Turkey: this time is different – contextualising the challenge and what comes next

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Executive summary | Turkey: this time is different with more uncertainty than usual

Diagnosing the challenge

1 Background

- USD-TRY has risen from 8.3 in September, when the Central Bank of Turkey (CBRT) began its current easing cycle to near 13.0 this week
- Despite the TRY collapse and inflation risks, CBRT has cut by 400bp since September, signalling a weaker TRY could lead to better macro outcomes
- Cause of the TRY selloff differ from the past – current concern is driven by the impact of rate cuts on local expectations and the demand for TRY
- On 23 November, the CBRT stated that it is observing “unhealthy price formations” in the FX market and that it has “no commitment to any FX level”
- Government is doubling-down on its credit-fuelled-at-all-costs strategy, prioritising weak TRY driven exports, despite runaway inflation and other risks

2 Transmission of rate cuts to lending and deposits

- Core factors complicate degree to which rate cuts leads to easing in credit conditions – we monitor four factors that can impact the Lira
- Supply has not changed much given increasing but still contained loan growth rate – signalling currently dynamics driven by falling Lira demand
- Weekly CBRT data enables us to see how the policy rate cuts are affecting market rates – though given the lag we observe up to 12 November
- Lower policy rates tend to translate into lower deposit rates quickly, increasing the risk of dollarisation – though magnitude remains to be seen

3 Markers to watch

- Authorities will avoid interventions, barring a disorderly Lira depreciation that would stoke the risk of an immediate balance of payments crisis
- (1) bank rollovers; (2) exodus to the parallel market; (3) corporate distress; (4) tourism downturn and export disruption; (5) dollarisation; (6) inflation
- If one or a combination of the above six conditions materialises, authorities would roll-out mild restrictions on locals to stem near-term dollarisatio

4 Macro and TRY outlook

- The uncertainty of forecasting policy decisions, asset prices and the Lira in the near-term is even higher than usual given this cycle is different
- Locals will tap renewed cheap loans as they continue to dollarise, compounding TRY pressure, while eyeing investment opportunities in hard assets
- A balance of payments crisis and/or disorderly TRY depreciation could trigger mild restrictions on locals to discourage FX transactions

5 What comes next

- Scenario 1: standard policy rules call for a significant tightening of monetary policy – normative view of what the CBRT and the authorities should do
- Scenario 2 (base case): CBRT reaction function will converge to that of previous TRY sell-off episodes, despite differences of this cutting cycle
- Scenario 3: unorthodox policy measures could come into play to try to keep rates low and the TRY stable at the same time

Background | this time is different – diagnosing the challenge

Fundamental change in the CBRT's reaction function

- **Time it takes for the Lira to breach key psychological levels on its way to fresh lows is shrinking**
- **Causes of the Lira sell-off differ from the past – driven mostly by the impact of rate cuts**

1 Background

- The Turkish Lira has come acute pressure since September losing more than 30% of its value against the USD (down ~40% year-to-date)
- The sell-off has been triggered by the CBRT entering a cutting cycle (100bp cut in September, 200bp cut in October and a 100bp cut in November), despite inflation running 4x above target at ~20% y/y and real GDP growth ~10% y/y
- The government is doubling-down on its credit-fuelled-at-all-costs strategy, prioritising weak currency driven exports, regardless of runaway inflation and currency risks

2 Causes

- The causes of the Lira sell-off differ from the past for two important reasons:
  1. Whilst the CBRT was arguably too early to cut (too late to hike) or cut too quickly (hike not quickly enough) previously, this time it should have been hiking rather than cutting rates, as inflation has not declined, inflation expectations have been rising and the economy has been operating above potential on the CBRT's estimates
  2. Unlike in 2019 when the fall in global rates enabled the CBRT to cut rates quickly, global rates are now expected to rise, putting more pressure on the Lira and inflation

3 Context

- Despite the depreciation and inflation risks, CBRT has cut rates by 400bps over the past three months, and has argued that a weaker lira could lead to better macro outcomes
- On 23 November, the CBRT published a short announcement stating that it is currently observing "unhealthy price formations" in the FX market, but that it "implements a floating exchange rate regime and has no commitment to any exchange rate level."
- We disagree with this view for four key reasons: (1) there is no strong evidence to suggest that a weaker currency meaningfully benefits Turkey's export performance; (2) inflation is already very high and depreciation risks a further acceleration of price growth as well as further de-anchoring inflation expectations; (3) both the corporate and the public sector have FX-debt, and; (4) dollarisation, which is already high at 56%, could potentially rise further, adding to foreign currency demand when Turkey's external funding requirement is already sizeable, at close to USD200bn (~20% of GDP).

