

TRIP NOTES

Turkey—A Short-Term Reprieve Amidst Persistent Uncertainties

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Turkey's economic crisis [erupted one year ago](#) with a calamitous depreciation of the Turkish lira. We recently returned to Turkey to take stock and gauge the outlook. This paper draws heavily on the insights gleaned from that trip.

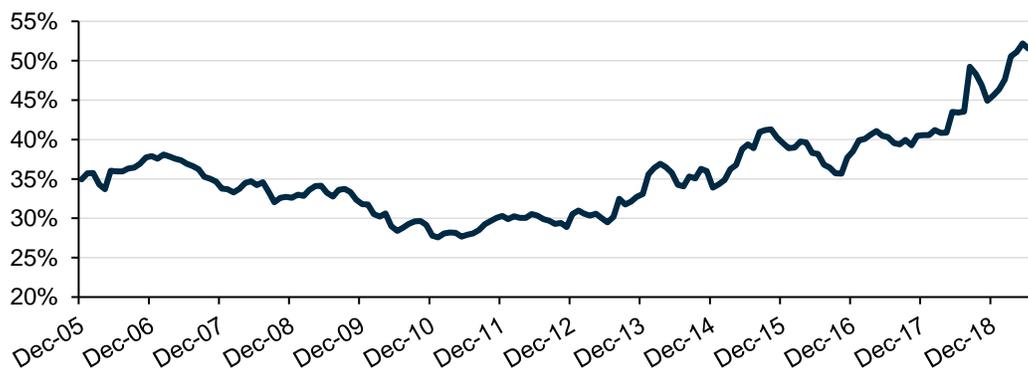
Turkey's large external financing requirements will likely remain its key vulnerability for the foreseeable future. Funding flows should continue normalizing, albeit at a lower level, provided that the favorable external environment holds up and any shocks that would halt (or reverse) capital inflows can be avoided. In this context, it is noteworthy that political uncertainty appears to have "troughed" and now seems less likely to hamper foreign financing flows.

Economic policy, however, remains decidedly ad-hoc and heterodox. Growth apparently remains the overarching policy priority, and any policy missteps risk draining the rather limited (unencumbered) official FX reserves. However, should such a scenario materialize, the authorities could turn to the IMF as a measure of last resort. On balance, we remain cautiously constructive on Turkey's outlook.

Limited FX Reserves and Large External Financing Requirements

Turkey's banking system was central to the foreign borrowing binge that set the stage for the ongoing economic crisis. Political uncertainty combined with ad-hoc policy decisions spurred large-scale dollarization. As result, slightly more than half of the deposit base is now held in FX (see Figure 1).

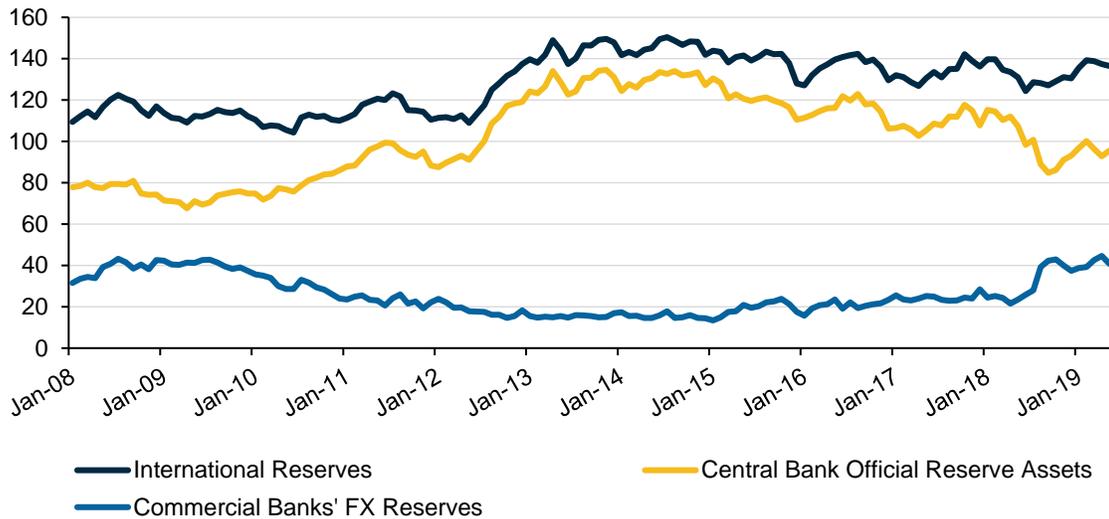
Figure 1: Share of FX Deposits in Overall Resident Deposits



