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THE WATCH

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Turkey: U.S. sanctions hit a vulnerable economy

- After recent Turkish military intervention in North Syria, the U.S. administration retaliated through a tariff of 50% on Turkish steel. The direct impact of this measure should remain quite muted since the U.S. is a minor export destination for the Turkish economy.
- However, indirect impacts, such as TRY evolution, debt rollover and payment behavior, would have wider consequences. The recent monetary policy easing was quite ahead of the curve and the TRY has already weakened (-5% in October to a 6-months low).
- Turkey's economy is not immune to a new shock. Though it has already exited from the deep recession experienced in H218, triggered by a sizeable exchange rate shock (-50% exchange rate depreciation, with a trough experienced in August 2018), GDP growth remains subdued (-0.2% in 2019 and +2.3% in 2020). It should recover to its pre-crisis level only in 2021.
- The materialization of sanctions from Europe would be the true game-changer, as the main Turkish foreign exposures are with Europe (trade, financial). But Europe's exposure to the Turkish economy is significant, making harsh sanctions (financial sanctions) unlikely.

What’s new?

After recent Turkish military intervention in North Syria, the U.S. administration announced sanctions on Turkey through a hike from 25% to 50% of tariffs on steel imports from Turkey and a ban of three top officials’ financial accounts in the U.S. Trade tariffs were already put at 50% from August 2018 as the TRY currency crisis was seen as a competitive threat by the U.S. administration, and unwound in May 2019 as the financial situation in Turkey normalized.

The direct trade channel of impacts appears quite limited at this stage. In 2018, Turkey’s goods exports to the U.S. amounted to USD8.3bn (4.9% of the total, 5th export destination) and its imports from the U.S. came in at USD12.4bn (5.5% of the total, 4th import source). Turkey’s export structure is fairly well diversified. Although the 5th most important export destination, the (already declining) share of the U.S. in Turkey’s exports of just below 5% suggests that any potential U.S. sanctions on Turkey would only have a moderate economic impact.

It would become problematic for Turkey if the EU would join the U.S. sanctions (as it did with Russia in 2014). But this is highly unlikely as the EU depends on Turkey for holding back a potentially huge influx of refugees to the EU – which President Erdogan has emphasized once again this week.

Table 1: Turkish trade exposure

	Main export markets	Share 2018	Share Jan-Aug 2019	% y/y Jan-Aug 2019		Main import markets	Share 2018	Share Jan-Aug 2019	% y/y Jan-Aug 2019
1	Germany	**9.6%**	9.1%	-4.3%	1	Russia	**9.9%**	11.1%	-1.3%
2	United Kingdom	**6.6%**	6.4%	-0.2%	2	China	**9.3%**	8.9%	-23.0%
3	Italy	**5.7%**	5.4%	-4.5%	3	Germany	**9.1%**	8.7%	-19.2%
4	Iraq	**5.0%**	5.0%	6.0%	**4**	**United States**	**5.5%**	**5.7%**	**-10.0%**
5	**United States**	**4.9%**	**4.7%**	**-1.5%**	5	Italy	**4.6%**	4.2%	-22.7%
6	Spain	**4.6%**	4.7%	3.0%	6	India	**3.4%**	3.3%	-16.0%
7	France	**4.3%**	4.6%	4.5%	7	United Kingdom	**3.3%**	2.5%	-41.1%
8	Netherlands	**2.8%**	3.2%	15.2%	8	France	**3.3%**	3.0%	-27.3%
9	Belgium	**2.4%**	1.9%	-15.8%	9	Iran	**3.1%**	2.2%	-43.0%
10	Israel	**2.3%**	2.5%	10.5%	10	South Korea	**2.8%**	2.9%	-17.2%
	EU (28)	**50.0%**				EU	**36.2%**		
	MENA	**23.2%**				MENA	**10.1%**		
	Asia	**7.4%**				Asia	**23.1%**		

Sources: National statistics, Allianz Research

We assess the potential impact of a new period of financial tensions in Turkey through three channels: foreign-currency exposure (trade and debt driven), payment behavior and potential spillovers.

