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ERDOGAN HAMMERS THE PARALLEL STATE

Introduction

Following the recent coup failure, President Erdogan initiated a purge of the Gullanist movement in an effort to once and for all eradicate the 'parallel state'. The infiltration of state apparatus was first initiated in the late 70s, and, thus, is deep-rooted. By invoking Article 100 of the Constitution, Turkey entered a state of emergency, which is set to last for three months, with an option to extend it for an additional four months. According to the official line, extraordinary times require extraordinary measures.

The new political environment will allow the passage of laws in a much speedier way, as any decree published in the official gazette becomes effectively law, without the prior approval of parliament. It is understood that within the next few working days, a decree will be passed, describing a legal framework with which to deal with some 60,000 civil servants who are currently detained and or suspended for their alleged involvement in the coup.

On the surface, the actions of the government have been proportionate so far, yet decisive and speedy. The attempted coup and its aftermath without doubt are set to have wide spread ramifications on the future of Turkey's political environment, domestic economy and geopolitics. The latter is particularly important given Turkey's membership in NATO and its vital role in the coalition against ISIS.

Politics

The latest upheaval in Turkey is no doubt perceived by Erdogan as a clear signpost of failure of the current political setting. As such, it is reasonable to assume that a final push for a fully-fledged presidential system will ensue. Given the state of emergency, Turkey's political setting will effectively, albeit temporarily, resemble a presidential system, run by parliament but under the strict chairmanship of the President.

A number of domestic and international commentators suggest that the ruling administration will become more divisive and will pursue its goal of amending the constitution more aggressively. According to official high rank ministers, however, political dialog and cohesion has much improved – reassuring words in these troubled times, but the reality might not necessary be so.

As it stands, the ruling party (AKP) does not have the required two-thirds majority to make constitutional changes without the need for a referendum. Ahead of recent events, it wasn't clear whether the idea of a presidential system would have garnered a required 50% of the popular vote. Can one reasonably assume that the failed coup would necessary improve the situation in this respect? It is too early to say; yet the risk remains.

Alternatively, Erdogan could use the current political havoc to call snap elections (as both opposition parties have likely been weakened) in hope of securing the super-majority. The risk of snap elections is certainly not imminent, but an early vote in early 2017, after some veneer of normalcy is restored, cannot be entirely ruled out.

If any of the two alternative scenarios were indeed in line with Erdogan's intention, he would firstly need to use this relatively short period of the emergency situation, which can last as long as seven months, to remove all those who stood behind the failed coup attempt. He also needs to calm the markets, markedly reduce security concerns and reassure domestic and international investors and consumers alike that business is normal in order to avert economic malaise. Time is scarce, so one should expect to see him act in a timely and decisive manner. This is his time to win the masses, and push for a final vote, either in a referendum or snap election.

Economics

Ratings

While it is reasonable to assume that some form of normalcy and order will return in the near term, at least on the surface, the extent and speed of the ongoing purge of the state apparatus ought to bring about much weakened institutional quality, introducing an element of uncertainty and unpredictability that will likely last for many months. These were the key reasons behind the announcement of the credit rating review by Moody's scheduled for August 5th, as well as an outright downgrade by S&P on July 20th. The latter is perhaps unsurprising, given S&P's keenness and readiness to respond to political uncertainties in a 'very timely manner', which is often perceived as preemptive.

Ahead of the coup attempt, real money investors' positioning in Turkey was light, thus large capital outflows are unlikely unless the country loses investment-grade status from Moody's. In that scenario, some preemptive reallocations away from Turkey, especially by active fund managers, will likely occur. The recent S&P downgrade will, however, result in the exclusion from the GBI-EM IG index in early September (as all three ratings from Moody's, S&P and Fitch are required to be investment-grade for continued inclusion), yet the outflows from Turkey's local-currency bond markets are unlikely to be significant, estimated at close to USD1bn.