Source: Haver Analytics and PGIM Fixed Income as of May 2019.

Dollarization and the resultant rise in banking sector FX liquidity added to pressure on the Central Bank of Turkey's (CBT) FX reserves. At \$96 billion (May 2019), the CBT's gross official foreign exchange reserves remain substantially below their pre-crisis levels (see Figure 2). Furthermore, dollarization heavily encumbers these reserves. We estimate the CBT bank "owes" \$51 billion in FX and gold to the domestic banking system on account of its fulfillment of central bank reserve requirements.¹ Although these funds are clearly available for reserve management purposes, they are a liability to the banking system and, ultimately, can be called in by Turkish depositors—much of it on short notice.

Figure 2: Much of the CBT's Still-Recovering FX Reserves Remain Encumbered By Reserve Requirements



Source: Haver Analytics and PGIM Fixed Income as of May 2019.

Gross official FX reserves, adjusted for the amounts owed to the banking system for reserve requirements, were \$45 billion at the end of May 2019. Subtracting reserve assets held in gold, lowers this figure to an estimated \$28 billion.² To mitigate some of the pressures on gross official reserves, the CBT effectively borrows FX from the Turkish banking system via FX swaps in exchange for extending Turkish lira liquidity. The amount of these swap operations varies on a daily basis, but further reduces the CBT's unencumbered FX cash reserves.

However, as dollarization has shifted FX liquidity from the CBT to the commercial banking system, FX reserves of the overall banking system—CBT and commercial banks combined—have remained surprisingly stable, especially given the depth of the crisis.

Turkey's external financing requirements exceed the CBT's unencumbered reserves by a considerable multiple, although the current account has swung to a modest surplus by now and is expected to stay broadly balanced next year. At \$119 billion (at the end of March 2019), short-term debt maturities alone exceeded the gross official exchange reserves. Furthermore, the authorities estimate that next year, \$52 billion is due in amortization on medium- and long-term debt.³

Overall, we estimate next year's external financing requirement in the order of \$175 billion. These figures are daunting—they underscore the imperative of macroeconomic stability, particularly with the lira.

¹ Approximately \$43 billion are on account of reserve requirements (RRs) on FX deposits; nearly another \$4 billion are held in FX in fulfillment of RRs on Turkish lira deposits under the reserve option mechanism (ROM). Likewise, an estimated \$4 billion of the central bank's overall gold holdings of \$21 billion are deposited by commercial banks under the ROM in gold (in fulfillment of RRs on TRY deposits).

² Overall CBT gold reserves were nearly \$21 billion in May, of which \$4 billion are held on account of reserve requirements under the ROM.

³ These liabilities may be larger by some \$23 billion according to the 2018 Article IV Staff Report; updated estimates are currently not available from the IMF.

Premium on Policy Credibility

The inflation outlook is central to lira stability. Consumer price inflation peaked at 25% year-over-year in September 2018 and has subsequently fallen rapidly to 16.7% (as of July 2019). The base effects of last year's sharp currency depreciation are starting to recede from the inflation index and, on current trends, inflation is likely to bottom out in October/November and may end 2019 near 12% year-over-year.

