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Free Falling Turkish Lira—What's Next?

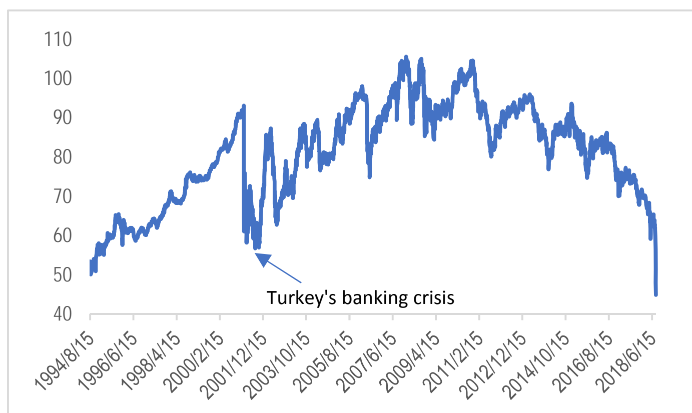
Since the end of July, the Turkish lira has declined close to 30%, sovereign CDS spreads have widened 250 bps to 570 bps, and local five-year bond yields have risen to 24%. Without comprehensive policy action, the free fall in the lira is likely to continue and risks unleashing a full-blown run on the banks and the $147 billion in resident dollar deposits. In principle, the policy options are clear but, as so often, all are politically costly, although to different degrees. Timing of decisive policy action remains uncertain—both President Erdogan's and Treasury and Finance Minister Albayrak's policy speeches on Friday and over the weekend served to further undermine market confidence.

The root cause of the crisis lies in a leverage-financed domestic demand boom that increased the external financing requirement of Turkey's corporations, banks, and government to an estimated $229 billion this year. Most of these liabilities fall on the private sector, mainly banks and corporates; the sovereign owes only $11 billion. What makes the problem worse is that the external financing requirement is trending up over the medium term, indicative of a long-standing over-reliance on foreign-funded leverage.

As the lira collapses, this lending boom now is undoubtedly grinding to a sudden halt. Foreign financiers, whether banks or bond investors, are re-assessing the outlook and related repayment prospects. Western European banks from Spain and France are particularly exposed, with over half of the debt owed to them. The trouble is that the Turkish financial system, as well as the corporate sector, are short dollars. We estimate that the financial system—the central bank and commercial banks combined—hold net foreign exchange liabilities (NFL) of about $27 billion (as of June 30, 2018). While that is undoubtedly a manageable figure, these liabilities only pertain to foreign lenders. Including the $147 billion in dollar deposits by resident households and firms, the "adjusted" NFL spirals up to nearly $175 billion—an undoubtedly less manageable figure.

This magnitude illustrates the paramount importance of immediate policy action to forestall a potential bank run that risks draining a large part of these deposits and risks burdening the hitherto fairly clean sovereign balance sheet. Absent such quasi-fiscal liabilities, the sovereign is overall in good financial shape. The general government stock of foreign debt amounts to $95 billion (as of March 31, 2018, approximately 14% of GDP), giving rise to amortization of some $10 billion per year over the medium term.[1]

Figure 1: The Lira's Free Fall in Real Effective Exchange Rate Terms



Source: Bloomberg as of August 13, 2018.

[1] *Public-sector-banks' foreign liabilities of $44 billion (end-March 2018) excluded from general government debt stock.*

The known unknown of course is what will happen to GDP in dollars. As a frame of reference, Turkey's 2001 banking crisis resulted in a GDP drop of approximately 25%. A more pronounced decline was averted thanks to the orthodox macro stabilization policies under the successful IMF program. A similar decline would lower Turkey's dollar GDP to about $650 billion. Absent such policies, however, in a pessimistic case, dollar GDP could decline well beyond this figure, possibly to about $400 billion. In either case, taken on its own, the sovereign debt load would still seem manageable.

Nevertheless, this conclusion once more highlights the critical importance of limiting the flow of private liabilities onto the sovereign balance sheet. The private sector holds $120 billion in short-term foreign liabilities and another $227 billion in long-term foreign liabilities (as of March 31, 2018). The central bank estimates that the non-financial corporate sector holds a short net foreign exchange position of $217 billion (May 2018). This sizeable short position underscores the risk of corporate default, especially in the transport, communication, energy and construction sectors that are known to have no meaningful dollar revenues. To the extent that the burden of such defaults would fall on the domestic banking system, rather than on prominent European lenders, they would also raise quasi-fiscal risks.