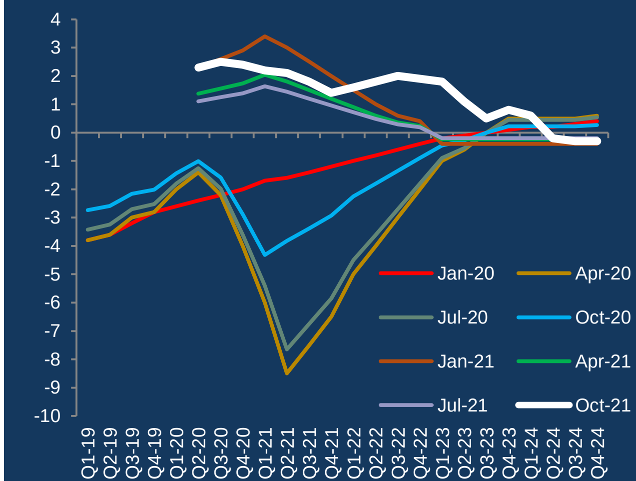
4 Outlook

- The uncertainty of forecasting policy decisions, asset prices and the Lira in the near-term is even higher than usual given this cycle is different from previous bouts of volatility
- Locals will tap renewed cheap loans as they continue to dollarise, compounding pressure on the Lira, while eyeing investment opportunities in hard assets such as real estate/gold
- A balance of payments crisis and/or disorderly Lira depreciation could trigger mild restrictions on locals to discourage FX transactions

- **Output is above potential since early 2021**
- **CBRT is cutting rates when inflation is high**

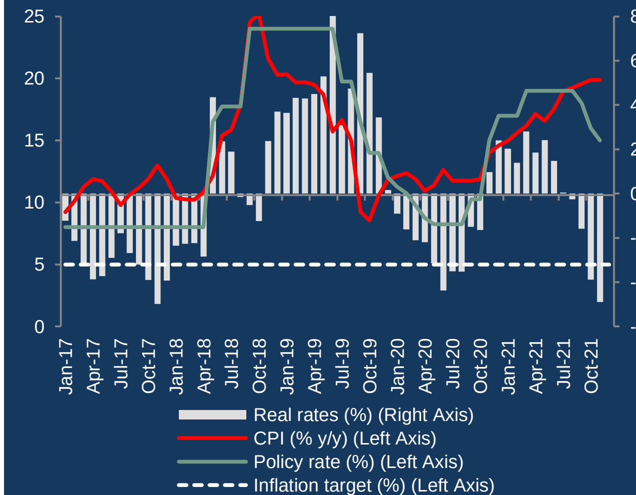
CRBT sees output above potential

CBRT's output gap estimates in successive inflation reports (%)



CBRT is cutting rates against higher inflation

Turkey one week repo (%), CPI (% y/y), real rates (%)



(Source) Bloomberg, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

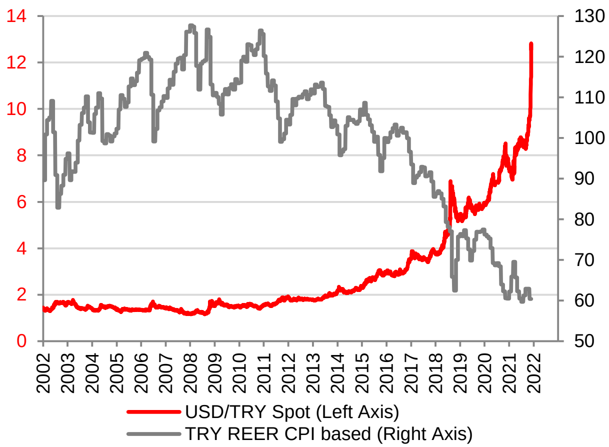
Turkey crisis in charts | contextualising the meltdown

Alarming deterioration in some metrics

- **Lira is collapsing at an alarming rate but policymakers seem to see benefits from currency weakness – we view this will worsen macro outcomes**
- **CDS spreads have been risen but not at their worst, current account is improving, debt rollover ratio is ~100% for banks, FX reserves are on the up**

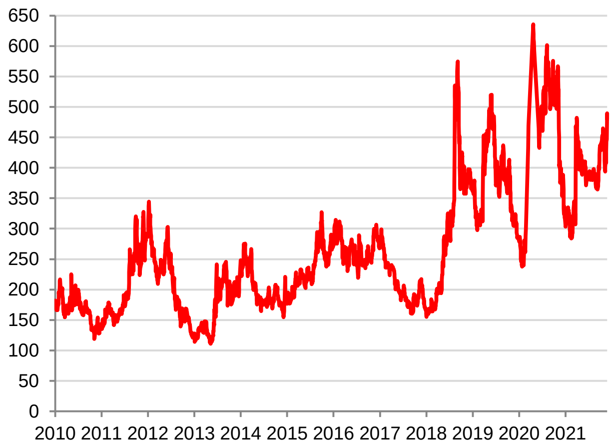
Parabolic Lira collapse matched with REER fall

