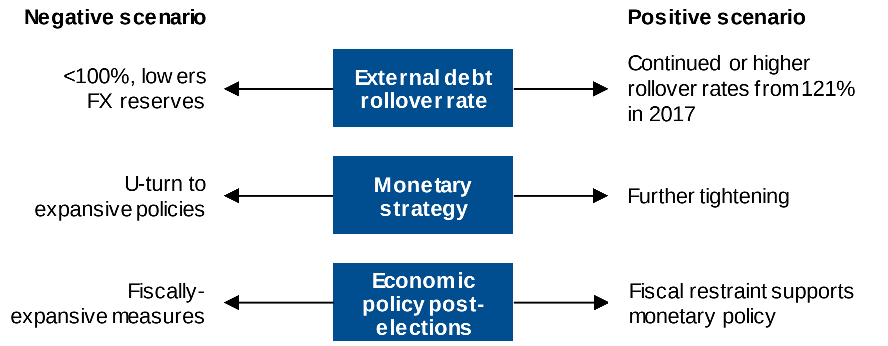
Mind the external gap: currency and inflation risks challenge Turkey's foreign debt roll-over

Turkey's (BB+/stable) risk perception has increased since the beginning of the year, as global liquidity conditions coupled with escalating local political tensions have raised the question of whether Turkey can meet its external financing needs. It is Scope's view that the uncertainties surrounding the upcoming early elections, a shift towards greater protectionism as well as persisting regional geopolitical tensions, create challenges. The Turkish Lira remains volatile despite significant interest rate rises, and inflation is well above target. A credible economic framework will be key to maintain confidence in this complex environment.

EM economies with large external financing needs like Turkey have been a focus of investor unease this year. The Turkish lira has depreciated faster with greater volatility against the USD than many other EM currencies, as recently evidenced in rising risk premium reflected in higher currency swap rates across all maturities and widening bonds and CDS spreads. Stronger risk aversion against Turkish assets reflects the country's high short-term external debt, widened current account deficit and investor worries about the credibility of authorities. This constellation makes the post-election economic policy framework a key factor for sustaining roll-over of Turkey's external debt as seen in Q1 2018 despite challenging conditions; next to the broader macroeconomic context and investor reaction to the outcome of the snap elections on the 24th June.

One underlying issue is that Turkey's widened current account deficit requires continuously high roll-over rates of external debt. For 2018, Scope believes that Turkey will manage to roll over its external debt, but high rates will negatively impact economic growth. The rationale behind Scope's expectation are the i) favourable structure of Turkey's short-term external debt limiting the country's exposure to sudden short-lived capital outflows and increasing the probability of being redeemed or refinanced; ii) soundness of the Turkish banking sector with adequate liquidity buffers and strong relationships with foreign banks; and iii) burdened but still healthy public finances which have cushioned the economy from shocks.

Figure 1: Scenarios



Source: Scope Ratings GmbH

The incoming government will be confronted with a negative feedback loop of currency weakness leading to monetary tightening, resulting in lower GDP growth of 5% in 2018 from last year's 7%. The recent central bank rate hikes are steps in the right direction but higher inflation over the summer period will likely offset the impact of recent hikes on the real policy rate. Therefore, monetary policy will need to remain tight, and matched with fiscal restraint to demonstrate a comprehensive anti-inflation policy. Focusing Turkey's economic policy agenda on lower but more sustainable growth rates would help the credibility of policy making at the central bank limiting external financing stress.