Against this backdrop, the CBT initiated a rate cutting cycle, lowering its one-week repo rate by a whopping 425 bps to 19.75% in July. This larger-than-expected move was clearly designed to fully unwind the emergency rate hike from September 2018 that reportedly caused a major rift between the CBT and President Erdogan. But even at the reduced policy rate, the real interest rate remains at 3% and could rise absent further rate cuts. While we see scope for another 400 bps in rate cuts, a "go-slow approach" is vital in order to maintain lira stability, facilitate a further decline in inflation, and contain the risk of sudden stops and capital outflows.

Beyond the very near term, the inflation outlook is fraught with considerable uncertainties. Unless monetary policy remains tight, inflation risks trending up next year and any potential wavering by the authorities could be seen as a potent signal that Turkey may be shifting towards a higher inflation regime on a more permanent basis.

Although this uncertainty is currently difficult to resolve, the 2020 budget could provide important information in this regard. On the one hand, overly optimistic growth and revenue assumptions could necessitate reliance on the inflation tax and signal a shift towards a permanently higher inflation regime. In our estimation, such a strategy risks sparking further dollarization and could well undermine the all-important foreign financing flows. As a result, it would risk draining further official FX reserves, thereby exacerbating Turkey's most pressing macro vulnerability.

Political Uncertainty Appears to Have Troughed

Turkey is infamous for its constantly evolving political challenges. President Erdogan and his AKP party conceded defeat in June in the repeat elections for the mayor of Istanbul, suffering the first major loss at the hands of the opposition. While the immediate impact is likely to be marginal, this outcome provides renewed impetus to opposition forces, and the first signs of changes to the political landscape are emerging. Ali Babacan, former Deputy Prime Minister (PM) and economic reformer, is forming a new political movement that is looking to go live before year end. This movement may chip away at the support for President Erdogan and could attract dissenting ministers of parliament (MPs) from the ruling AKP party as could another new party that is being formed by former PM Davutoglu, who is also a former leader of the AKP.

Banks Should Survive; Modest Recapitalisation Would Help

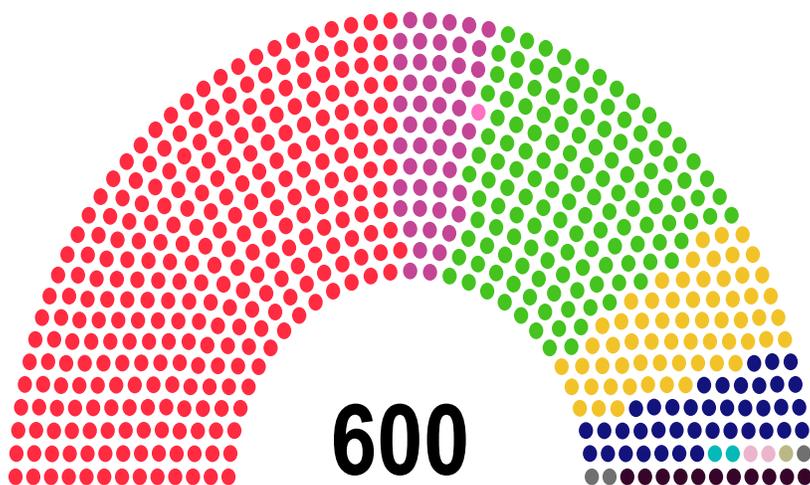
While the external funding requirement remains the key vulnerability for Turkey's banks, this does not appear to be of immediate concern. We estimate existing excess FX liquidity is sufficient to service large banks' FX bond and syndicated loan maturities for 18 to 36 months (should refinancing access be unavailable). A key worry would be depositor flight, including FX deposits. Yet, the August-September 2018 run on the lira did not lead to meaningful cash FX withdrawal nor SWIFT transfers abroad.

Many investors question the reliability of the sector's reported NPL (non-performing loan) figures. A key difference of these against the newly emerged European Banking Authority (EBA) standards relates to existing loans that have been restructuring or have forbearance applied to them. To summarize, we would estimate the current 4.36% figure provided by the Turkish regulator for "stage 3 NPLs" would be around 7% of loans under the new EBA standards. At a rounded exchange rate of TRY6 to 1 USD, this would equate to about \$30 billion of NPLs in the system compared to \$17.5 billion reported by the regulator and \$40 billion of loan loss reserves.