USD/TRY (spot) vs TRY REER CPI based (100 = 2003)



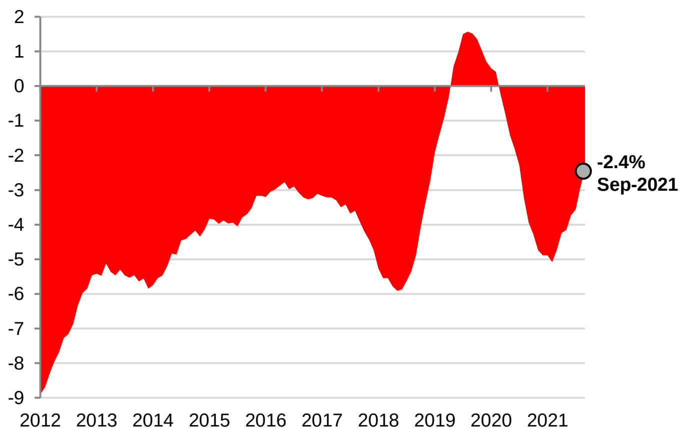
5 year CDS has risen but 2020 was much worse

Turkey 5 year CDS spreads (basis points)



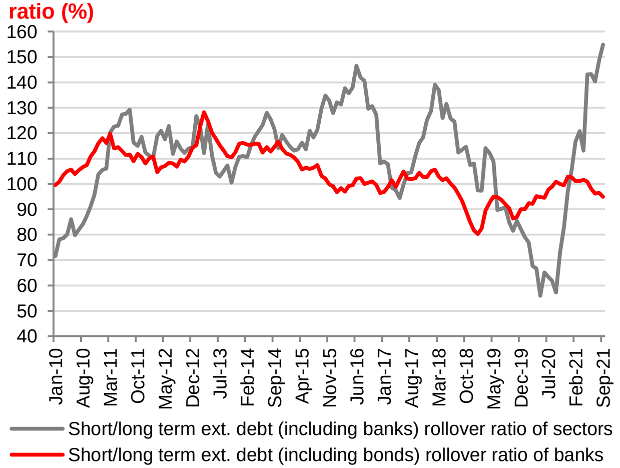
Current account balance has been improving

Turkey current account balance (12 month rolling basis) (USD bn)



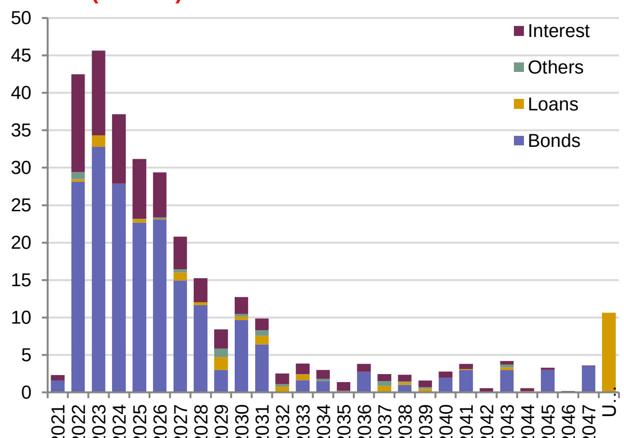
Surge in corporates external debt rollover ratio

Short and long term external debt (inc. banks) rollover ratio (%)



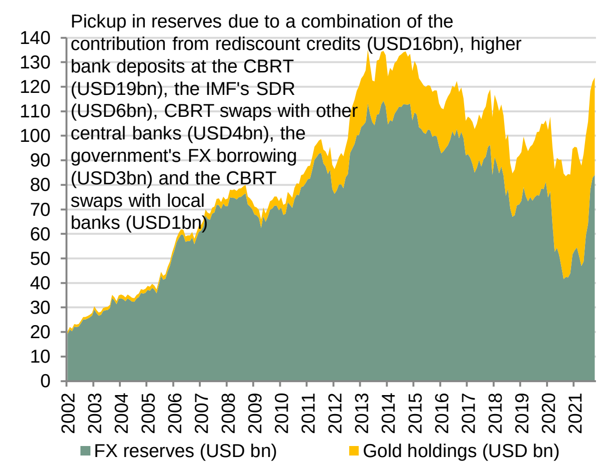
Front-loaded repayment schedule in 2022-28

Debt outstanding profile on bonds, loans, interest and others (USD bn)



Marked rise in FX reserves and gold holdings

Turkey FX reserves and gold holdings (USD bn)