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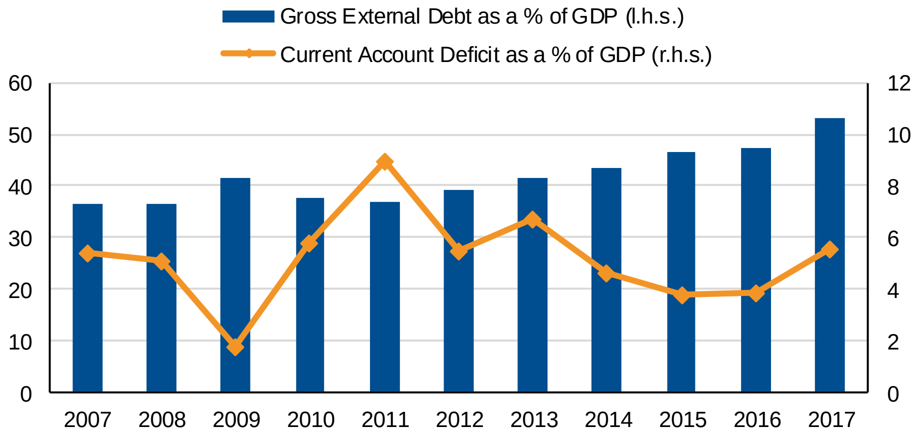
#1: External debt-roll over

Widened current account deficit and rising external debt

When comparing Turkey's position in an EM context, main investor concerns regarding the Turkish economy are its widened current account deficit (from 3.8% in 2016 to 5.6% in 2017) which has been partially financed with more volatile capital flows and increasingly high external debt stocks. Turkey's external debt increased to 53.2% in 2017, reflecting insufficient domestic savings which caused a surge in private sector's debt stock in the last decade as the Turkish economy has grown at a higher pace thanks to abundant global liquidity.

Figure 2: Current Account Deficit and External debt as % of GDP (2007-2017)



Source: Central Bank Turkey, Calculations Scope Ratings GmbH

Key fragility: Large external financing needs

Global liquidity conditions coupled with escalating local political tensions triggered the question of whether Turkey will be able to sustain its large external financing needs, a key fragility of the Turkish economy. In line with recent years, Turkey's external financing requirements of around 25% of GDP in 2018 are mainly determined by external debt maturities (around 20% of GDP) and the increased current account deficit. A rule of thumb in assessing external vulnerability for today's environment, where capital flows dwarf trade, is the 'Guidotti-Greenspan rule'. This rule states that usable foreign exchange reserves should be sufficient to meet all repayments and interest costs on foreign debt payable over the following year[1]. This rule is sometimes expressed as 'being able to live without new foreign borrowing for up to one year'.

Low FX reserves compared to the stock of short-term debt

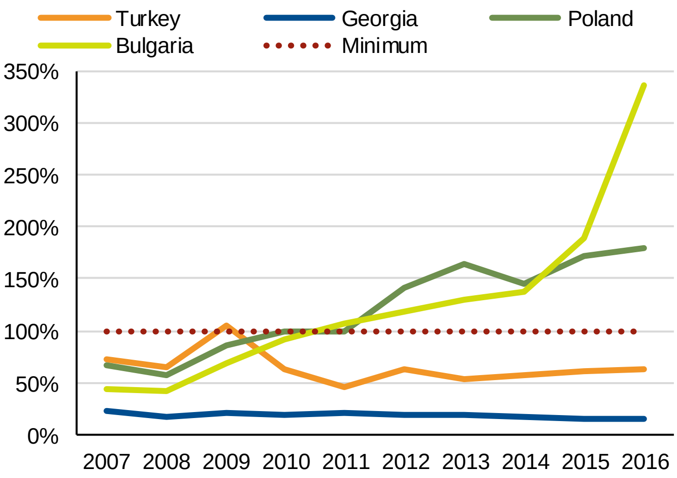
At the end of Q1 2018, Turkey's external debt stock maturing within 1 year or less amounted to a high USD 181bn, mostly denominated in USD and EUR. As a first step in the analysis, Scope expanded the Guidotti-Greenspan Rule by adding external financing needs from the current account deficit, adjusted by foreign direct investment flows (like intra-company loans which are less prone to market volatilities) to the rule (i.e. to the denominator)[2].

Compared to other EM countries, Turkey's FX reserves are low and on a worsening trend using the expanded rule. This helps explain, in line with the geopolitical developments and rising risk premia for EM countries, why the Turkish lira depreciated faster than other EM currencies. However, it is Scope's view that the (expanded) Guidotti rule has the advantage of simplicity, with the caveat that it merges short-term external debt as one type of potential claim and compares it to international reserves.