Turkey: Long Term Foreign and Local Currency Issuer Ratings

	Sovereign Rating		Local Rating		
	Rating	**Outlook**	**Rating**	**Outlook**	**Next Review**
Moody's	Baa3	Negative, Ratings Review	Baa3	Negative, Ratings Review	August 5th, December 2nd
S&P	BB	Negative	BB+	Negative	November 4th

Source: Bloomberg

Assuming the country also loses investment-grade status from Moody's, the ensuing outflows on the back of a loss of the eligibility for sovereign debt for all investment-grade benchmarks would likely trigger much fear of forced selling in the magnitude of USD7-8bn at a minimum. At this stage, it is difficult to foretell the extent of spread widening due to a downgrade to below investment-grade. One can, however, assume that rolling forward external liabilities will certainly come at a higher price than during previous episodes of heightened global market volatility.

Balance of Payments

From a market perspective, the highest priority for Erdogan ought to be significantly improving the security situation. This would likely have a direct bearing on the real economy via tourism and business and consumer confidence; not to mention foreign investments, which are imperative for a country burdened with a heavy reliance on foreign sources of financing for the country's excessive external imbalances.

The ongoing war in Syria and increasingly frequent terrorist attacks on home soil, together with the past restrictions on Russian travel to Turkey have all led to a significant decline in foreign tourist arrivals (see table below).

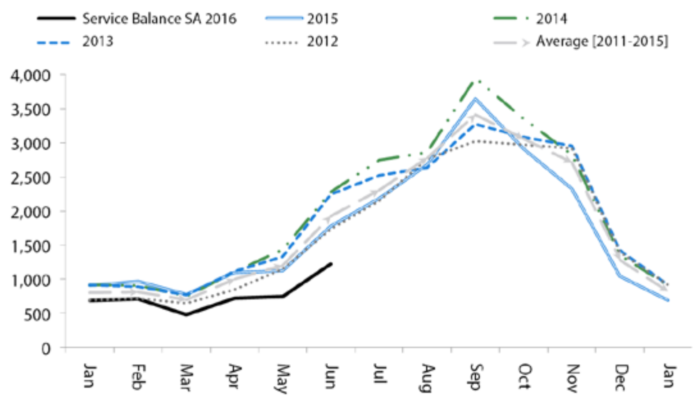
Foreign Tourists Arrivals to Turkey

	2015	2016	
Tourists by Nationality	**Jan - May**	**Jan - May**	**Difference**
Russia	642,859	132,692	-510,167
Germany	1,417,872	1,126,757	-291,115
France	251,036	175,083	-75,953
Holland	344,941	273,735	-71,206
England	511,364	398,246	-113,118
Switzerland	172,031	94,342	-77,689
Italy	166,679	90,187	-76,492
Total Europe	5,145,565	4,024,240	-1,121,325
Total America	380,422	297,293	-83,129
Total Africa	343,767	267,502	-76,265
Total Asia	2,032,643	1,778,878	-253,765
Grand Total	**9,967,991**	**8,010,990**	**-1,957,001**

Source: The Central Bank of The Republic of Turkey, CBRT

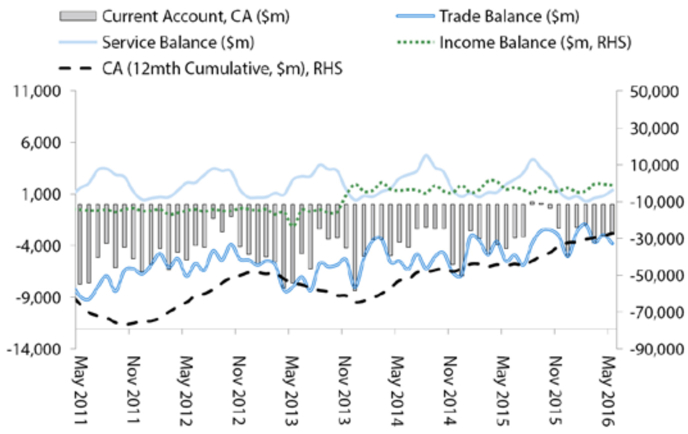
The recent improvement of ties with Russia is likely to stimulate some recovery of Russian tourism to Turkey, yet one cannot reasonably assume that the numbers will revert back to the past highs. Even if the recovery was greater than assumed, this is unlikely to change the picture dramatically as the total loss of tourists from Europe and other regions was nearly four times larger than a loss ensuing from lower Russian arrivals. Unless security concerns are quelled and/or the Syrian conflict dissipates, the tourism industry will continue to suffer, adding pressures to the already weakening growth momentum at home.

