7 Turkey: likely to face continued headwinds

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Referendum results and implications

On April 16th, Turkish voters voted 'yes' by a very narrow margin for a referendum favouring constitutional change, which among others, introduces an executive presidency giving President Erdogan further powers. The outcome of the referendum – 51.4% in favour – has been widely contested by the opposition, as well as by election observers from the OSCE (the Organisation of Security and Cooperation in Europe). National elections are scheduled for November 2019, and the narrow victory most likely rules out early elections. The new constitution would enable President Erdogan to remain in office until 2029.

While the outcome of the referendum has stabilized markets in the short term, we expect this positive market reaction to be short-lived. All Turkish assets including the Turkish lira, which had been suffering for a while, benefitted from this result. However, the medium-term outlook looks rather uncertain for a variety of reasons.

I. **Continued geopolitical and domestic tensions** and related security issues are likely to impact growth and investor confidence negatively.

II. **Lax fiscal and monetary policy:** Given the slowdown in growth, expansionary fiscal and monetary policies are likely to be pursued.

III. **EU membership talks in jeopardy:** The institution of the "death penalty", which is under discussion, could create further rifts between Turkey and the EU and could lead to the suspension of EU accession.

IV. **Weaker institutional strength:** the executive presidency could further pressure the proper functioning of institutions such as the press and the judiciary and weaken the system of checks and balances.

V. **Poor external liquidity:** Turkey has large structural current-account deficits and poor external liquidity. This is unlikely to improve, given the current geopolitical context, which has impacted tourism negatively.

Evolution of Credit Quality

The result of the referendum does not augur well for Turkey's credit quality, which has been deteriorating over the past year, leading to negative rating actions by the rating agencies. Currently the sovereign is rated non-investment grade (Ba1 negative / BB negative / BB+ stable) by the three rating agencies (Moody's/ S&P/ Fitch).

The reasons for the rating downgrades were related to a combination of institutional and economic concerns:

Fitch: Fitch's main concerns are political and security developments, including 'high profile terrorist attacks" which could further damage consumer and investor confidence and tourism, as well as the erosion of "checks and balances". Turkey's vulnerability to shifts in investor confidence, due to a "strained external liquidity position", is also mentioned among the factors leading to the January 2017 downgrade. Moreover, the agency expects a slowdown in GDP growth to 2.3% average per annum in 2016-18 versus 7.1% the preceding five years.

Standard and Poor's: S&P, on the other hand, is more focused on the high external financing needs and large net external liabilities of the sovereign, and the relatively limited international reserves buffer (24% of GDP). Rising balance of payments and fiscal risks were among the factors contributing to the revision of the rating outlook to Negative in January 2017.

Moody's Investor Service: Moody's' prominent concerns are a combination of the above: the mix of large external financing requirements and a 'turbulent geopolitical backdrop", undermining growth and investor confidence. The agency expects prolonged political uncertainty and little scope for structural reforms in such a context.

The essential

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Conclusion

Despite the reprieve provided by the referendum results, we believe that the Turkish economy will continue facing headwinds, given continued geopolitical and domestic political tensions, weakened institutions, poor external liquidity, and slower growth, all within a global context of rising interest rates. These tensions are likely to weigh on credit quality and the performance of Turkish assets in the medium-term.

"Moody's' rating action is motivated by large external financing requirements and a 'turbulent geopolitical backdrop", undermining growth, investor confidence and structural reforms"

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