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TURKEY’S CRISIS AND ECONOMIC GROWTH

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It has been a complicated year for emerging markets (EM). After a healthy start to the year, the group has struggled, given slower demand from China, tariff concerns, and a firming U.S. dollar. Most recently, Turkey’s diplomatic and political struggles have devolved into a currency crisis that has weighed on the world’s developing markets, despite encouraging economic fundamentals that suggest an otherwise high growth trajectory for EM.

We’ve emphasized our expectation that the economic growth rate for EM this year will be the highest for any global region. We still believe this is the case, and we look for Turkey’s currency turmoil to be resolved in relatively short order as international pressure combines with the necessary monetary steps to address the economic, debt-service, and currency risks.

TURKEY’S CURRENCY CRISIS

The collapse of the Turkish lira, stemming from the country’s economic woes, is a variation on issues plaguing several EM currencies this year. The Turkish lira has plunged 16% in August to a record low relative to the dollar amid steep sanctions stemming from a diplomatic struggle with the U.S. The severity of the lira’s sell-off has unnerved investors around the globe with concerns about the possible contagion risk for the global economy, especially given the potential for an increased pace of capital flight from many EM economies. Turkish president Recep Tayyip Erdogan’s refusal to mollify the concerns of global investors regarding the independence of Turkey’s central bank has compounded worries, further pressuring EM currencies and financial markets.

These recent developments pose legitimate threats to Turkey’s economy if they persist. The lira’s weakness could raise prices in the country, and without the proper monetary policy response, runaway inflation could significantly curb output. Moreover, Turkey’s economic situation is especially fragile. Given the complexity and nuance of its debt markets, a variety of reports suggest Turkey holds in excess of $200 billion in dollar-denominated debt. This compares with $851.1 billion in gross domestic product at the end of last year (according to the World Bank). As the dollar strengthens against the lira, it becomes more expensive for Turkish corporations and the government to convert lira into dollars in order to service the debt, and an inability to service interest payments would no doubt weigh on global sentiment and increase capital flight. Turkey’s current account deficit is also one of the largest among EM countries [Figure 1].
Nevertheless, consensus expectations for Turkey’s economic growth are still optimistic, indicating that this storm may pass with minimal damage. Bloomberg consensus expectations are for Turkey’s gross domestic product (GDP) to grow 4.1% in 2018, down from a 4.2% median growth forecast in June. The median consensus forecast for Turkey’s GDP in 2019 has dropped to 3.4% (from 3.7% in June). Even if Turkey’s economic turmoil intensifies, it’s unlikely to derail global economic growth, considering Turkey’s GDP constitutes only about 1% of global GDP.

EM’S GROWTH TRAJECTORY REMAINS STRONG

Turkey’s currency crisis is the latest reminder of the rough year EM currencies have endured. Trade discussions and global risk-off sentiment have roiled EM currencies, while the dollar has surged amid tightening U.S. monetary policy. Trade tensions, especially between the U.S. and China, have further complicated matters for EM.

The U.S. has already imposed tariffs on $34 billion in Chinese goods, and levies on $16 billion more in Chinese imports are scheduled to take effect August 23 (with likely retaliatory tariffs from China). In response, the yuan has dropped 9% relative to the dollar from its highs earlier this year.

However, we maintain our forecast of 4.8% GDP growth for EM in 2018 (as mentioned in our Midyear Outlook). Emerging-market economies as a whole are still in the early stages of an economic recovery, and stand to benefit from robust consumer demand and dynamic global output changes. We believe the U.S. and China will reach an agreement on trade that avoids any significant negative impacts to either economy.

The U.S. economic growth story is still compelling to us, and we believe it will remain intact regardless of recent global developments. Interest rates are still relatively low, the labor market is healthy, GDP growth is strong, and tax cuts are providing an additional $350 billion tailwind to the economy. We also maintain our projection of up to 3% U.S. GDP growth in 2018, a forecast also outlined in our Midyear Outlook.

THE RISKS

We recognize that there are substantial risks to our optimism on EM economic growth, which could end up weighing on U.S. economic growth as well. The biggest risk to our economic projections is a full-blown global trade war. Larger and more severe tariffs could hinder China’s economic activity and further destabilize emerging markets, given China is the most influential country for EM growth. We estimate that tariffs imposed to date would cause only a 0.1% to 0.2% drag on U.S. GDP annually, but this headwind could increase if more meaningful tariffs are implemented.

Further gains in the dollar also pose a risk to both EM and U.S. economic growth [Figure 2]. A strengthening dollar often results in weaker EM currencies and further economic disruption.
The dollar’s rally could pressure the prices EM consumers pay for food and energy, boost import prices, and make it difficult for EM corporations and governments to service about $4.5 trillion in outstanding dollar-denominated debt. The Federal Reserve must also be mindful of global stability when deciding on future monetary policy, so the central bank may need to tone down future monetary directives in an effort to stabilize the dollar’s rise and protect emerging markets from economic instability.

There are also intangible impacts to consider. Recent management commentary suggests that some U.S. companies may delay business spending as they await greater clarity on trade discussions. We also recognize that any instance of global fragility can have a general chilling effect on domestic economic sentiment. Investors may also ultimately choose to reduce (or eliminate) their exposure to Turkey and EM to protect themselves from geopolitical turmoil.

**CONCLUSION**

Recent events in Turkey have been understandably unsettling for investors. It can be difficult to quantify the implications, and currency crises in the past (such as the Thai baht crisis) have devolved into financial market panic.

However, we believe the current situation in Turkey will remain relatively contained, and high growth prospects for emerging markets will prevail after currency fears subside. We expect EM economic activity from advantageous consumer demographics and early cycle acceleration to help offset any negative impacts from weakening currencies or geopolitical turmoil.

Nevertheless, we’ll continue to monitor developments in emerging-market countries and the risk of global contagion on the U.S. economy.
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