Low foreign reserves put depreciation pressures on the TRY

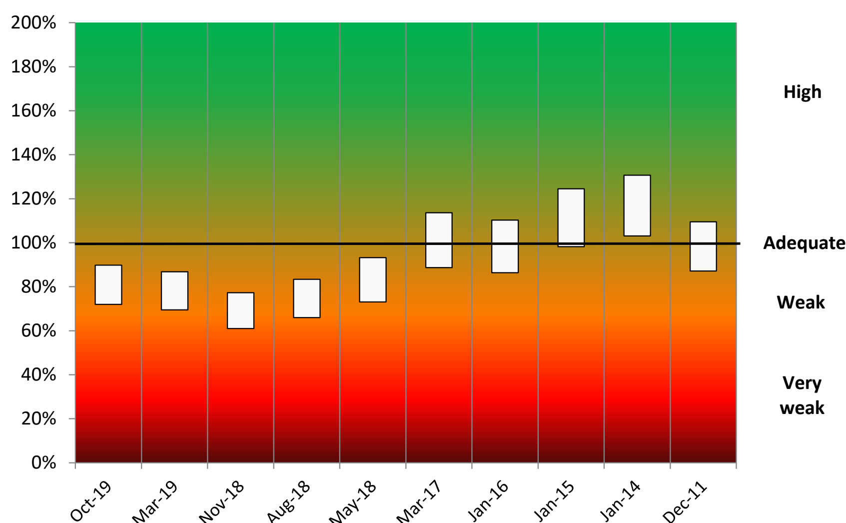
Turkey's foreign reserves have partially recovered as a result of the rebalancing of the trade balance. However, FX reserves are still below an adequate level: They do not cover all the potential liquidity needs that would arise in case of a shock. This means that Turkey's central bank would not be able to defend the TRY and that a new depreciation would be likely.

The data show that Turkey's biggest exposure is a full-blown export free-fall (exports represent about 28% of GDP), which is not a central scenario (a full-blown trade war and recession in the Eurozone would be triggers). External debt rollover is also a significant exposure: The size of capital flow reversals was about -25% of the current level of foreign reserves in the past systemic crisis. As the level of external debt did not diminish during the last few months, a shock of the same size is still a possibility.

Capital flight from residents is also a risk in case of an extension of sanctions to financial ones: This would put about -25% of foreign reserves at risk, given the current value of Turkish money supply. It comes from the high level of dollarization in the Turkish banking system, which makes the economy vulnerable to a sudden loss of its access to dollars abroad.

A full-blown shock with trade sanctions (also from Europe) and a broadening of sanctions from the U.S. against Turkish access to dollars would likely generate a default, given this inadequate FX reserves level.

Chart 1: FX reserve adequacy (FX reserves in % of potential liquidity needs in an adverse environment)



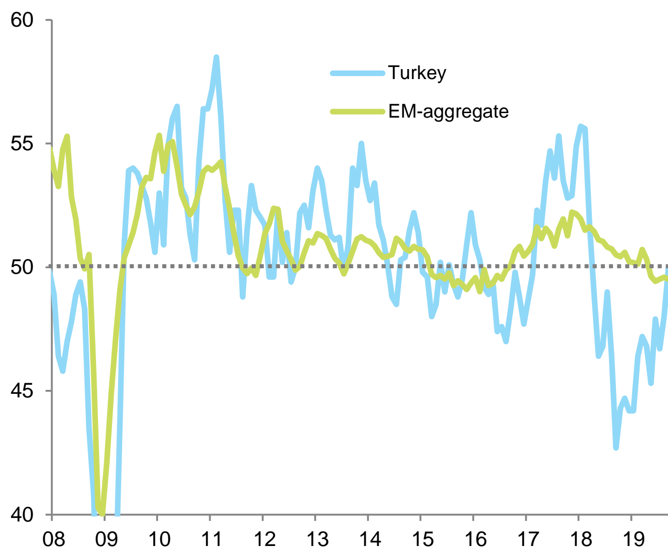
Sources: National statistics, Allianz Research

The economic momentum has improved but mind the credit cycle

Turkey experienced a severe recession in H218 (seasonally adjusted GDP was in Q418 -4.1% below Q218 GDP), but there was evidence that the economy bottomed out after experiencing a sizeable demand adjustment (imports dropped by -20% y/y on average during the last 12 months). This favored a stabilization of the economy and the central bank eased its monetary policy through a -325bps in September 2019.

