At a tipping point: a currency crisis roils Turkey's economy

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Turkey's $720 billion **economy** rebounded surprisingly quickly after the coup last summer, but that may be about to change as political turmoil grows, the lira drops and foreign direct investment dries up. This weekend, the country was roiled again by bomb attacks that killed 38 people and wounded 155 outside a soccer stadium in Istanbul.

The Turkish currency has lost nearly 20 percent against the dollar this year, a large enough drop to declare a currency crisis, said Steve Hanke, director of the Troubled Currencies Project at the Cato Institute. On Monday, the lira fell more than 1 percent hit by data showing Turkey's**economy shrinking for the first time since 2009** by 1.8 percent in the third quarter.

"The Central Bank has done a surprisingly good job until now," said Hanke. "But things have deteriorated rapidly."

Last week, President Tayyip Erdoğan appealed to Turkish citizens to convert savings held in foreign currencies into gold and Turkish lira. As of press time, the lira had fallen to 3.47 **lira** against dollar. Gold is on track for **one of its worst quarters in two decades.**

According to economists, the fear is if uncertainty persists it could induce capital flight out of Turkey and that could put the country on shaky ground.

The political turmoil is affecting foreign direct investment which keeps the economy afloat. It fell 68 percent in the first seven months of 2016 to $2.5 billion, down from $7.5 billion in the same period 2015, statistics from the Turkish Treasury reveal.

"The key concern for foreign investors relates to the erosion of the rule of law," according to Sinan Ulgen, managing partner at Istanbul Economics and a visiting scholar at the Carnegie Endowment for International Peace. "Turkey is going through exceptionally difficult domestic conditions following the botched military coup of last July."

The currency crisis comes in the wake of a series of events including the**European Parliament voting to suspend talks with Turkey on EU membership; Donald Trump's** election, which roiled emerging markets; and the erratic behavior by Erdoğan.

In the past three weeks, he has threatened to allow about **3 million migrants to flood the European Union** if the **EU** blocked membership talks, which it did temporarily in response to his targeting of political dissidents. Erdoğan also launched what Hanke called "a war with his own central bank."

He has been resisting the normal response to a sliding currency — higher interest rates — and instead asked Turkish citizens to buy lira and gold to prop up the lira.

Just as alarming is the crackdown Erdoğan has imposed to root out perceived internal enemies. It has included shutting down social media channels including Facebook and Twitter and taking over some **496 companies**, some with publicly-held units, in the hunt for coup plotters. Purges have even included the Capital Markets Board, preventing voting on debt and capital issuances for more than two months until the government appointed new board members.

US companies at risk

For U.S. companies with major investments in Turkey the turbulence is unsettling. Among those at risk are **Microsoft**, **Intel** and **Coca-Cola** that have their **regional headquarters** there and are exposed to domestic market turmoil.

Ford has spent $1.6 billion building factories in Turkey, making the country its export hub for Europe. The company has a partnership with Turkish holding company KOC Holding AS. With over 10,600 employees, Ford is the biggest employer in the Turkish automotive industry.

GE also is heavily entrenched in Turkey. In 2012, GE, announced a three-year $900 million investment program that supplies turbines for wind farms, builds locomotives and manufacturers engine blades. Today, the company supplies 26 percent of Turkey's electricity. Interviewed on an annual trade mission to the U.S. in November, Canan Ozsoy, CEO of GE in Turkey, would only say that it has been an "interesting" year to pitch Turkey as a trade destination.

Other western companies have also poured hundreds of millions of dollars into the country including **Procter & Gamble** and **PepsiCo.**

For now, Turkey's currency crisis is deterring foreign investors but companies with important investments in the country remain committed to the nation's long-term prospects. Some — like PepsiCo and GE — are continuing their expansion plans. For example, PepsiCo is building a sixth factory for $120 million and GE Health announced it would be part of a group financing a $668 million health campus in Izmir, according to the Investment Support and Promotion Agency of Turkey.

Some private investors and bargain hunters that can stomach volatility are launching funds in Turkey. For example, Abraaj Group, a $9.5 billion private equity firm that invests in some of the world's most volatile markets, created a $526 million Turkey Fund that is betting on the long-term growth of the Turkish economy.

"It is a very pro-business government," said Serra Akçaoglu, chief executive of Citibank Turkey. "That makes us feel better." She said the government had enacted a list of 25 reforms to improve the investment climate and seems determined to keep interest rates low.

The **reforms** include corporate tax exemptions and a boost in export financing.

Whatever the future holds for Turkey, it's important to understand the the country's market dynamics. Through 2015, the Turkish economy had been holding its own in the face of the refugee crisis and the civil war in neighboring Syria. Turkey had been on a path of economic growth, with expected GDP growth this year of more than 3 percent, according to the World Bank. In 2015, the Turkish M&A market recorded a total deal volume of $16.4 billion through 245 deals, a slight decrease from 2014, according to a **report** by consultancy Deloitte. Foreign investors accounted for 70 percent of the total deal volume.

After the geopolitical situation worsened, with the abortive coup this summer, the growth estimate was revised and lowered to **2.4 percent**due to challenges of supporting the influx of refugees, rising unemployment and a decline in investment activity. As a result, Moody's Investment Service has cut its rating on Turkish government bonds to below investment grade. One reason Moody's cited was concerns about rule of law.

A threat to the political and economic ties between Turkey and the EU is serious: Turkey is the European Union's fifth-biggest trading partner, with total trading volume of 140 billion euros. The start of a new round of trade liberalization talks with the EU is expected for early 2017. The goal is to help Turkey to upgrade law standards and provide sound guarantees for overall investment protection.