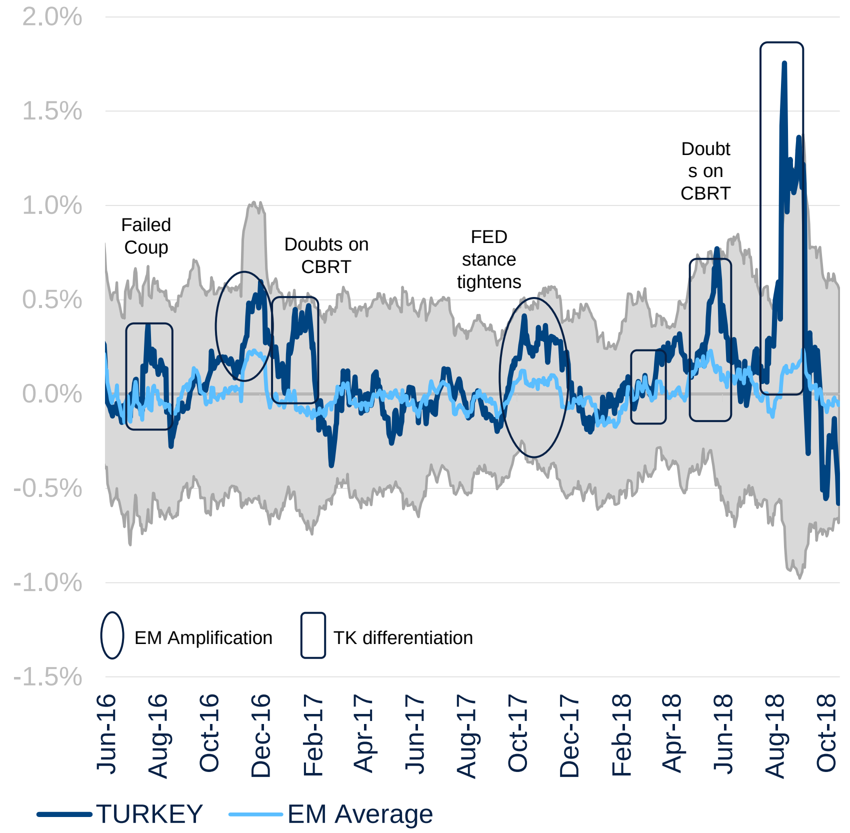
Turkish Lira vs USD

(Level)

Source: BBVA Research

EM Currencies volatility

(% daily change moving average 1M moving Avg. One Standard deviation range)



(*) A positive value indicates a depreciation of the local currency.
Source: Bloomberg

Economic activity rebalancing is already happening and will accelerate in 4Q. This is in line with our growth forecast of 3% for 2018

Turkey: Activity Indicators

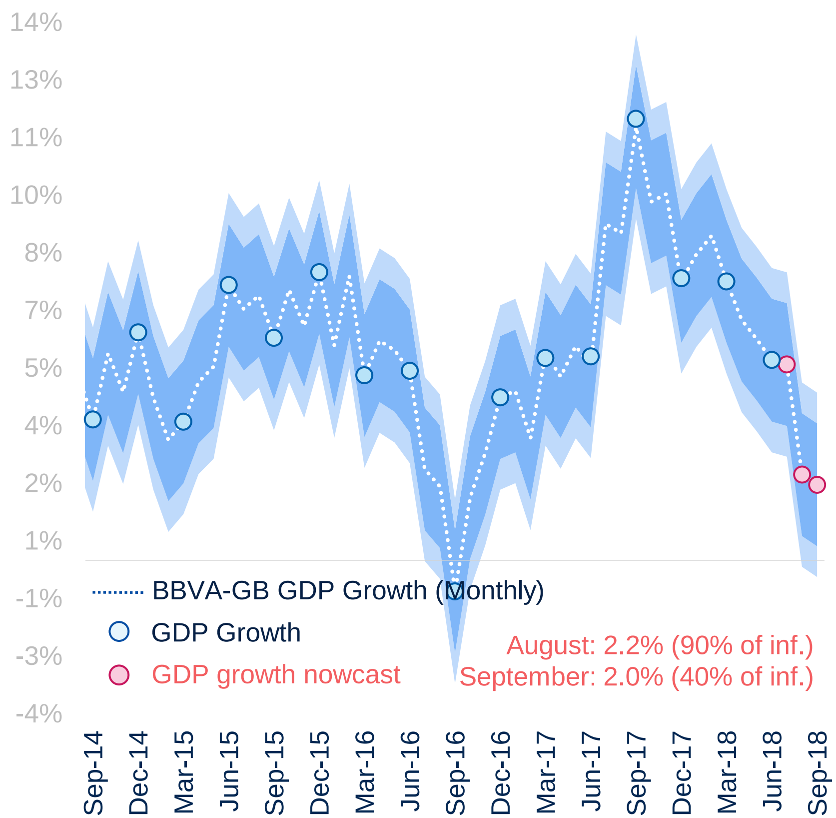
(%YoY, mov. Avg. 3m)

		2018							
	Mean	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Industrial Production	7.9	11.2	9.9	7.3	6.4	5.0	5.9	-0.3	
Non-metal Mineral Production	7.9	24.6	16.7	10.3	6.0	3.1	2.8	-4.8	
Electricity Production	5.0	3.4	3.0	2.4	1.9	0.9	0.9	-0.4	0.2
Auto Sales	7.0	-1.8	2.2	0.4	-4.1	-13.1	-24.0	-36.7	-51.2
Tourist Arrivals	5.5	33.4	34.9	31.2	29.4	28.3	21.0	17.7	14.0
Number of Employed	3.9	5.2	4.4	3.7	3.0	2.5	2.1		
Number of Unemployed	1.6	-14.5	-13.5	-10.9	-7.1	-2.3	0.6		
Auto Imports	9.3	-5.7	-1.0	-3.2	-7.4	-21.2	-35.3	-50.9	-59.3
Auto Exports	7.4	-4.7	-3.1	-1.5	-6.1	-9.8	-19.1	-29.1	-15.7
Retail Sales	6.6	8.9	8.9	7.7	6.7	5.8	4.6		
Manufacturing PMI	51.5	52.7	49.6	51.7	49.5	48.4	49.6	46.4	42.7
Total Loans growth 13-week	19.3	13.2	13.1	15.9	17.0	14.5	10.2	1.7	-2.2
Real Sector Confidence	106.7	110.8	111.9	111.2	109.9	104.6	102.7	96.4	89.6
MICA Forecast								2.2%	2.0%
GDP YoY						5.2%			

