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## Turkish lira – what are the reasons behind the current crisis?

Anton Hauser



The Turkish lira reflects the difficult situation Turkey is currently in. This year alone, the currency has shed more than 45% of its value to date. Interview update with Anton Hauser, Senior Fund Manager, Eastern Europe bonds.

The yield of the 5Y local currency bond has increased by almost 1000bps to 22.4%. The spread between Turkish government bonds and US-dollar-denominated government bonds has widened by 165bps to 455bps (N.B. 100bps = 1 percentage point).

### What is the reason for this development?

The massive current account deficit, the high short-term government debt, the excessively loose monetary policy, and the high political risk have led to a crisis of trust among international investors.

In addition to doubts about the independence of the central bank, the most recent deterioration of the relationship between the USA and Turkey has put further pressure on the Turkish lira. The imposition of sanctions – which at face value are not particularly troublesome – step up the risk further that the relationship between Turkey and international investors may take a turn for the more complex in the foreseeable future.

### Exchange rate Turkish lira vs. euro (-5Y)

Source: Teletrader.com; as of 9 August 2018, 08:46

### How dependent is Turkey on external investors?

At USD 182bn in external debt falling due within the coming twelve months, the external gross financial needs of Turkey are substantial. In addition, the country is running a current account deficit of about USD 55bn, largely caused by the high oil price, and a foreign exchange imbalance in the corporate sector of USD 222bn. The central bank holds foreign reserves of only USD 34bn. This means that the foreign exchange liabilities of Turkey are not in the least covered by currency reserves. While these imbalances are nothing new and financing has been rather stable so far, they do lead to an increase in exposure of Turkey in an environment of rising US interest rates.

### What impact does the currency depreciation have?

The rising worries over a hard landing have moved the falling asset quality of banks into focus. Rising interest rates as additional cost factor among private households and the increasing debt burden (i.e. interest and redemption) in foreign exchange of companies that do not generate enough foreign exchange revenues should cause default rates to rise. At the moment, however, the default rate is 2.8% of total debt outstanding, which is low. Also, the Turkish banking sector is well-capitalised and thus protected against any credit defaults.

The only sector that could benefit from the depreciation is the tourism industry. Holidays in Turkey have become cheaper for European tourists.

### What is your current assessment?

From our point of view, it is too soon to switch to "positive" for Turkish fixed income and the Turkish currency.

The massive external imbalances of the country, both with regard to flow data (current account) and stock data (significant foreign exchange debt), have been the key drivers of the widening spreads of almost 165bps to 455bps in the year to date. In view of the substantial refinancing needs over the coming twelve months, the challenging international environment, and the government's propensity towards unorthodox policies (which is unlikely to change after the elections), we maintain our defensive stance. With regard to hard currency instruments, we are prominently positioned in bonds with short remaining time to maturity and low cash prices.

### What is your conclusion?

Local currency bonds and the Turkish lira seem to have reached attractive levels. The real effective exchange rate has fallen by more than 20% in the past two years to historical lows. At the same time, real interest rates are in a bandwidth of 4 to 5%, which is high both relative to Turkey's own history and to other emerging markets. That being said, we think the spreads can still be justified, and given the current economic uncertainties, could widen still. Further fiscal expansion geared towards supporting long-term growth targets (or short-term, politically motivated election pledges) cannot be ruled out, while the slow-down in global liquidity growth in connection with the external imbalances of the country as well as the inflation pressure could push domestic interest rates up even more.

We are prepared for such a scenario and maintain our defensive stance vis-à-vis the Turkish lira and local currency bonds.

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