Balance of Payments – Service Balance (Travel – Seasonally Adjusted)



Source: Bloomberg

Balance of Payments – All Components



Source: Bloomberg

Looking at the seasonally adjusted service balance related to travel under the balance of payments, the pattern of this year's underperformance becomes pretty clear. On a year to date basis the surplus was significantly lower than in the past few years. The data is likely to deteriorate somewhat further, yet one should not expect this to have an overwhelming impact on the overall current account position. Meanwhile, the much lower oil import bill as compared to previous years together with relatively strong exports to Europe has recently resulted in a much-improved current account deficit.

Also, the large decline in the Lira and lower consumer confidence will likely boost the competitiveness of Turkey's exporters and lower the appetite for imported goods, in turn improving the non-oil related trade deficit. This should be sufficient to offset the negative impact resulting from lower tourism arrivals (all else being equal, particularly oil prices) resulting in a slight improvement in the current account.

Recently closer ties with Russia, Iran and Israel could open up new export destinations, further improving the trade balance. The change in the trade balance will also be dependent on the strength of the Euro vs US Dollar, as Turkey's export receipts are predominantly Euro-denominated, while import payments are in US Dollars. Any improvement in the current account, regardless of the source, will certainly be a welcome development, as external financing could come under pressure in the forthcoming months.

Policy Reponses

Currency

According to the latest Article IV review by the IMF, Turkey has one of the most negative net international investment positions among the G20 countries. Thus, a large change in risk premia is likely to have a much greater impact on asset prices, in particular the Lira. The price action in the aftermath of the July 15th coup was case in point. Generally one can identify a number of channels by which the currency could be impacted in the coming months.

Firstly, we have already identified the possible portfolio outflows related to the potential downgrades below investment-grade. This will be an important consideration in early August, when Moody's concludes its review.

Secondly, the behavior of domestic savers might also play an interesting part in foreign-exchange (FX) price dynamics. Recently we have observed that domestic players were buying into the Lira weakness, reducing their US Dollar positions. This has effectively acted as an automatic stabilizer in FX market. But at what point can one expect to see a sharp increase in dollarization of the economy? A monetary policy mistake (i.e. preemptive easing) might be one of the triggers, but also a protracted period of uncertainly is likely to continue re-pricing political risk into the FX market, in turn eroding investors' confidence in the central bank, the government and the Lira itself.

Thirdly, the large foreign currency-denominated liabilities of both banks and non-financial corporates might raise concerns about the future availability of foreign capital to finance it, particularly in the event of a weakened political climate and stagnating economy. Over the past years, cheap sources of foreign capital led the banking sector to borrow extensively, while corporates increased their net short-FX liabilities. Domestic banks' net liabilities are close to USD100bn (portfolio-side and loans). Similarly, the net short FX position of domestic non-financial institutions is close to 25% of GDP (USD190bn), as far as long term liabilities are concerned.