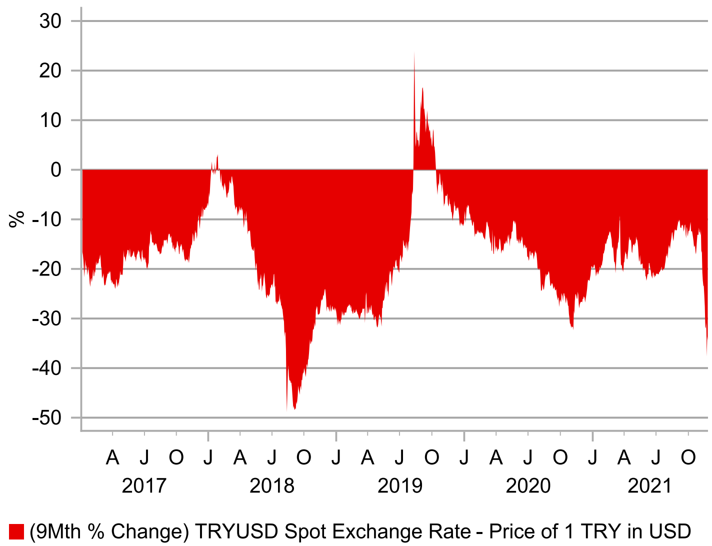
(Source) Bloomberg, Central Bank of Turkey (CBRT), Macrobond, TurkStat, MUFG Research

TRY hit hard by another sudden stop | it may get worse before it gets better

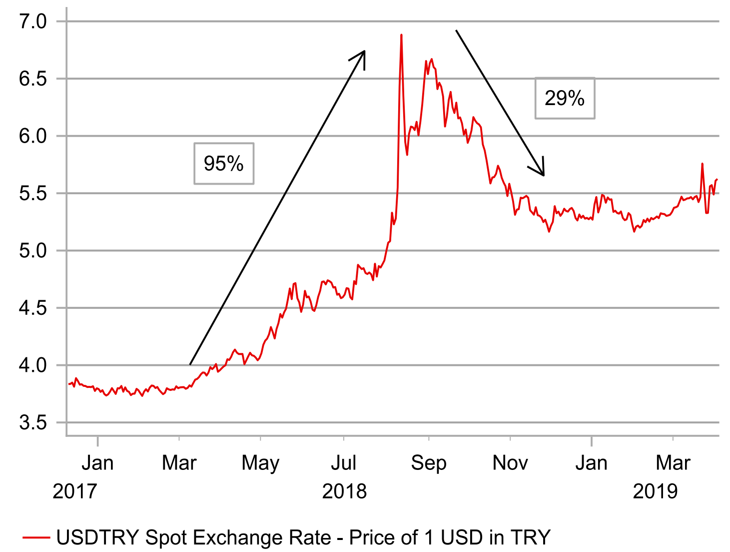
TRY has already adjusted significantly lower but unlike in 2018 there is no immediate trigger for a reversal

- **The TRY has now lost just over 40% of its value against the USD since the February peak. It is biggest TRY sell off since 2018.**
- **The CBRT was forced to raise rates aggressively in 2018 to restore TRY stability. On this occasion a policy reversal would be a harder pill to swallow. A delayed policy response leaves risks skewed to the downside for the TRY in the near-term even though it is likely already undervalued.**

Worst TRY sell off since 2018



TRY performance around last sudden stop in 2018



- The 2018 currency crisis provides a good reference point for recent TRY developments. The TRY lost just over half of its value against the USD between Sept 2017 and Aug 2018. The pace of TRY losses accelerated in August 2018 when Turkey experienced a sudden stop for capital flows. It followed an announcement from President Trump on 10th August that steel and aluminium tariffs on Turkey would be doubled. The CBRT was forced to raise rates aggressively by a cumulative 16 percentage point to help restore stability in the TRY. After falling to undervalued levels during the sudden stop, the TRY then rebounded by around 30% before stabilizing at stronger levels for around a year. The sudden stop , sharp tightening of monetary policy and elevated inflation resulted in Turkey's economy slowly sharply in the following years.

- On this occasion, policymakers in Turkey remain reluctant to tighten policy despite the increasing risk of a bigger negative shock from another currency crisis. It leaves the lira vulnerable to further weakness in the near-term even if the TRY is likely already undervalued. The situation is likely to get worse before it starts to get better. We would begin to turn more bullish on the TRY if: ii) the CBRT performed a policy u-turn and tightened policy significantly, ii) Turkey asked for external support and/or iii) an early election was called and market participants started to become optimistic that it could result a shift away from President Erdogan's commitment to unconventional policy settings.