[1] Minimum Ratio: FX Reserves / Short-term external debt = 100%.

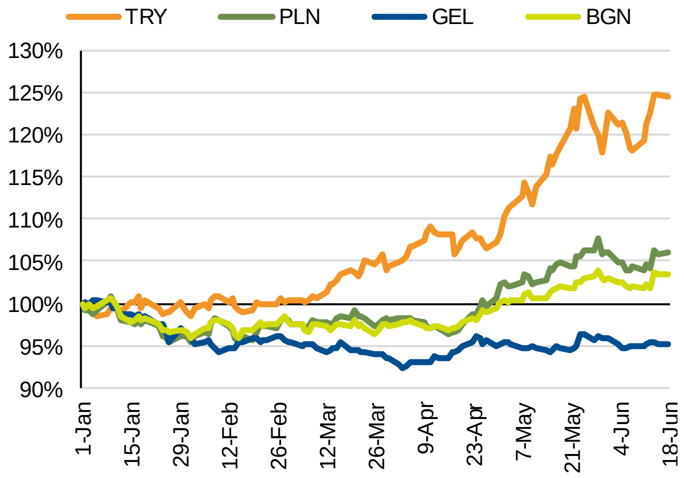
[2] Scope notes that the rule implicitly assumes that there is a balanced current account, no other capital transactions, and no capital flight which would be most likely to occur just when the adequacy of reserves is attracting investor's attention.

Figure 3: Expanded Giudotti-Rule, 2010-2017



Source: Haver, Calculations by Scope Ratings GmbH

Figure 4: Currency depreciation since beginning of 2018



Source: Haver, Calculations by Scope Ratings GmbH

Structure of external debt determines a country's exposure to market volatilities

A more sophisticated approach would also look at the structure of financial claims and their probability of being redeemed or refinanced during short-lived market shut-downs. It is Scope's view that the FX reserves should be compared with a volatility-weighted aggregate of liabilities to more precisely quantify the exposure to sudden capital outflows or short-lived market shut-downs. In this regard, next to FDI, which proved to be more stable than portfolio and bank flows during the Asian crisis, trade-related credit is also less volatile than other forms of short-term credit, for example (see p.4 for more details). For this reason, Scope took a closer look at the structure of Turkey's external debt stock (latest available data) maturing within 12 months, according to the type of debt.

1) Government debt (3% of short-term external debt) – low roll-over risk

Low external financing needs from government

Government of Turkey benefits from good international market access, healthy public-sector financial balances, strong fiscal indicators and overall low general gross financing needs of 6.5% of GDP in 2018 and 7.1% of GDP in 2019. Since the global downturn in 2008, fiscal discipline became even more important for Turkey, as reflected by a declining ratio of public debt stock to GDP (to 28.5% in 2017 from 43.9% in 2009), demonstrating commitment to fiscal discipline over a long period.