Contraction	Slow-down	Growth	Boom

Turkey: GDP Monthly Indicator

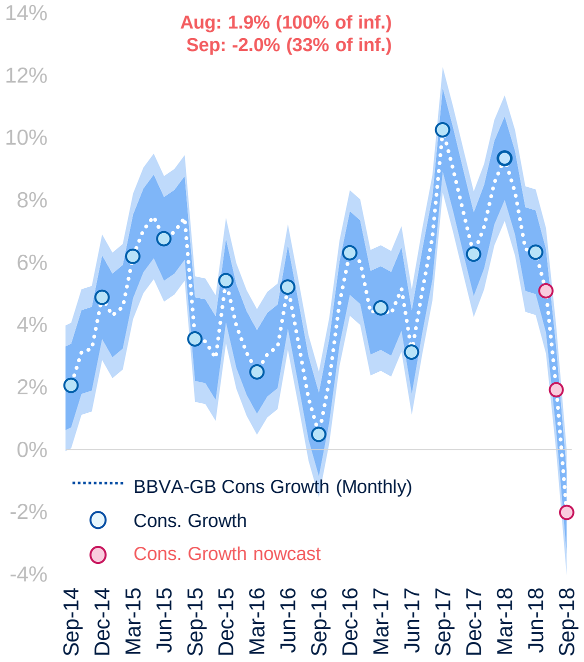
(%YoY mov. Avg. 3m)



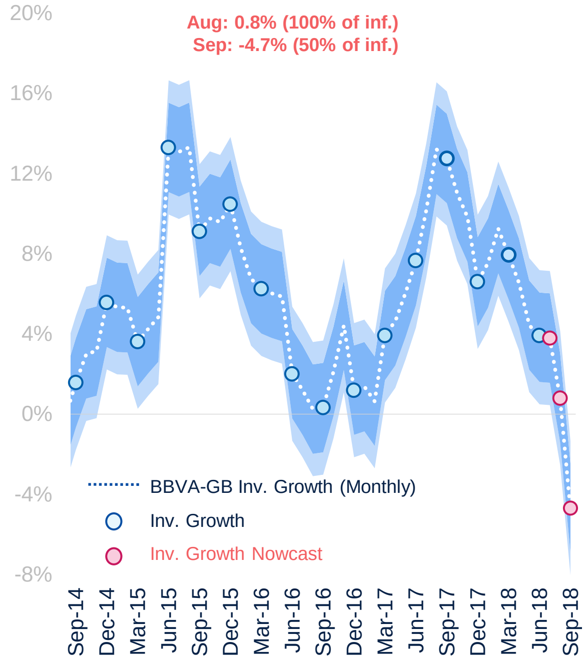
Source: CBRT, TURKSTAT, BBVA-Research Turkey

A significant rebalancing of activity: A sharp adjustment in domestic demand with a positive reversal of external demand

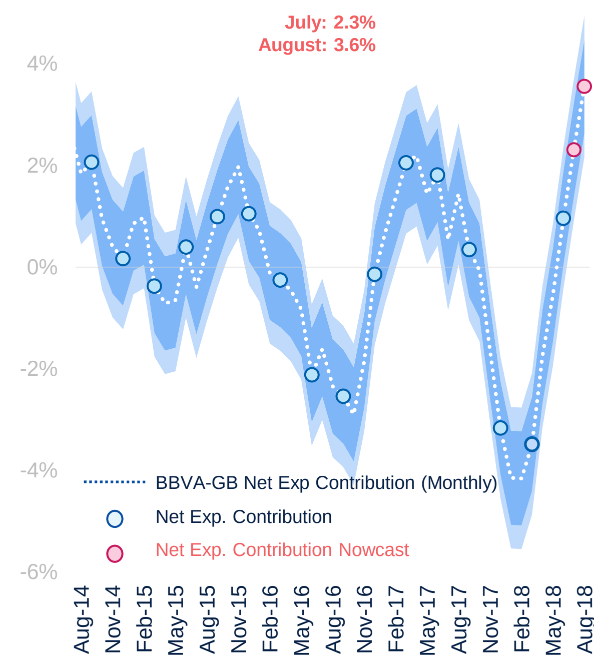
Turkey: Private Consumption
(%YoY, mov. Avg. 3m)



Turkey: Total Investment
(%YoY, mov. Avg. 3m)



Turkey: Net Exports
(% Contribution to GDP Growth)



Source: CBRT, TURKSTAT, BBVA-Research Turkey

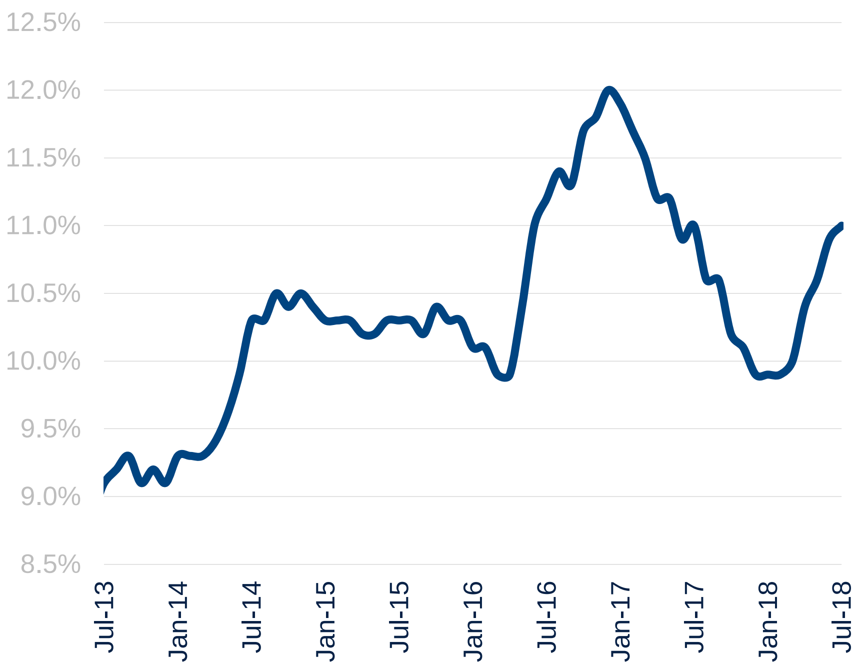
The tightening of financial conditions and the recent financial shocks weigh on domestic demand, particularly on private consumption and investment

The decline in imports, undervalued exchange rate and robust tourism revenues are triggering a sharp positive reversal of the external demand

Employment is not immune and in some sectors the adjustment is sizeable… (i.e. those boosted by the Credit Guarantee Fund)