(Source) Bloomberg, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

Transmission of rate cuts to lending | conditional on a number of policy levers

Examining the transmission of rate cuts to lending aggregates as the exchange rate is a function of Lira supply and demand

- **In Turkey, core factors complicate degree to which rate cuts leads to easing in credit conditions – we monitor four factors that can impact the Lira**
- **Supply has not changed much given increasing but still contained loan growth rate – signalling currently dynamics driven by falling Lira demand**

Tranmission channels

1 Credit guarantee fund

Shifting credit risks from banks to the government

- The transmission of rate cuts to credit growth will depend on the accompanying changes to quasifiscal policy and regulatory measures
- Policymakers communication suggests that they want the expansion in credit to be selective and towards key sectors
- Going forward, the key policy lever that can be expanded is the Credit Guarantee Fund

2 Capital injections to state banks

Capital injections to state banks are key to gauge

- State-owned and privately-owned banks may respond differently to rate cuts – state banks recently said that they will be reflecting rate cuts in their lending rates but private banks are less willing
- Given their high lending in 2020, some state banks have limited capital buffers to increase their lending further, which acts as a major constraint on the transmission of rate cuts into higher loan growth – thus, capital injections to state banks are key to watch

3 Regulation to loosen bank credit policies

Spurring private sector credit through regulatory changes

- Private banks are likely to refrain from cutting their loan rates as they price off the Turkish yield curve, which has steepened in response to the rate cuts
- Still, regulatory changes could be employed to encourage them to loosen their credit policies, though this seems less likely at this stage with private sector agents fearing a hard landing

4 Composition of CBRT funding

Unclear whether CBRT will lower its funding through auctions

- Examining the composition of CBRT funding is key as more than half of total funding comes from the CBRT swaps with banks, a depreciation mechanically implies an increase in Lira funding if the total USD amount of swaps remains unchanged
- It remains to be seen whether the CBRT will lower its funding through auctions to offset the impact of the Lira depreciation that has already taken place

(Source) Bloomberg, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

Transmission of rate cuts to deposits | more immediate elevating dollarisation risks

Swifter implications for deposits than lending from rate cuts

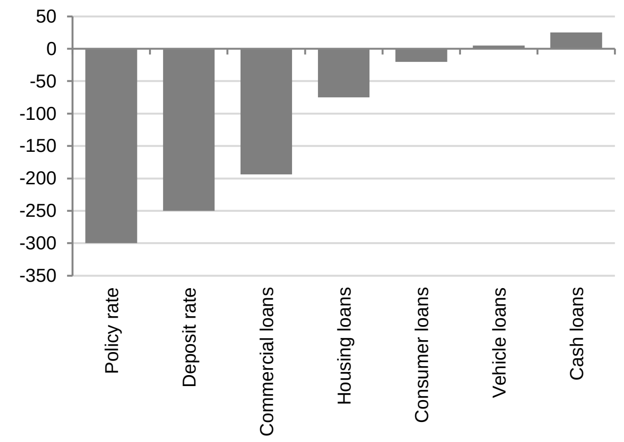
- **Weekly CBRT data enables us to see how the policy rate cuts are affecting market rates – though given the lag we observe up to 12 November**
- **Lower policy rates tend to translate into lower deposit rates quickly, increasing the risk of dollarisation – though magnitude remains to be seen**

Comments

- The 300bp of cuts have already led to a 250bp reduction in deposit rates compared with a 194bp reduction in commercial lending rates
- In our view, banks may be less willing to lower their lending rates given the steepening yield curve but a lower policy rate means that the cost of funding through the central bank becomes cheaper immediately compared with borrowing from depositors
- Consequently, ex-ante real rates have fallen sharply. Since the beginning of the year, using the 12-month-ahead inflation expectation, the ex-ante real policy rate has fallen from 6.4% to -0.4% – TRY deposit rates have remained below the policy rate for some time so the real rates facing savers are even more negative
- Low real rates increase risks of a fall in the demand for Lira and/or further dollarisation – predicting how local depositors will behave is difficult but it does serve as an example of how quickly depositor behaviour change
- The impact of the policy rate cut on the exchange rate has been more immediate this time around – available data show a limited reaction from dollarisation and credit growth so far, as the rate cuts are relatively new – instead, we view that the significant move in the Lira was driven by expectations as the exchange rate is a forward-looking asset price moving on the expectations of investors and the broader population

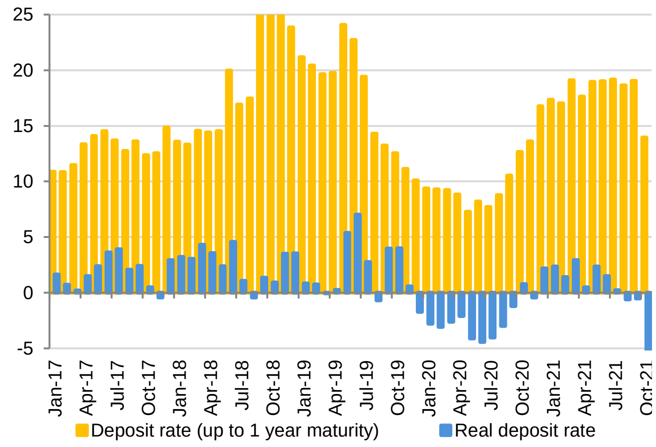
Deposit rates fastest to come down from rate cuts