2) Bank sector (57% of short-term external debt) – medium roll-over risk

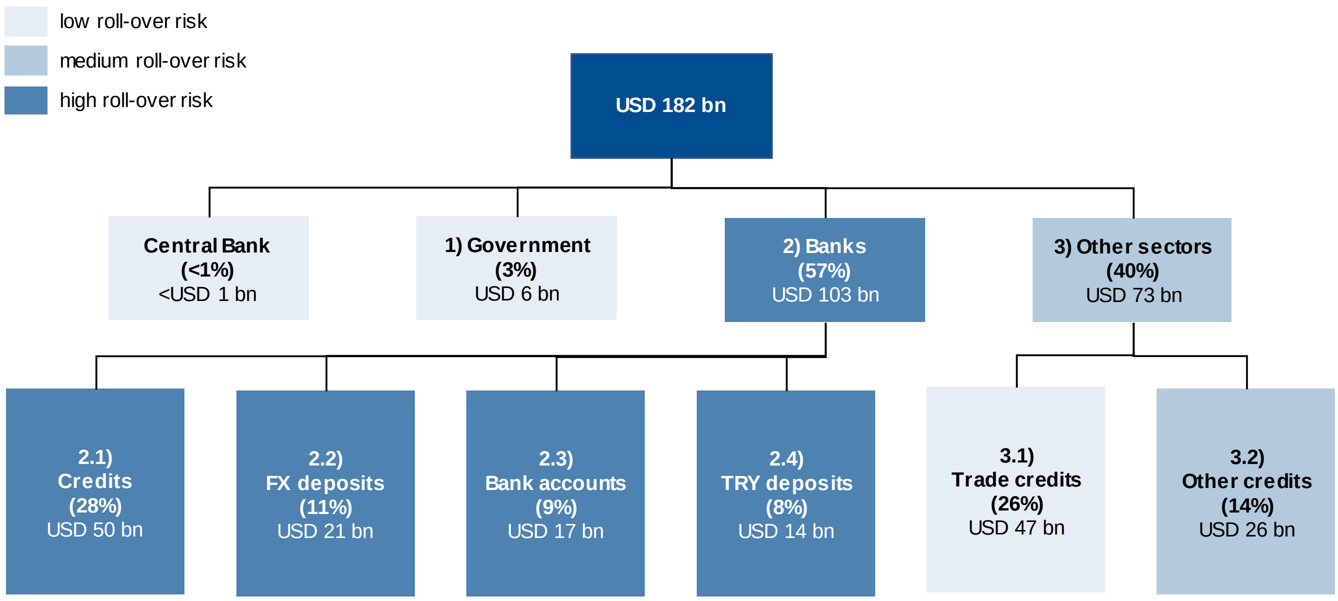
High external financing needs from bank sector reflect strong FX-denominated loan demand

The high level of Turkey's financial sector's short-term external debt stock (USD 103bn in Q1 2018) reflects strong FX-denominated loan demand from the real economy, financed by abundant global liquidity. Strong loan growth above the historical averages in 2017 contributed to a further increase in bank funding requirements. However, the recent loan growth was driven mainly by Turkish lira sources which increased deposits leading to a moderation of foreign source demand by banks. An important structural factor for the increase in external debt of banking sector has been the reserve option mechanism introduced by the Turkish Central Bank in 2011 as banks almost fully utilized the mechanism (USD 30bn) to maximize their interest margins and profits.

Bank sector maintained strong liquidity position in Q1 2018

Despite these challenging conditions, the bank sector maintained its strong liquidity position in Q1 2018 and is increasing its use of foreign sources. Moreover, syndicated loan rollovers by banks rose to 111% in Q1 2018 from 100% at the end of 2017. Loan spreads were not widening, the cost of borrowing has only increased due to rising international LIBOR. The external debt roll-over ratio continues its path above 100% despite increases in costs. In addition, banks can borrow syndicated loans with up to two years of maturity, indicating continued credit supply from foreign financial institutions, also acknowledging the Turkish banking sectors' strong capital base and high return-on-equity ratios, sound asset quality and adequate level of liquid assets.

Figure 5: Structure of external debt maturing within 12 months at the end of Q1 2018 (regardless of original maturity).



Source: Central Bank of Turkey, Calculations Scope Ratings GmbH

3) Other sectors (40% of short-term external debt)

Redemption of trade credit is supported by central bank measures

Trade Credits (26% of short-term external debt – low roll-over risk) are less prone to market volatilities than other forms of short-term credit. This is due to the typical repayment structures, underlying business relations and goods/services of the credit transaction, resulting in a different payment character compared to repayments to holders of bullet bonds, for example. Furthermore, Scope positively notes the additional Turkish central bank measures applied on 25th May. In principle, the measures will cap the costs on repayments of external debt (related to lira-depreciation effects) for fundamentally important exporters and foreign exchange earning services.[3]