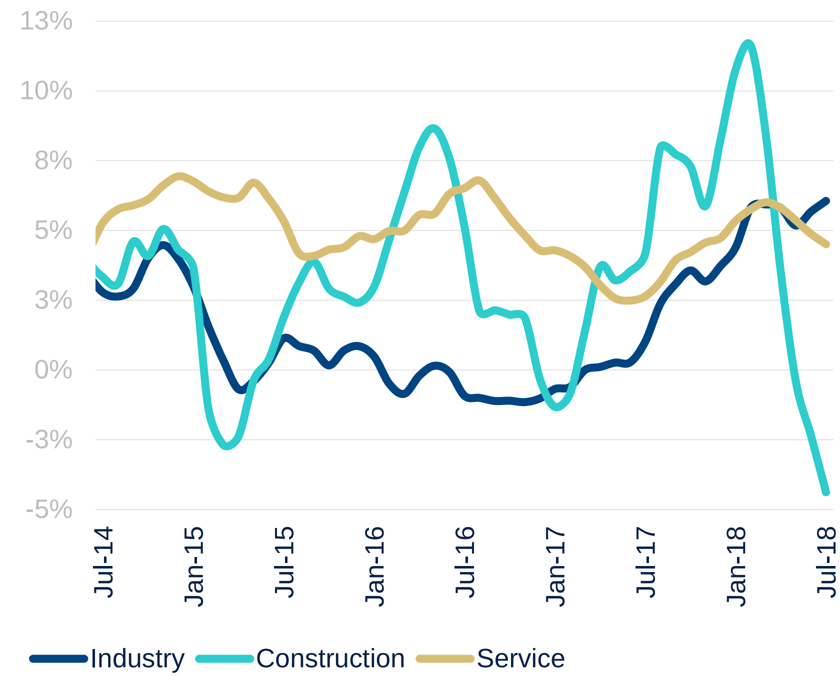
Turkey: Unemployment Rate

(SA, %)



Turkey: Employment growth by Sector

(3MA yoy)



Source: TURKSTAT, BBVA-Research Turkey

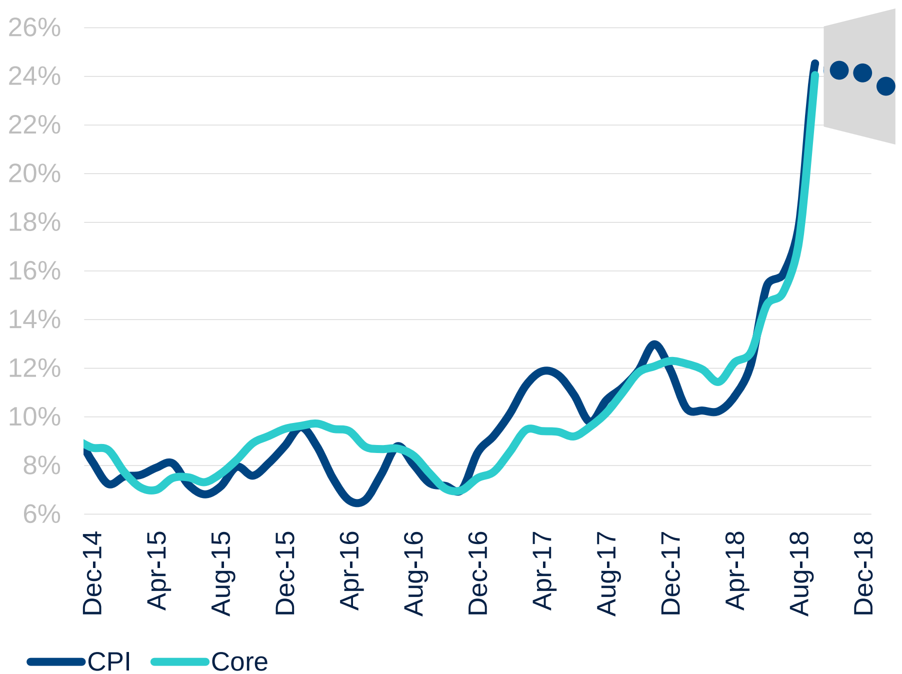
The unemployment rate has started to rise and will respond with a lag to the business cycle conditions

Employment creation so far remains resilient in Industry and Services, while it is already being negatively affected in Construction

Inflation will remain high in the short term with the "Anti-Inflation" program providing some transitory relief

Turkey: CPI and Core Inflation

(YoY)



Source: CBRT, TURKSTAT, BBVA Research Turkey

Turkey: Anti inflation Program

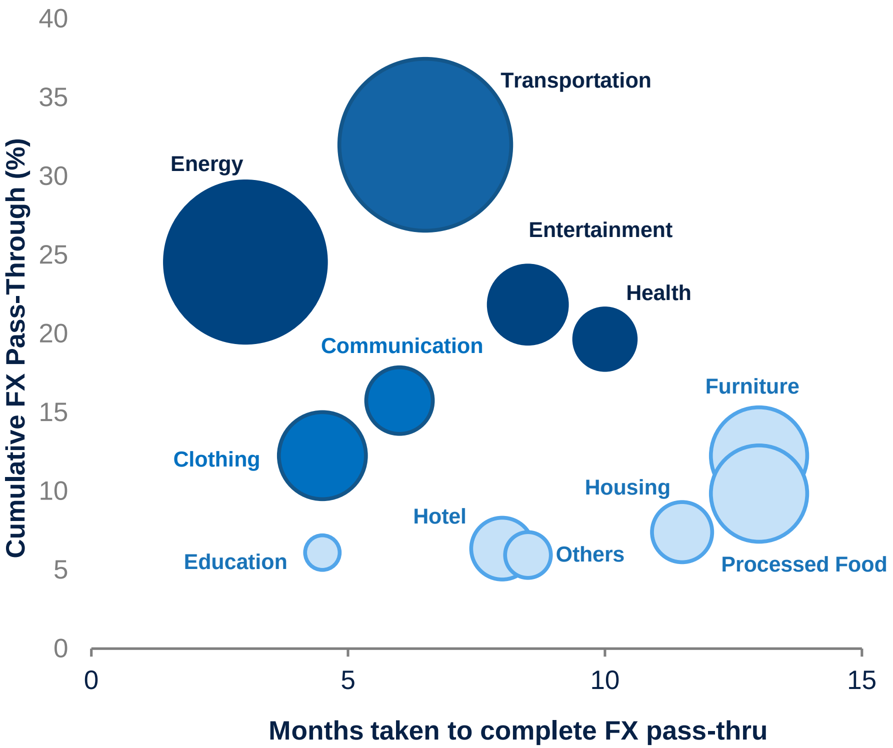
- A "voluntary" campaign of minimum 10% reduction on prices until the end of the year
- There would be no increase in electricity and natural gas prices until the end of 2018
- The Government will accelerate and target 50% of value-added tax (VAT) returns by the end of the year (0.9% of GDP)
- We expect these measures to have some transitory impact on inflation until the end of the year