Difficult Policy Options

At this juncture, the economy is likely to enter stagflation. The collapse of the lira combined with dwindling foreign financing is bound to depress activity and heighten inflationary pressure. All policy options are painful, but their costs critically hinge upon swift implementation. Any undue delays would risk adding to the economic and political costs. The overriding objective of any policy package would be to manage Turkey's large external financing requirements in order to limit the economic and social fall-out from a potentially severe funding shortage. A key element of such a strategy is to forestall a possible run by the public on the lira and the FX deposits in the banks.

Orthodox Policy Package

An orthodox policy package would involve several cornerstones. Its timing and credibility is key. Any undue delay may require turning to the IMF, as unpalatable as that may seem for the authorities.

- **Monetary policy**—A confidence building interest rate hike is necessary. It is likely that inflation expectations have become unhinged; the market is pricing in about 800 bps in rate hikes to the 17.75% policy rate. To avoid the need for piecemeal policy tightening, a rate hike of at least 10% seems warranted. Swap lines from major central banks would be of great help, but may be difficult to orchestrate, given strain on the foreign policy front.
- **Procyclical fiscal tightening**—politically very costly, but necessary to help reduce the savings and investment imbalance and, therefore, bring the current account deficit closer to balance; as a result, external financing requirements would decline commensurately.
- **Productivity enhancing structural reform**—necessary to raise potential output growth and help mitigate the savings investment imbalance.

Heterodox Policy Package

The unsavory political costs of any orthodox package may result in an alternative approach. Rather than rebuilding investor confidence and securing foreign funding through an orthodox policy tightening, capital controls would likely be central to a heterodox policy package. In an attempt to circumvent the "diktat" of the market, the temptation would be to tap into the large FX deposits in resident banks. In principle, this could be done by forcibly converting some of these deposits into lira. Besides being highly unpopular, such an approach harbors considerable risks. Any hint of capital controls could trigger a capital stampede out of Turkey. Moreover, a significant share of the foreign funding sources would likely dry up immediately and trigger an even deeper recession. A dramatic change in the investment regime would also have substantial adverse consequences over the medium to long term. Another possibility would be a turn by Turkey to other foreign sources of financing such as Russia or China. Given Turkey's membership in NATO, the implications of this could be substantial.

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Geopolitics

The economic situation in Turkey is made substantially more complicated by U.S./Turkish relations, with a long list of grievances on both sides. The U.S. is pressing for release of American Pastor Brunson, who the Turks arrested as a conspirator in the coup against Erdogan, and for the Turks to participate fully in the sanctions against Iran. Additionally, U.S. relations were soured by the Turkish unwillingness to allow use of bases and airspace during the Iraq war. The Turks, on the other hand, are demanding an end to U.S. military support of the Kurds, an exemption from future Iran sanctions and leniency for past violations, and extradition of Fethullah Gulen, who they claim organized the 2016 coup attempt. Each side seems to be digging in, with the Trump administration threatening last Friday to double tariffs on Turkish steel and aluminum and Erdogan claiming in speeches that the west is waging an economic war against his country.

The good news is that the two sides continue to meet, but unfortunately with no effect so far. A meeting on August 8, 2018 between nine Turkish ministers and U.S. Deputy Secretary of State Sullivan resulted in no movement from either side.

Strategy and Market Outlook

Given all of the above, our base case is for continued volatility in Turkish assets. An improvement of the political impass could be signaled by the release of Pastor Brunson, which could have a near-term positive impact on the market. Even if this were to occur, absent a sharp shift in macroeconomic policies the Turkish economy is at risk of a hard landing with significant reduction in GDP and potential distress in corporates and banks. We will be monitoring the potential for runs on hard currency deposits in local banks, as well as signs of stress in corporates with currency asset/liability mismatches.

The dramatic selloff has made the Turkish lira cheaper on an inflation adjusted-basis than it has been since the 1990s. Despite this, we are avoiding exposure to Turkish local markets until we get a better sense of a more orthodox policy response from the government.

While the near-term outlook for hard currency sovereign bonds is also uncertain, our base case is that the sovereign remains solvent. Sovereign creditworthiness is buttressed by a low 11% external government debt/GDP and manageable short-term liabilities, but this strong balance sheet is partially offset by the likely sharp decline in GDP, the potential need to fund a bailout of the banking system, and intransigence to enact orthodox economic measures.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of August 2018

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