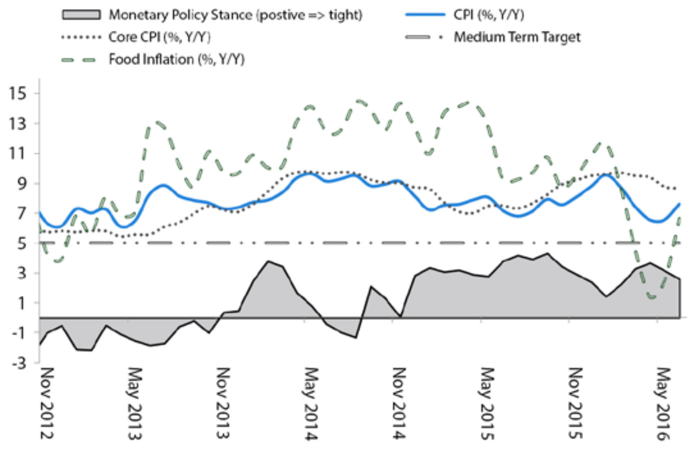
The corporates can deal with short term fluctuations in Lira, given their USD4bn worth net long FX position, yet the longer the conflict persists the higher the risk associated with this structural mismatch. Despite several incidents of global market volatility after the global financial crisis, domestic banks and corporates have been successful in accessing FX liquidity from abroad and manage large Lira fluctuations. The risk, however, remains that, should the liabilities be called upon, the pressure on the currency could be less manageable than before.

Lastly, the improvement in the current account position in recent years might come to a sudden halt, should the security concerns at home further deter foreign tourists, and, thus, exacerbate losses from tourism receipts. Should the latter also coincide with a rebound in oil prices, the current account deficit, regardless of consumption dynamics (the extent of the import substitution), would inevitably balloon, adding further pressures on the inadequate stock of reserves, assuming limited availability of foreign sources of capital.

Inflation – monetary policy

As FX pass through is generally fast and relatively large in Turkey, a much weaker currency will have a negative impact on core CPI, which in itself is already lofty.

Domestic Inflation



Source: Bloomberg

Higher inflation and potentially lower economic growth momentum might pose a dilemma for the central bank (CBRT), and its independence will likely be tested once again. An increased populist agenda by the government and renewed political pressures on the institution of the central bank might see rates decline beyond what is acceptable to anchor medium-term inflation expectations, adding additional pressure on the currency and increasing the risk premium for bond markets to compensate for higher inflation uncertainty.

Market participants must hope that the CBRT has learned from the costly lessons of the past, as restoring stability in the currency often implied large losses to the foreign reserves stock, emergency interest rate hikes, and ultimately, the loss of credibility.

Economic slowdown – fiscal policy

In the event of the government's failure to restore business and consumer confidence at home, an economic slowdown is likely to follow. It is perhaps too early to forecast with any degree of certainty the likely impact this might have on GDP growth, yet according to some projections, if the current decline in tourist arrivals were to continue for the remainder of the year, the ensuing cost could be as high as 0.5% of the GDP.

Fortunately, Turkey's relatively strong fiscal position will likely afford the Ministry of Finance scope to introduce countercyclical policy measures aimed at mitigating the loss of momentum, without necessarily endangering its fiscal position. Fiscal prudence has been a bright spot of Turkey's policy making for a number of years and authorities are unlikely to put that into jeopardy.

Geopolitics

The ramification of the failed coup from a geopolitical standpoint remains uncertain, yet the country's importance as a NATO ally and a member of the anti-Islamic State coalition, albeit often uncooperative and driven by self-centered ambitions, could have widespread consequences. Turkish officials in their usual heated and undiplomatic manner blamed America for indirectly staging the coup, demanding the extradition of Fethullah Gulen (a powerful, reclusive US based Muslim cleric – a mastermind behind the eponymous Gulen movement and creator of the parallel state), or else risking Turkey turning its back on the West.

Straying away from political pluralism at home is set to increase the risk of a protracted conflict with the Kurds on home soil. This is likely to lead to a resurgence of the terrorist attacks with PKK (the main Kurdish militant organization) as a driving force. Once some domestic political stability is returned, Erdogan's effort will likely focus on resolving the long-standing issue with the Kurds. At this stage, it appears unlikely that Erdogan will reinstate the peace process, which would have given the Kurds more rights and recognition in the new constitution, and as some of the most recent extremist activity has been conducted by the PKK, he will likely increase attacks on the southeastern part of country in an effort to root out that problem.