Annual inflation climbed to 24.5% in September on top of rapid exchange rate pass-thru after sharp currency depreciation, climbing cost-push factors and high food inflation despite favorable seasonality

A "voluntary" campaign of minimum 10% reduction on prices until the end of the year could help temporarily but may create additional inflationary pressures for 2019. The sharp divergence in inflation expectations should be the main concern for the CBRT

The pass-thru coefficient is far from homogeneous in terms of activity and duration. Exchange rate volatility matters…

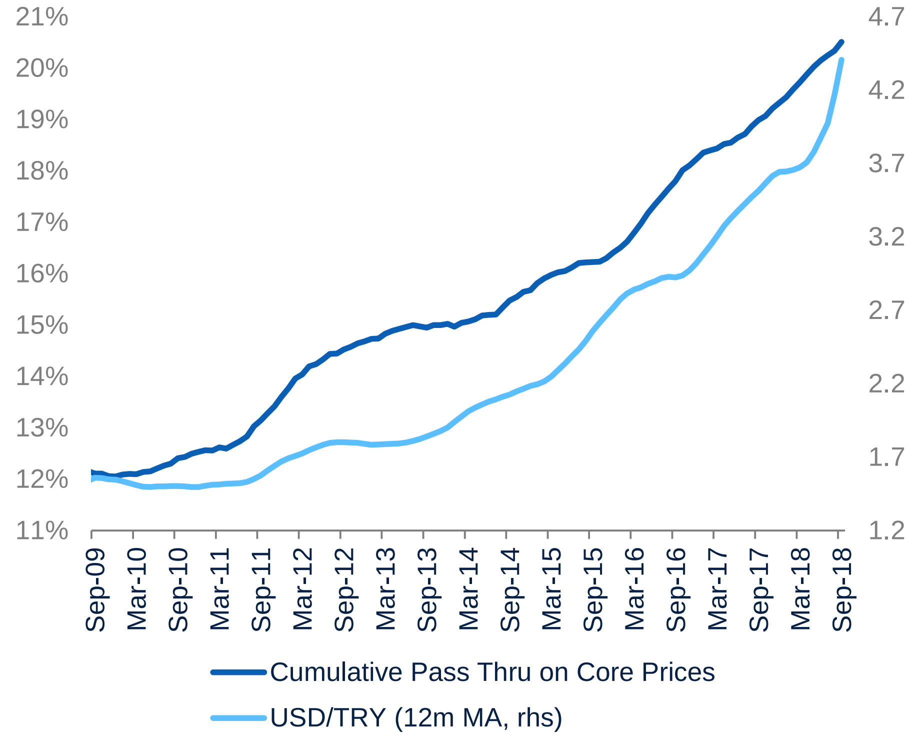
Turkey: FX Pass-thru on CPI Items*



*Bubble size corresponds to the weight of each item pass-thru in CPI.
Source: CBRT, TURKSTAT, BBVA Research Turkey

Exchange rate and Pass-Thru coefficient*

(Avg 12 months)

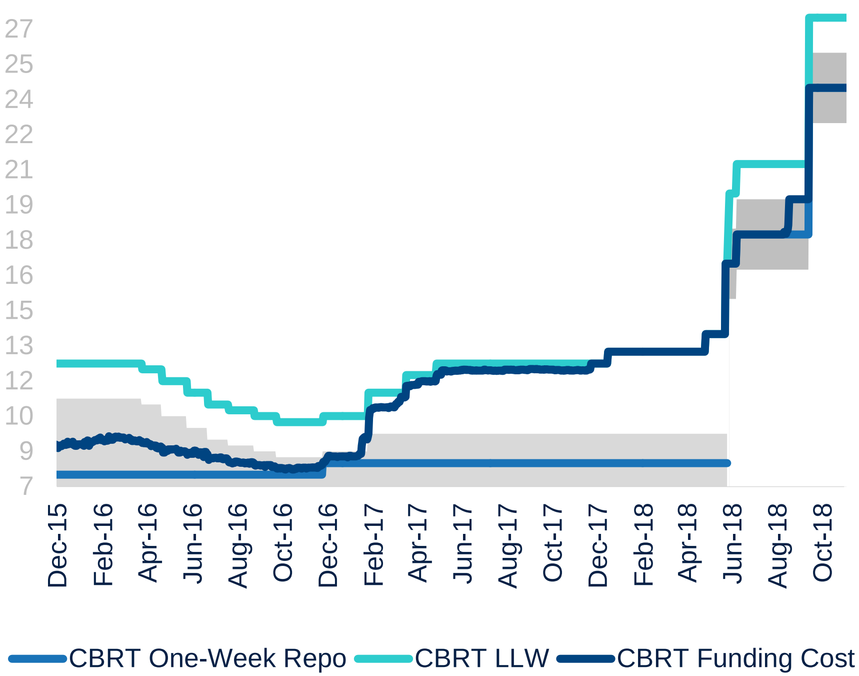


*Core Prices refer to Core-D (CPI excluding unprocessed food , alcohol and tobacco)
Source: CBRT, TURKSTAT, BBVA Research Turkey

The CBRT tightened its stance further to control inflation and exchange rate pressures in September and stayed on hold in October. It should be cautious as inflation expectations are far from anchored

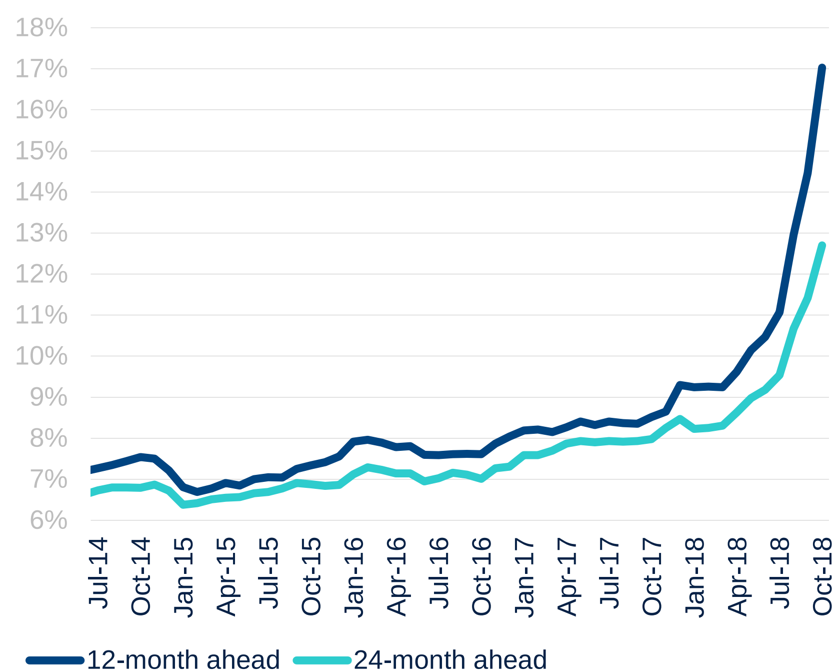
CBRT Interest Rates

(Annual Level, %)