Key uncertainty is roll-over of corporate loans

Other credits (14% of short-term external debt – high roll-over risk) have a higher exposure to sudden capital flow shocks as the macroeconomic environment pushes inflation and interest rates higher and makes it more expensive for companies to service and repay foreign currency-denominated loans. Although the upward trend in the real sector's FX open position (short- and medium-to-long-term debt) moderately slowed down in 2017, the size of the significant open position of around USD 220bn at the beginning of the year is a risk factor. High levels of FX liabilities may increase the vulnerability to exchange rate shocks of firms with insufficient amount of FX income and assets or with maturity mismatches in their balance sheets. In this context, Scope positively notes efforts based on Turkey's FX debt regulation and systemic risk data tracking, which was initiated for the FX debt management of large corporates.

[3] Repayments of rediscount credits for export and foreign exchange earning services that have been extended before 25 May 2018, which will be due by 31 July 2018, can be made in Turkish liras at an exchange rate of 4.2 for the USD, 4.9 for the Euro, and 5.6 for the GBP at the cost of central bank, if they are paid at maturity. In case the exchange rate on the date of credit extension is higher than these rates, the exchange rate on the date of credit extension will be applicable in credit repayment.

As a positive note, households in Turkey have no net short FX position as banks are not allowed to lend FX-denominated consumer loans.

Conclusion:

Roll-over risk of corporate loans may put pressure on bank balance sheets

Key uncertainty for the upcoming period in case of a stress scenario, in which the Turkish lira depreciates further and domestic demand sharply contracts, is the extent of losses and defaults in the real economy and the extent to which the surge in currently low levels of non-performing loans (around 3% of total loans) may put pressure on bank balance sheets. It is Scope's view that the probability of such a stress scenario depends as much on investor perception of Turkey and its political risks as its fundamentals.

Lower roll-over rates could negatively affect low FX reserves

The sensitivity of Turkey's funding situation to rollover rates of the private sector in combination with low reserve buffers helps explain the weakening of the lira. Even though external funding remained healthy in Q1, Turkey could experience a sizeable reserve drain in 2018 if foreigners became more reluctant to increase exposure to Turkey. Therefore, in a scenario where the average rollover rate falls to around 100% from 121% in 2017, there could be a substantial reserve loss.

Structure of external debt supports continued roll-over

As tighter external financing will likely weigh on imports, this will require not such as high roll-over rates of external debt like seen in Q1. Given the tight monetary stance and the structure of external debt, in case of a stress scenario whereby the Turkish lira depreciates further and domestic demand sharply contracts, Turkey will be able to roll over its external debt at higher interest rates at the cost of lower growth.

#2: Monetary Strategy:

Investor concerns about post-election central bank independence

After several years of overshooting, the commitment of the central bank to the official 5%-inflation target has been in question. Recent comments by the Turkish president have raised investor concerns about the post-election central bank independence, exacerbating exchange-rate depreciation and volatility, increasing the country's risk premia and thus heightening risks associated with external debt.

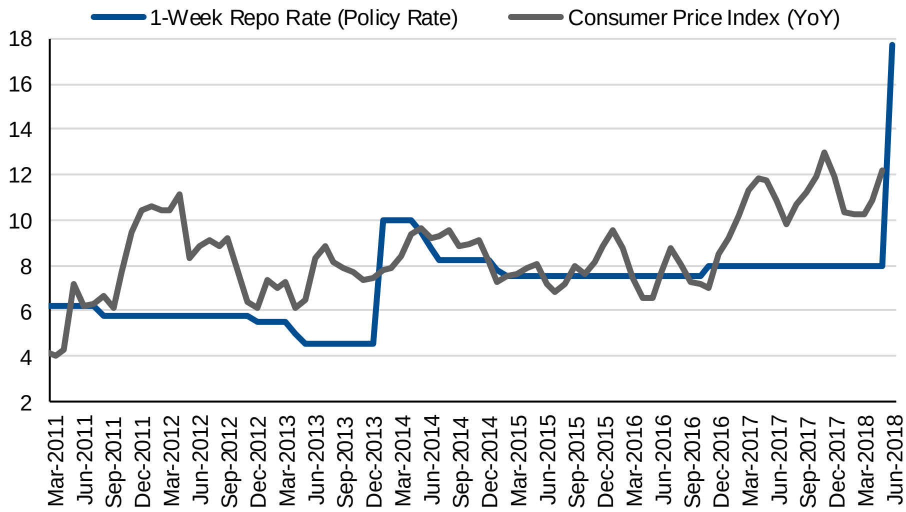
Higher inflation over the summer period expected, requiring further central bank action