Basis points



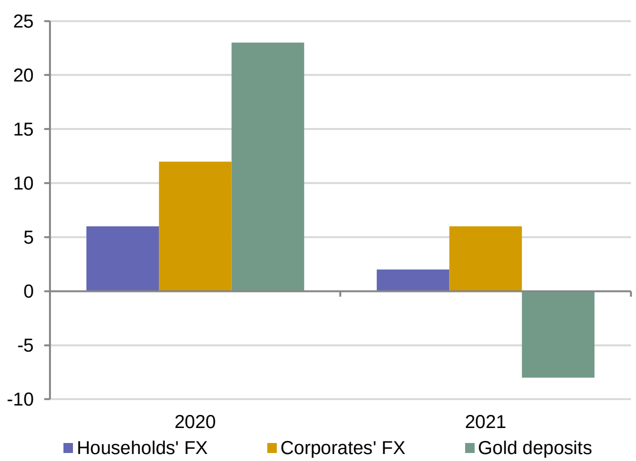
Real TRY deposit rates nearly -5%

Deposit rate (up to one year maturity) and real deposit rate (%)



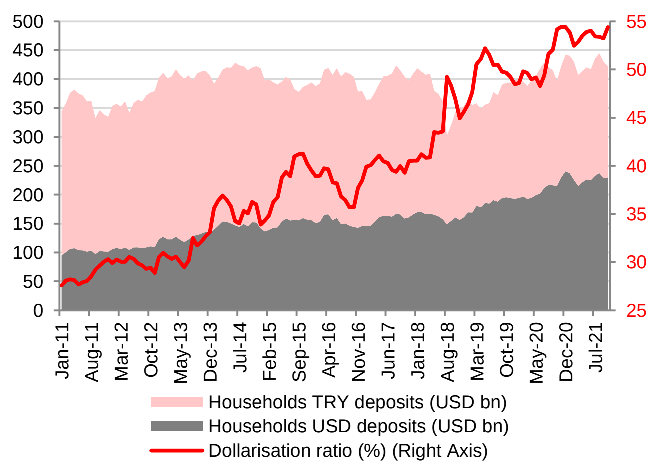
Households' FX deposits little changed this year

USD bn



Current dollarisation at historic highs

Share of FX and Lira deposits in total deposits (%)



(Source) Bloomberg, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

Markers to watch | key signposts

Six factors to monitor

- **Authorities will avoid interventions, barring a disorderly Lira depreciation that would stoke the risk of an immediate balance of payments crisis**
- **If one or a combination of the below conditions materialises, authorities would roll-out mild restrictions on locals to stem near-term dollarisation**

1 Bank rollovers

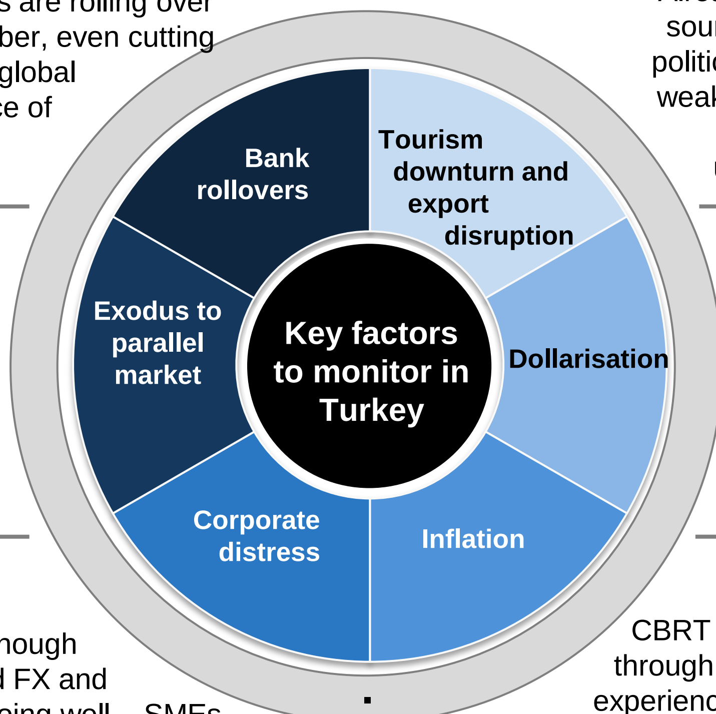
Currently over 100% but would be exposed to potential, but currently unlikely, Western sanctions or Financial Action Task Force blacklisting – banks are rolling over sizable borrowings expiring in November, even cutting costs--signalling continued access to global markets and easing short-term balance of payments pressures

2 Exodus to parallel market

While currently not the case, locals could desert the financial system to take their investments offline, trading FX in the Grand Bazaar – any divergence will be a clear bellwether

3 Corporate distress

Turkish corporates will feel the pain, though large firms have recently accumulated FX and exporters, with a natural hedge, are doing well – SMEs with FX debt or import exposure but TRY revenues are most at risk – on the whole, lower interest rates will dampen banks' financing costs and reduce losses but distress needs monitoring