Turkey: Inflation expectations

(%)



Source: CBRT and BBVA Research Turkey

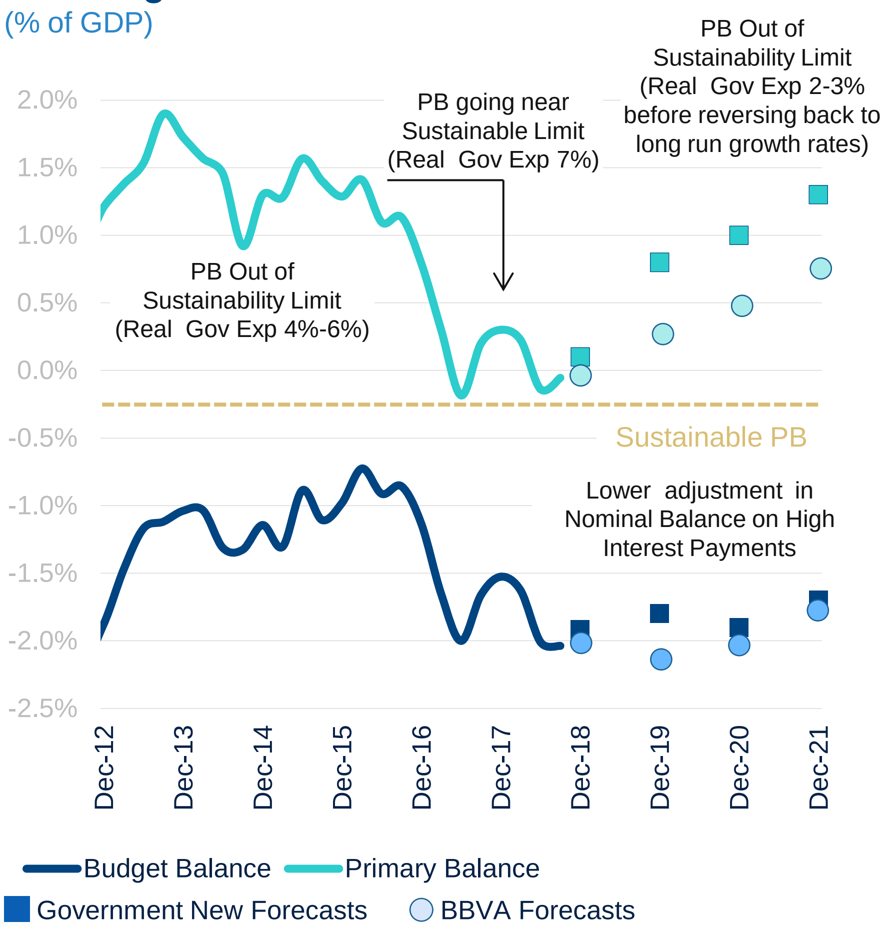
The Central Bank (CBRT) surprised on the upside and hiked its policy interest rate (one-week repo) by 625bps to 24.0% in September

The recent stabilization in the currency and voluntary discount campaigns could have provided buffer for the CBRT not to react in October. Monetary policy should remain alert as inflation expectations are far from anchored

The New Economic Program (NEP) macroeconomic assumptions are more realistic

CG Budget Balance and NEP Forecasts

(% of GDP)



Source: Ministry of Treasury and Finance, BBVA Research Turkey

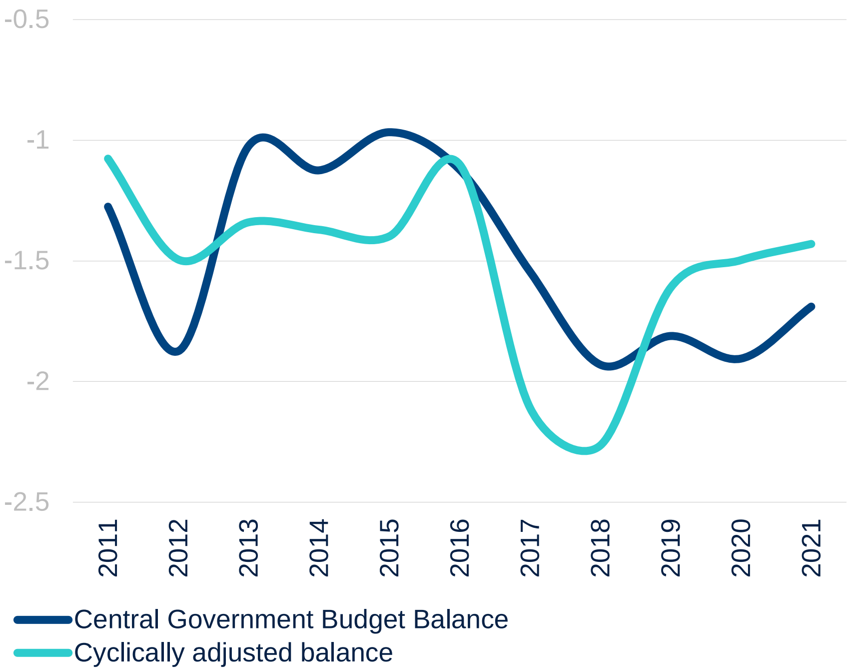
Turkey: New Economic Program (NEP) Assumptions

	2017	2018 (e)	2019 (f)	2020 (f)	2021 (f)
GDP Growth (%)	7.4	3.8	2.3	3.5	5.0
Unemployment Rate (%)	10.9	11.3	12.1	11.9	10.8
USD/TRY (Year Avg)	3.6	4.9	5.6	6.0	6.2
Inflation Rate (eoy %)	11.9	20.8	15.9	9.8	6.0
Central Gov. Budget Balance (% GDP)	-1.5	-1.9	-1.8	-1.9	-1.7
Central Gov. Primary Balance (% GDP)	0.3	0.1	0.8	1.0	1.3
Current Account Balance (% GDP)	-5.6	-4.7	-3.3	-2.7	-2.6
EU Defined Gov. Debt (% GDP)	28.3	31.1	28.5	28.2	27.2

The NEP includes sizeable fiscal effort in 2019. It also envisages a turning point to restore the fiscal prudence in the medium term

