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Is Turkey about to run into a balance of payments crisis?

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Turkish assets underwent a strong correction in May. The Turkish lira had intermittently lost more than 11% relative to the euro, while the yield of the 5Y local currency bond increased by almost 200bps to 15.3%, and the interest rate differential (spread) between Turkish government bonds and US dollar-denominated government bonds widened by 72bps to 390bps (N.B. 100bps = 1 percentage point). The Turkish central bank was forced to raise its most important interest rate by 300bps and to re-align its monetary instruments. What are the reasons for this nosedive?

Central bank is not acting independently

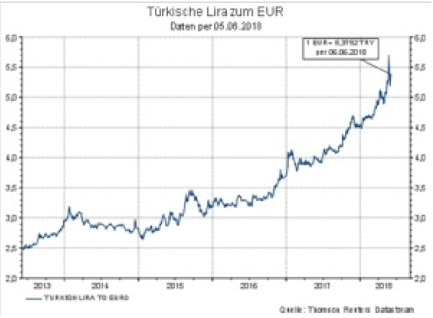
New statements made by President Erdogan according to which he wanted to take over the monetary policy in the event of an election victory set off a loud alert among investors. Erdogan has often expressed his opinion in the past according to which rising interest rates were causing rising prices and has thus exerted pressure on the central bank to refrain from hiking rates.

However, the imbalances in the Turkish economy have become so noticeable in the meantime that the continuation of the unorthodox and hesitant monetary policy of recent years would make a hard landing of the Turkish economy increasingly likely. For example, economic growth amounted to 7.4% last year, while inflation had soared to 12%. This means that inflation is twice as high as the inflation target set by the central bank. The current account deficit last year accounted for more than 6% of GDP. The current account deficit pushes up debt and thus the dependence of the country on external lenders.

Significant external vulnerability

At USD 182bn falling due in the coming twelve months, the external gross financing need of Turkey is very high. In addition, the country has to deal with a current account deficit of about USD 55bn and a foreign exchange imbalance in the corporate sector of USD 222bn. This is juxtaposed by a mere USD 34bn worth of foreign exchange reserves. This means that the foreign exchange liabilities of Turkey are a long shot away from full coverage by the central bank's own reserves. While these imbalances per se are nothing new and the financing regime of the deficits has been stable to date, they do push Turkey into a rather exposed situation, given the rising US interest rates.

Turkish lira vs. euro (06/2013-06/2018)



Source: Thomson Reuters Datastream; data as of per 6 June 2018

Currency depreciation affects asset quality of banks

Increasing worries over a very hard landing have moved the focus onto the asset quality among banks. Rising interest rates, i.e. an additional cost factor, and the increasing interest and redemption outlay for companies with outstanding foreign exchange loans and a lack of forex revenues should cause the number of non-performing loans to rise. At the moment, however, the share of non-performing loans is at a very low 2.8% in terms of total loans outstanding. Also, the Turkish banking sector is very well capitalised and thus thoroughly shielded against any credit defaults.

Uncertainty prior to snap elections

At the end of April, President Erdogan announced parliamentary and presidential elections for June, to the surprise of some market participants. As a result of this election, Turkey will switch to a presidential system, which means that the president will be holding more power. Whereas the confirmation of Recep Tayyip Erdogan's presidency seems likely, polls suggest that the opposition might secure a majority in parliament, which could make the future decision-making process significantly more complex. For the case of an all-around AKP majority, on the other hand, investors are concerned that this would mean further drifting towards economic and financial instability.

Fiscal policy turning pro-cyclical

With government debt of 28% in terms of GDP, Turkey is in relatively good shape when compared to countries with similar ratings. At the moment, Turkey holds a Ba2 rating from Moody's, which puts the country into the high-yield segment. The new debt of only 1.5% in terms of GDP also illustrates the budgetary discipline and supports the rating of Turkey. The announcement of a fiscal stimulus package worth USD 6bn in a period of economic overheating as election sweetener has led some market participants to question the continuation of this unorthodox fiscal policy and to reduce positions in Turkish assets.

Outlook: the most recent steps taken by the central bank, i.e. an interest rate hike and the simplification of the monetary policy, can be interpreted as sign that all the political decision-makers have wised up to the seriousness of the situation. This means that the monetary policy might switch to an orthodox regime in the wake of the elections. For example, steps towards reducing the current account deficit and the inflation rate have been announced for the time after the elections. In addition, the good shape the public finances are in provides the Turkish state with some room to manoeuvre in the event of the worsening of the status quo. In our base case scenario, we therefore expect the Turkish currency and bond markets to calm.

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