4 Tourism downturn and exports disruption

Already suffering from the pandemic, this key source of FX for Turkey could take a hit from political instability –all things being equal, Lira weakness typically supports Turkey's tourism industry; meanwhile exports could come under pressure due to rising import costs

5 Dollarisation

Expanding credit growth could feed into rapid dollarisation – Locals are likely to dollarize, while also eyeing other investment opportunities in assets led by real estate and cars on the back of renewed credit expansion

6 Inflation

CBRT estimates suggests exchange rate pass-through (ERPT) to inflation is about 15%, but the experience of EMs as well as IMF research shows that pass-through can increase when the pace of depreciation is particularly rapid and where inflation expectations are not well anchored – Turkey meets both of these criteria, and as a result, we the ERPT could be in a range of 20-30%.

(Source) Bloomberg, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

What comes next | scenario analysis

Three scenarios to capture the range of outcomes

- **Three not exclusive and stylised scenarios that endeavours to capture what the next 12 months from a policy perspective could look like in Turkey**
- **(1) normative view; (2) CBRT reaction function converges to previous TRY sell-off episodes (base case); (3) unorthodox policies come into play**

1 Standard policy rules call for significant tightening of monetary policy

- **Taylor rule calls for 26% interest rates:** Given that output is above capacity and inflation is above target, a standard Taylor rule would call for interest rates of ~26%, assuming a 3pp estimate of the real neutral rate and the official inflation target of 5pp
- Using standard coefficients from literature (1.5 on the deviation of inflation expectations from the target and 1.0 on the output gap), the inflation gap would currently add 16pp to the optimal rate and the output gap another 2pp, assuming the TCMB's 2% of GDP output gap estimate and the 12-month-ahead inflation expectation of 15.6% y/y from the CBRT survey – if the authorities were effectively aiming for single-digit inflation, they could opt for a policy rate of around 23% instead
- Such a sharp change in the policy rate would very likely lead to a significant slowdown in economic activity and quite likely to a contraction, similar to 2018 – three ways to combat this:
  1. If a rate hike was accompanied by clear guidance on rates staying on hold, changes in the central banking law to make it difficult to replace governors will build confidence
  2. In the short-term, there is potential for a supply-driven recovery
  3. Notable improvement in the fiscal balance
- **Lira impact:** recover some losses, but lowering inflation would take time as services inflation tends to be sticky in Turkey and expectations are increasingly de-anchored but would be possible

2 Base case: CBRT reaction function converges to previous TRY sell-off episodes

- **Reluctantly raising rates to 20%:** In our base case, we still expect the CBRT to change course and tighten policy but to do so reluctantly akin to 2018 (sharp recessions) and late 2020/early 2021 (soft landing) when the CBRT reacted to Lira volatility by raising rates sharply – we see policy rates going from a trough of 14% to 20% by end-2022
- The closeness to the election cycle, the fact that two hiking cycles in the last few years were abandoned prematurely and the recent changes to the CBRT's reaction function make another U-turn less likely than in the past
- Even if the authorities were quick to change course, the sell-off in the Lira that has already taken place is significant enough to meaningfully alter the inflation path and negatively impact domestic demand. Inflation is likely to stay above 20% in most of 2022
- Given the very rapid pass-through from the exchange rate to prices, in particular to durable goods, consumption is likely to be negatively affected as well – hence, the economy is arguably on a higher inflation, lower growth path
- **Lira impact:** less costly way of Lira stabilisation, compared with imposing unorthodox measures – our conviction that policymakers will change course is less than in previous episodes of Lira volatility and rising inflation however

3 Unorthodox policy measures could come into play to try to keep rates low and TRY stable

- **Keeping rates low at 14%:** we view the current macroeconomic policy mix is not sustainable but the authorities have clearly shown that they prefer low rates (ending the cycle in December at 14%) and are willing to implement them even if this leads to significant pressure on the Lira
- The CBRT Governor has stressed that they do not want a broad easing in policy but rather that they want to facilitate cheaper funding for certain sectors, in particular exporters – solely based on this and similar comments, one can argue that the authorities are already going for a different policy mix
- In the past, the authorities opted for introducing regulatory and administrative measures to manage certain sectors of the economy and the financial markets –some of these were expanded and still significantly impact the way markets work today and some were abandoned. For instance, the Banking Regulation and Supervision Agency limited the amount of swaps banks can do with offshore banks to 50% of banks' regulatory capital back in the summer of 2018, and within a couple of months, this was reduced to 10%, effectively leading banks to move the bulk of their swaps onshore to the CBRT
- Two variables are key to monitor – (1) weighted average cost on USD deposits; and (2) gross reserves
- **Lira impact:** As Lira depreciation quickly turns into higher inflation, it is also politically costly and the authorities may want to somehow combine low rates with measures to stabilise the Lira