Turkey: Central Government Balances

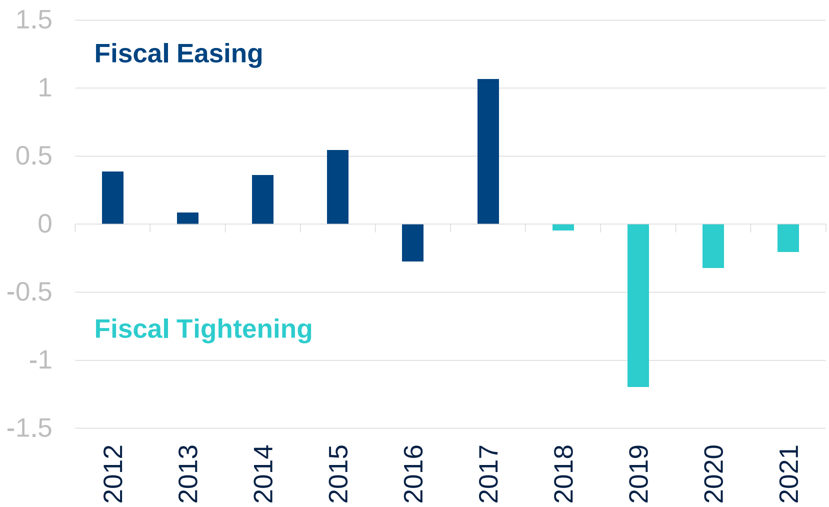
(% of GDP)



Source: Ministry of Treasury and Finance, BBVA Research Turkey

Turkey: Fiscal Impulse

(Negative change in cyclically adjusted balance, % of GDP)



* The 2019 savings amount 60bnTL (1.3% of GDP) coming from:
- postponing investment (0.7% of GDP),
- reducing incentives (0.3% of GDP),
- cutting social security (0.2% of GDP)
- reducing current expenditures (0.1%).
- higher interest expenditures

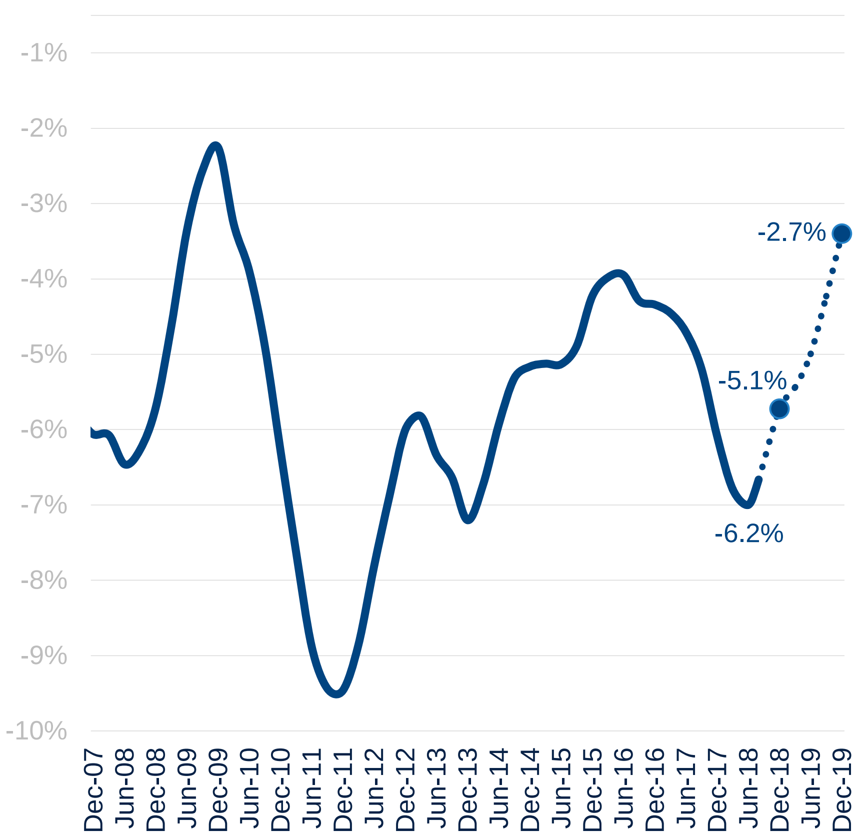
On the revenue side, the Government extra revenues (0.4% of GDP) in 2019

In cyclically adjusted terms, the Central Government budget balance shows a significant fiscal consolidation next year

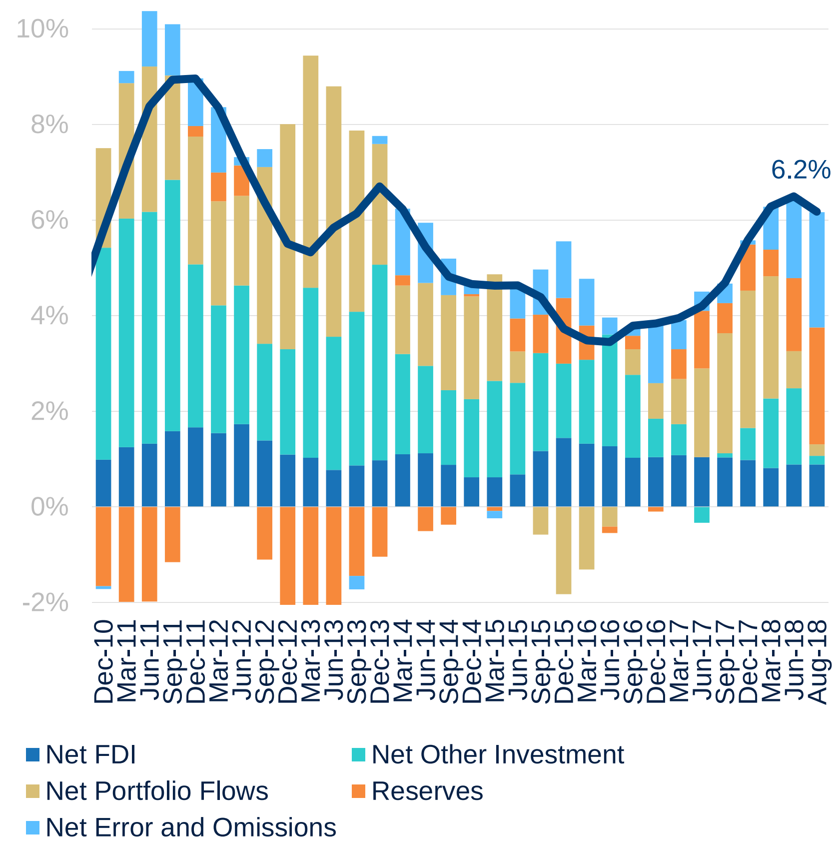
The consolidation will be provided mainly by savings in expenditures (near 1.3% of GDP)

The current account deficit will adjust rapidly as domestic demand contracts, and exports and tourism revenues remain robust

Current Account Balance
(12M sum, % GDP)