However, among the Emerging Markets, the Turkish economy still appears to be the most exposed to an external shock, as a result of strong financing needs. The dovish stance of the central bank has weakened the TRY (-5% in October to a six-month low), with an additional depreciation risk (-25% in a scenario where meaningful sanctions from Europe would be imposed).

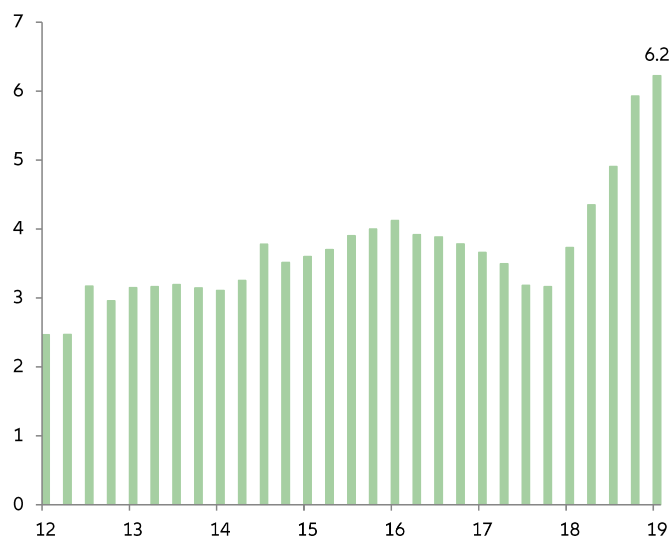
Chart 2: Manufacturing PMI, Turkey vs. Emerging Markets



Sources: IHS Markit, Allianz Research

The buildup of corporate debt and the recent recession have engineered an insolvency U-turn. The deterioration of payment terms added to cash needs since Days Sales Outstanding (DSO) increased by +11 days from 2008 (68 days of turnovers) to 2018 (79 days). In the banking sector, non-performing loans (net of provisions) have grown from 3% to 6% of banks' capital during the last year. In parallel, we expect corporate insolvencies to grow by +8% in 2019 and reach a level +20% above the 2016-low.

Chart 3: Non-performing loans net of provisions to capital (%)



Sources: National statistics, Allianz Research

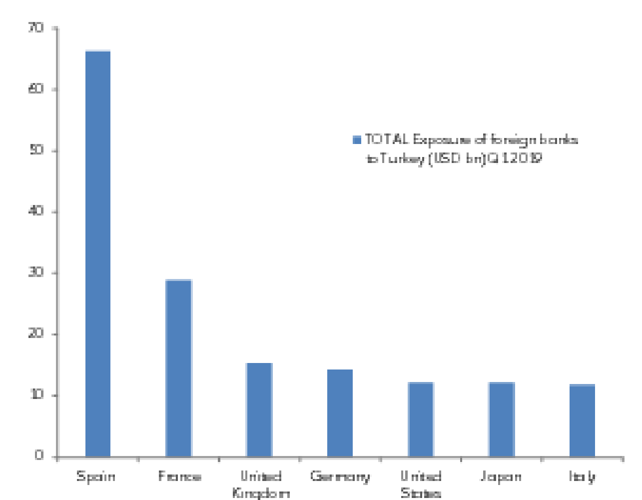
Spillovers to Western Europe would come through the banking channel

European economies are not immune from any contagion. A sovereign-banking loop is the most likely channel of impact, since EU banks have one of the widest exposures to Turkey and, at the same time, some European economies still face a significant level of non-performing loans in their banking systems and high levels of public debt. For example, one year ago, Italian spreads widened following the exacerbation of troubles in Turkey.

Despite monetary easing in the U.S., we observe a poor pass-through to the Emerging Markets asset class, particularly in countries where policy heterodoxy and debt exposure are the widest. The period opened by U.S. monetary policy tightening in 2018 has not ended so far, since private investors deleveraging towards the riskiest countries put their credit conditions under pressure.

Spanish, French and British banks are the most exposed to Turkey and overall exposure is still significant, despite a symmetric drop during the last year (about -20%).

Chart 4: Exposure of foreign banks to Turkey (USD bn)



Sources: BIS, Allianz Research

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