(Source) Bloomberg, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

Turkey | key indicators and forecasts

As of 24 November 2021

	Turkey – core indicators	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
1	**Production, demand and population**											
2	Real GDP growth (% y/y)	8.5	5.3	6.0	3.3	7.4	3.0	0.9	1.8	9.1	4.4	3.6
3	Nominal GDP (USD bn)	947	925	859	858	851	768	753	718	822	869	915
4	GDP per capita (USD)	12,388	11,964	10,996	10,861	10,665	9,386	9,090	8,562	9,686	10,110	10,532
5	Private consumption (% y/y)	7.9	3.0	5.5	3.6	6.0	0.5	1.6	3.2	8.4	5.5	4.2
6	Government consumption (% y/y)	8.1	3.1	3.5	9.8	5.1	6.6	4.4	2.2	2.9	6.5	1.8
7	Investment (% y/y)	14.0	5.5	9.1	2.4	7.2	-0.3	-12.4	7.2	7.9	1.5	3.7
8	Population (m)	76.5	77.3	78.2	79.0	79.8	81.9	82.9	83.9	84.9	85.9	86.9
9	**Inflation**											
10	CPI, end-of-period (% y/y)	7.4	8.2	8.8	8.5	11.9	20.3	11.8	14.6	20.8	15.2	11.5
11	CPI, average (% y/y)	7.5	8.9	7.7	7.8	11.1	16.2	15.5	12.3	17.3	16.6	10.4
12	**Money, interest rates and FX**											
13	Broad money supply M3 (% y/y)	21.5	11.9	18.4	17.6	15.5	19.4	26.6	37.3	20.5	18.0	18.0
14	Real private sector credit growth (% y/y)	18.4	19.0	5.6	2.3	8.5	-18.4	-0.8	20.4	-1.6	0.5	-1.5
15	Policy rate, end-year (%)	7.75	11.25	10.75	8.50	12.75	24.00	12.00	17.00	14.00	20.00	20.00
16	USD/TRY, end-year	2.15	2.34	2.92	3.52	3.79	5.32	5.95	7.43	14.00	11.00	12.00
17	USD/TRY, average	1.91	2.19	2.73	3.02	3.65	4.84	5.68	7.02	8.80	12.00	11.50
18	**External sector**											
19	Merchandise exports (USD bn)	163.4	170.9	152.0	150.2	165.8	178.5	182.3	168.2	201.8	207.9	214.1
20	Merchandise imports (USD bn)	243.3	234.9	199.9	191.0	224.4	221.5	198.9	206.1	229.3	242.2	255.0
21	Trade balance (% of GDP)	-8.4	-6.9	-5.6	-4.8	-6.9	-5.6	-2.2	-5.3	-3.3	-4.0	-4.5
22	Current account balance (USD bn)	-65.0	-45.9	-32.1	-32.5	-47.1	-27.1	8.0	-36.7	-20.0	-20.5	-24.8
23	Current account balance (% of GDP)	-6.9	-5.0	-3.7	-3.8	-5.5	-3.5	1.1	-5.1	-2.4	-2.4	-2.7
24	Net FDI (USD bn)	9.8	5.5	11.5	8.9	8.1	9.5	6.3	4.6	5.0	6.0	6.2
25	International reserves (ex gold) (USD bn)	112.0	106.3	95.7	92.0	84.1	72.0	81.0	51.6	82.0	97.0	112.0
26	Import cover (months)	5.5	5.4	5.7	5.8	4.5	3.9	4.9	3.0	4.3	4.8	5.3
27	Gross external debt (USD bn)	388.2	402.4	398.0	404.9	453.0	441.0	437.6	450.0	465.0	479.0	498.0
28	Gross external debt (% of GDP)	41.0	43.5	46.3	47.2	53.3	57.4	58.1	62.6	56.5	55.1	54.4
29	Short-term external debt (USD bn)	129.3	132.9	102.7	98.0	117.7	114.7	118.2	138.0	142.0	148.5	159.4
30	Short-term external debt (% of international reserves)	115.4	125.0	107.3	106.5	140.0	159.3	145.9	267.4	173.2	153.1	142.3
31	**Public sector**											
32	Fiscal balance (% of GDP)	-1.0	-1.1	-1.0	-1.1	-1.5	-1.9	-2.9	-3.4	-3.8	-3.7	-2.8
33	Gross public sector debt (USD bn)	295.2	263.5	235.1	240.1	238.4	231.8	244.9	285.9	324.3	352.2	372.7
34	Gross public sector debt (% of GDP)	31.2	28.5	27.4	28.0	28.0	30.2	32.5	39.8	39.4	40.5	40.7

(Source) Bloomberg, CEIC, IMF, Macrobond, Central Bank of Turkey (CBRT), TurkStat, MUFG Research

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