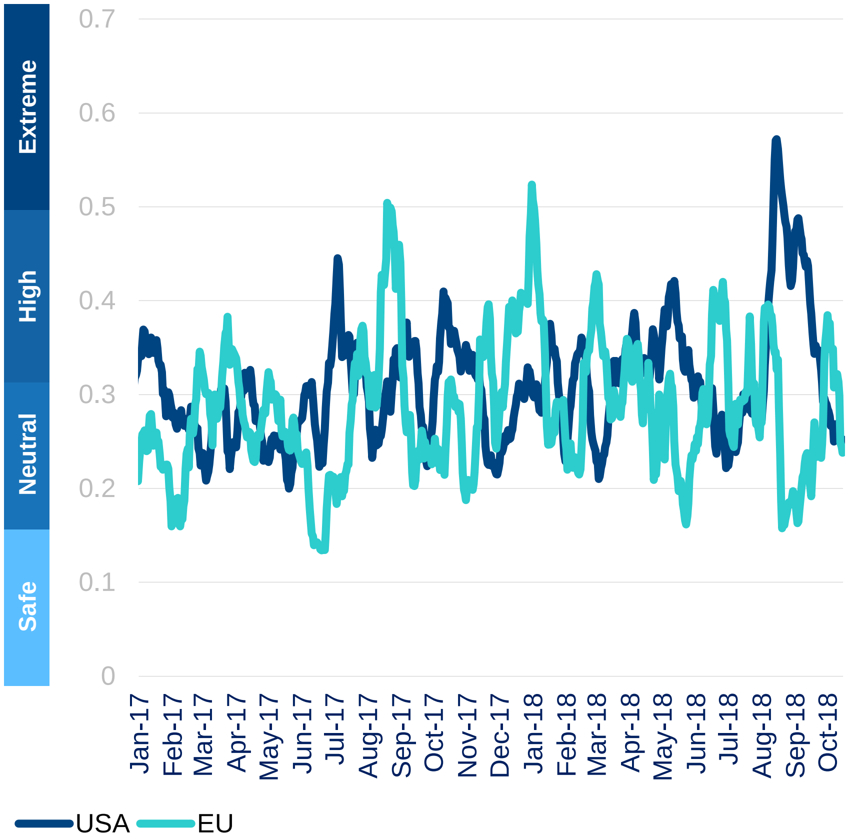
Current Account Financing
(12M sum, % GDP)



Source: CBRT, Turkstat and BBVA Research Turkey

The recent improvement in Turkey-US relations should help to eliminate uncertainties

Turkey: Foreign Relationships Index
(Sentiment level index using GDELT)



Source: GDELT and BBVA Research Turkey

- Reverend Brunson was finally released after the reduction of the Penalty
- This is a critical step as it should open a way to reduce uncertainties about additional sanctions and restore the relation with the US
- There are still pending issues with the US: S-400, Syrian position and potential sanctions against Iran
- The collaboration of Turkish authorities in Khashoggi’s killing could help to restore foreign affairs links with the West

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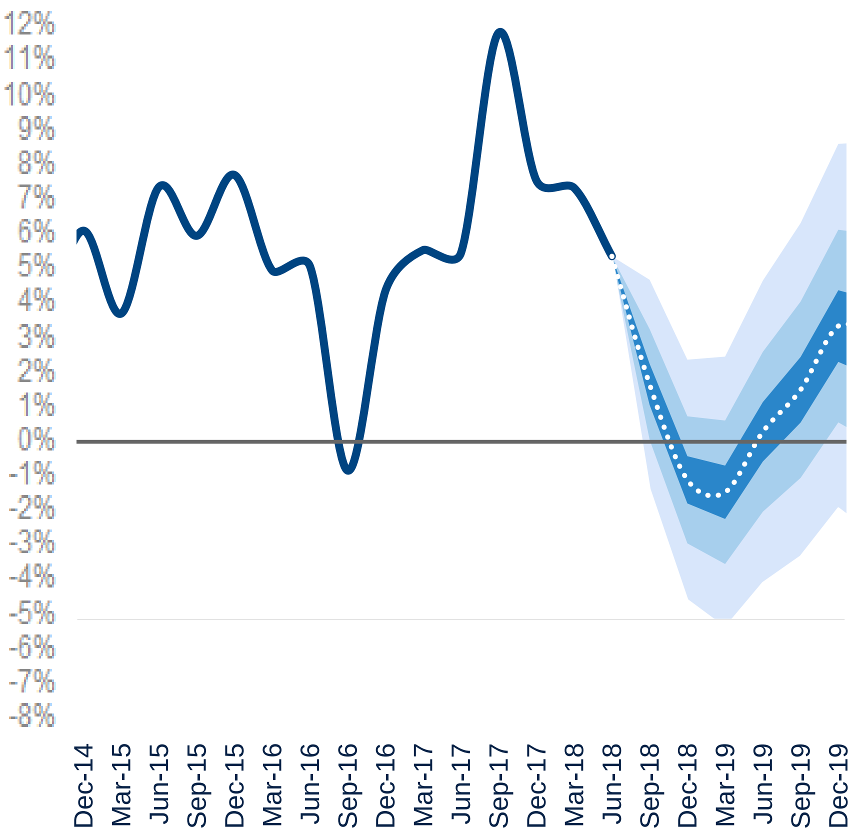
03

Turkey Baseline Scenario

Recent financial shocks and necessary steps of monetary and fiscal tightening to restore confidence will weigh on GDP

GDP Forecast
(YoY)

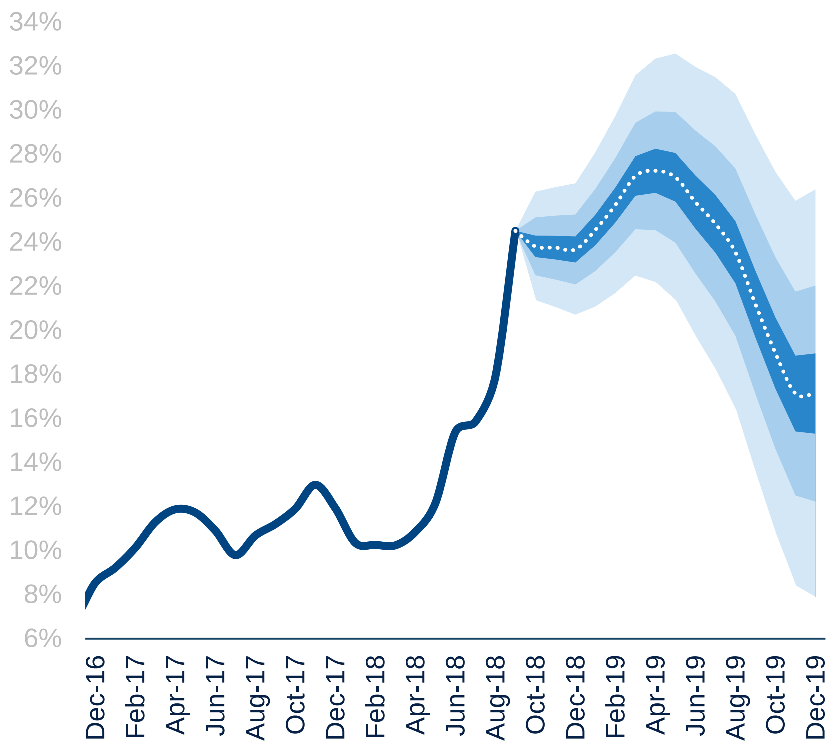


Source: BBVA Research Turkey

- Economic activity has started to rebalance and the adjustment will become more obvious in the second half of the year
- This will be the reaction to the recent financial shocks and the necessary steps of monetary and fiscal policy tightening to restore confidence in the Turkish financial markets
- We forecast that GDP growth will slow down to 3% this year and will decelerate further to 1% in 2019