After rate hikes of overall 500 bps since April 2018, simplification of its policy framework and some provisions of liquidity support measures, the central bank stated that the tight stance will be maintained decisively until inflation outlook displays a significant improvement. However, inflation expectations are not promising. Over the summer period, higher inflation will likely offset the impact of recent hikes in terms of real interest rates. Furthermore, high core prices pose additional risks, signalling that there is a broad-based problem. The recent exchange rate pass-through reinforces already elevated inflation rates. Inflation is also pushed by an output gap that remains positive and supply side shocks, leading the headline inflation likely to breach 14% during summer 2018. Scope expects that inflation pressures will ease somewhat in late 2018 but not substantially.

Recent pro-active central bank measures support financial stability

There are, however, also positive developments. Scope notes that predictability of monetary policy has improved with recent simplification measures, loan and deposit rates indicate tighter financial conditions. Loan growth momentum has converged to historical average trends, and the outlook for asset quality is reassuring. It is Scope's opinion that the recent measures by the Turkish central bank have been pro-active, which will help to restore credibility faster. However, to strengthen credibility of monetary policy in view of the 5%-inflation target, it is Scope's view that the government needs to reinforce its commitment to central bank independence. Conversely, any sign of a weakening independence, illustrated, for instance, via a change in key personnel or an alteration of the mandate of the central bank, would be credit negative.

Figure 6: Policy rate and inflation (%)



Source: Central Bank Turkey, Calculations Scope Ratings GmbH

#3: Post-Election Economic Policy Framework

Investor concerns about credibility of authorities

Following the announcement in April of early parliamentary and presidential elections, scheduled for the 24th June, the lira and Istanbul stock initially rallied; reflecting investors' hopes that the anticipated victory of President Erdoğan and the ruling AKP party would reduce political pressure to pursue high economic growth. However, during mid-May, during the trip of President Erdoğan to the United Kingdom, investor hopes, following Erdogan's statements that he intended to take control over monetary policy, were diminishing. His statements resulted in a further strong depreciation of the lira to new lows.

Close outcome in historically important elections expected

Recent polls show contradictory outcomes, also reflecting the historical importance of the upcoming elections. In April 2017, a small majority voted for a constitutional amendment in the country. This will become effective after the election on 24 June 2018 (or a possible run-off election on 8 July 2018) and will result in a significant shift of power in favour of the executive.

Incoming government will be confronted with lower growth

Irrespective of election outcomes, the new government will be likely confronted with lower growth. Even though real GDP growth was 7.4% (YoY) in Q1 2018, above market consensus, Scope expects growth to slow but to stay around 5% in 2018 and 2019. The slowdown is due to i) further expected lira depreciation effects, raising inflation through imported goods with increasing oil prices compounding the depreciation effects on inflation; ii) tighter financial conditions as bank sector ability to support growth in 2018 is set to weaken, despite being well capitalised, as narrowing interest margins due to higher funding costs will hit bank sector profitability; iii) continued regional political instability; and iv) persisting geopolitical risks threatening the economy. Turkey has recently been blocked from receiving certain high-visibility military imports from the US amidst increasingly fractious relations between the two NATO allies. To faster regain credibility, the incoming government will need to demonstrate a credible disinflation agenda within management goals for the economy. Also, a new impetus of sustained structural reforms aimed at improving the business environment will be needed to make it more broad-based.

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