Perhaps the more important unknown is the potential peak NPL ratio. Significant EM banking crises (outside of sovereign defaults) set peak NPL benchmarks that ranged from 7.5% on mortgage loans, 15% on non-FX leveraged corporates, 20% on domestic currency unsecured consumer loans, and 25% for corporates that borrowed in FX without predominant FX earnings. Looking at the structure of corporate borrowing in Turkey, this leads to a weighted average NPL rate of 17.5%. On this, a weighted average expected loss rate would be nearer 75%. The impact of this would be for the banks to have an added credit provision need of just under \$40 billion through the cyclical downturn. This is almost the same as the estimated pre-provision earnings generating capacity of the system at the end of 2020 (on the basis of multiplying the year-to-date amounts). Thus, the system as a whole could have zero earnings accumulation (there currently being virtually no dividend payouts).

Our estimate is that a relatively modest recapitalisation of \$10 billion could help the sector maintain the current average equity capital ratio. Some of this could come from foreign owners of banks or from a recapitalization fund.

Figure 3: The AKP-MHP Coalition Remains in Control, But, Under Certain Circumstances, Early Elections Are Not A Foregone Conclusion



Political Groups	Seats	Alliance
AKP-MHP	340	Governing Coalition
CHP	139	Opposition
HDP	62	Opposition
İYİ	39	Opposition
Other	10	Other Opposition
Vacant	—	10

Source: Grand National Assembly of Turkey and PGIM Fixed Income

However, under the Presidential system, Parliament needs a qualified majority to call early elections. Achieving such a three-fifths majority would require 360 votes in the 600-member Parliament (see Figure 3); in other words, 110 MPs would need to break away from the ruling AKP-MHP Alliance coalition, and the opposition would need to vote in unison (250 votes) in favor of early elections.⁴ This is a tall order and, therefore, may not be achieved without a decision by the nationalist MHP to end the ruling coalition at some later stage, even though at present, the party is determined to remain in the coalition government. Such a break could mobilize (a maximum of) 50 votes and would likely maneuver the AKP into a minority government. At such a stage, an early election may no longer be inconceivable.

Conclusions

Turkey's high external financing requirements combined with its low official FX reserves remain its Achilles heel. However, in the near term, political risks appear to have troughed, and the U.S. has so far indicated a light-handed sanction response to the S-400 weapons issue. Moreover, amidst the unexpectedly benign external environment, external financing flows have begun to normalize, while the banking system has used its FX liquidity to begin the deleveraging process. As another tailwind, inflation is coming down swiftly largely as base effects from last year's lira collapse are dropping out of the CPI index, and the central bank can embark on interest rate cuts.

Against this favorable near-term backdrop, the 2020 budget preparations may provide an important indicator for the risks ahead. If fiscal policy supports the recovery with an appropriately loose stance, based on realistic growth and inflation assumptions, the central bank would have the flexibility to curtail inflation beyond just the "lucky tail winds" from the dissipating base effects of the prior lira devaluation. Such a stance could shore up the lira and support continued foreign financing flows, thereby mitigating Turkey's key vulnerabilities.

On the other hand, if the 2020 budget projects revenue or expenditure developments in an overly optimistic manner, it could markedly increase the risk that the authorities may have to resort to the inflation tax as a means of financing fiscal overruns. Monetary laxity could trigger renewed lira instability and a possible ebbing of foreign financing flows. However, even in such a scenario, we remain constructive on repayment prospects for sovereign debt. Against this backdrop, PGIM Fixed Income has continued to increase its exposure to Turkey amidst the favorable current tailwinds, especially in hard currency bonds.

⁴ The opposition jointly has 250 votes; there are 10 vacant posts in parliament.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of August 2019.

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