Inflation will stabilize in the short term at very high levels. The disinflation path will start in 2Q19

Inflation Forecast
(3m YoY)



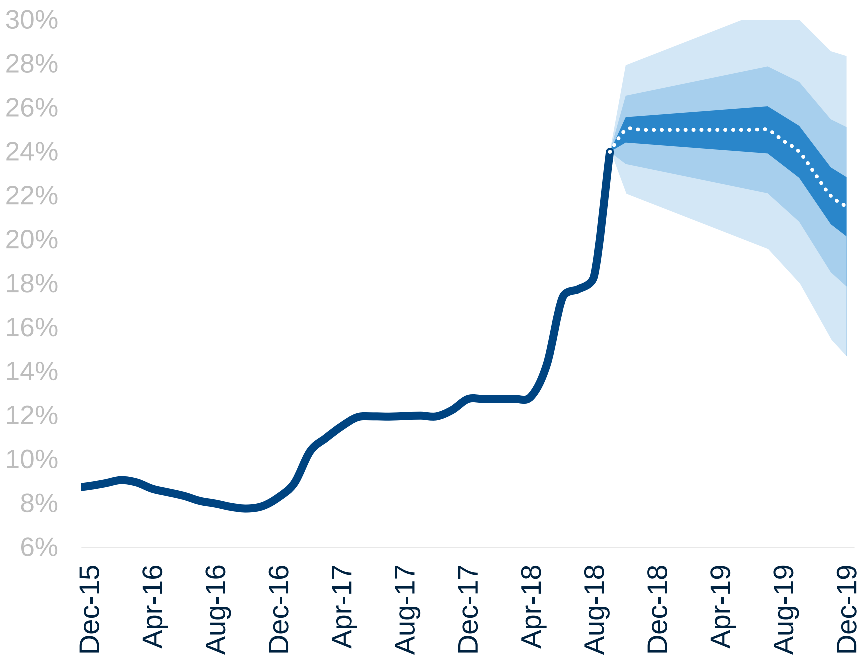
- Inflation will temporarily stabilize on the anti-inflation plan measures to be effective until December
- Inflation will increase transitorily at the beginning of next year on base effects and likely utility price hikes
- The effects of monetary policy with wider negative output gap will become evident from 2Q19 onwards
- It is important to maintain a tight policy mix to curb inflation expectations as soon as possible

Source: BBVA Research Turkey

Monetary policy should remain "tight" until inflation expectations are curbed. We maintain a prudent forecast for exchange rate

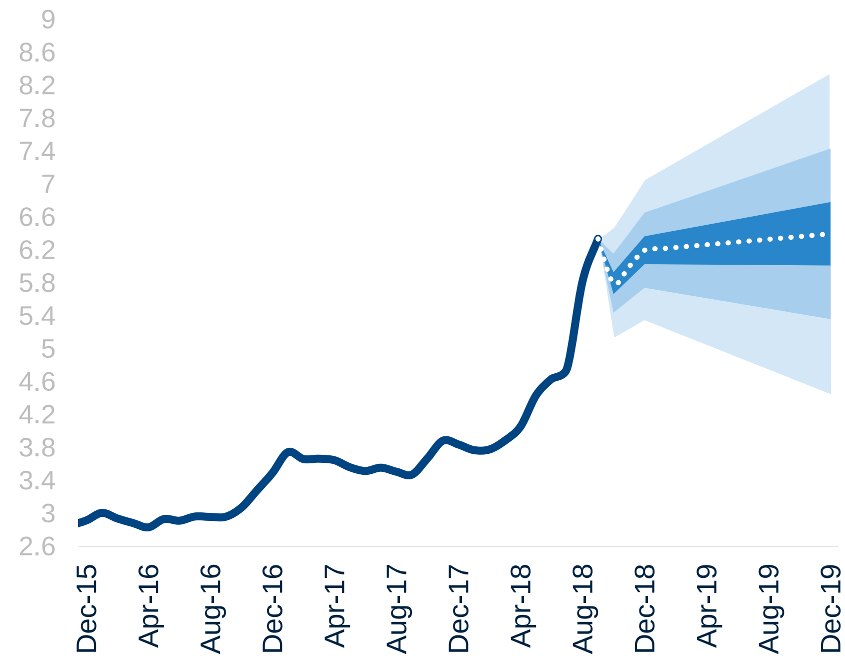
Monetary Policy Forecasts

% CBRT Funding Cost



Exchange Rate Forecasts

USDTRY Level



Source: BBVA Research Turkey

Monetary policy should remain tight until inflation expectations will be under control. There are some risks on the upside as there is some uncertainty on the exchange rate pass-thru to final prices

The incoming economic adjustment, a non supportive global environment and a new political cycle lead us to maintain a prudent exchange rate forecast

Turkey Baseline Scenario

	2017	2018 (e)	2019 (f)	2020 (f)
GDP (%)	7.4	3.0	1.0	2.5
Private consumption (%)	6.1	3.5	0.4	1.9
Public consumption (%)	5.0	3.5	3.5	3.0
Investment in fixed capital (%)	7.8	-2.7	-6.6	2.4
Exports (%)	11.9	4.7	6.0	6.0
Imports (%)	10.3	-0.8	-3.2	5.0
Unemployment rate (average)	10.9	11.3	13.5	12.8
Inflation (end of period, YoY %)	11.9	23.5	17.0	12.0
CBRT funding rate (end of period, YoY %)	12.75	25.0	21.5	15.0
Exchange rate (USDTRY, end of period)	3.77	6.20	6.40	6.55
Current account balance (% of GDP)	-5.5	-5.1	-2.7	-2.6
Central government budget balance (% of GDP)	-1.5	-2.1	-2.2	-2.0

(f) Forecast. (e) Estimated.

Source: BBVA Research Turkey

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