At this stage, it appears unlikely that Turkey's NATO membership is under threat. Turkey will continue to be a forward bastion of the West against the insurgence of ISIS; yet the country's rapprochement with Russia and Hamas in Palestine could in time make it an "unreliable" ally, particularly over the issues of Islamic State and Syrian refugees.

Meanwhile, Erdogan appears to have also made a U-turn with respect to the Syrian foreign policy. Turkey's worst case scenario in Syria has materialised; namely, Russian military support enabled Assad to hold on to power, while the US military support strengthened the Kurdish militia. Fearing that Assad's demise could lead to Kurdish autonomy, Erdogan's stance on Assad's departure being the only way of stabilising Syria, might just soften. This would also explain an effort made to improve ties with Russia, Assad's key ally.

Furthermore, a potential reinstatement of the death penalty (abolished in 2004) would most certainly spell the end of Turkey's EU ambitions. That said, while Erdogan's Turkey might at times prove to be an uneasy partner, it will be deemed better to have it as an ally as opposed to a dangerous and unpredictable foe.

Conclusion

After the coup failure, Erdogan wasted no time in using this as an opportunity to eliminate supposed enemies of the state. The key targets were factions of the army and air force commands, and the judiciary; all those who advocate that secular democracy being a true legacy of the forefather of the modern state, Kemal Ataturk. The key threat is that Erdogan succeeds in making constitutional changes, effectively turning Turkey into a presidential Islamic republic akin to the once-mighty Ottoman Empire. The initial shock after the failed coup appears to have already been priced in, yet should the future path of domestic politics move further away from political dialog and cohesion (which we fear could happen), risk premia will have to be adjusted again.

The introduction of a presidential system would be met with a general disapproval from the international community, triggering renewed loss of confidence in Turkey as an investible market. Financing the excessive external liabilities might get trickier, and if the sources dry up, the stock of foreign reserves might get depleted.

The central bank will be reluctant to raise interest rates at least initially (thus committing a policy error), which would likely trigger a currency sell-off. High inflation, however, and the risk off de-anchoring inflation expectations, will ultimately push the authorities to force emergency rate hikes as in 2014, which might cause the local bond curve to invert and the currency to stabilise.

Consumer confidence might also suffer, boosting hard currency accumulation by households and lowering consumer spending. The impact on the balance of payments will be largely dependent on foreign tourist arrivals, the extent and speed of the import substitution effect, and equally importantly, the cost of oil imports.

Non-financial corporates are set to use their net long FX position in the short term to manage Lira volatility, but the longer the uncertainty prevails, the riskier the mismatch between the short and long-term net asset positions become. As for corporates, many are naturally hedged given large export receipts, so systemic risk is likely to be relatively contained at this stage.

Meanwhile, closer ties with Russia and Hamas, and a renewed oppression of the Kurds in Turkey and Syria might intensify tensions between the Turkish and NATO agenda. The failure of the US to extradite Fethullah Gulen could also lead to some cooling of ties with America. In the above scenario, Turkey is likely to become somewhat isolated from its Western allies, while the economy slows down.

The alternative outcome, which is the most optimal from the market's standpoint, is for Erdogan to swiftly and proportionately deal with the dissidents and embark upon political dialog with the opposition parties. The return to normalcy would not be immediate, but the country would likely avoid a number of risk events as described above. In this case, the economy would nevertheless slow down somewhat, yet a counter cyclical response from the Ministry of Finance with a concomitant support from the central bank would mitigate economic deceleration.

We remain skeptical, however, that the latter will occur; as such, Turkey is likely to face a bumpy road ahead. Fortunately, at this stage, the impact on global markets appears to be largely contained to Turkey due to the political nature of the crisis.

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