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Turkey: CBRT delivers hefty tightening in an attempt to support the lira

At its scheduled meeting on June 7th, the Central Bank of Turkey (CBRT) delivered a second consecutive - in the last two months - interest rate hike to support the domestic currency. Previously, in an emergency meeting in May 22, CBRT had unexpectedly raised the Late Liquidity Window (LLW) lending rate by 300 bps to 16.50%. A few days later, it announced its decision to simplify its operational monetary policy framework by adopting the 1-week repo as the key policy rate, setting it equal to the funding rate (16.50%) with an interest rate corridor of 150 bps below/above, and raised the 1-week repo by another 125bps at its scheduled MPC meeting on June 7th to 17.75%. Factoring in the 75bps rate hike delivered in April, the cumulative tightening rendered has reached 500bps year to date. Accordingly, all other interest rates increased so that the Late Liquidity Window (LLW) Lending Rate now stands at 20.75%, and the Overnight Borrowing and Lending Rates at 7.25% and 9.25% respectively. The statement released after last week's meeting was hawkish in its rhetoric: CBRT expressed its concern over recent elevated and broad-based price pressures' dynamics and inflation expectations, as well as their impact on pricing behavior. At the same time, CBRT stated that it will maintain its tightening stance until inflation outlook improves, emphasizing that it is determined to tighten further if it is needed.

- **Turkish assets have come under significant pressure over recent months:** Despite these hefty rate hikes and simplification of monetary policy, these Central Bank moves appear to have failed to sustainably sooth financial markets' concerns over macro prospects and monetary policy. As of June 15, the lira remained 20% weaker against the USD and ca 4% higher from a record low of 4.9221/$ hit in late May. The main BIST 100 stock index has lost more than 12% since the beginning of the year. Meanwhile, the yield of the local currency-denominated benchmark government 10-year bond spiked to a record high of 15.3% in late May, from levels around 12% in the beginning of the year, and Turkish 5-year CDS spreads have spiked to near 280bps, their higher level in 1 ½ years, vs. 165bps at the end of last year. Undoubtedly, the hike supports the currency's higher yield allure given the rise in real interest rates, which are currently estimated at around 6%. However, the latter number still lags behind other EM high yielders. Although the CBT's last move in the previous week was definitely a step towards the right direction, the renewed weakness of the Turkish currency suggests that the Central Bank may have to render further tightening in the near future.

- **Idiosyncratic factors have been mostly at play:** Concerns about heightened, double-digit and well above the official target inflation in tandem with the lack of more aggressive Central Bank monetary policy response have taken a toll on the country's financial assets. Notwithstanding the aforementioned, global developments have also weighed on the Turkish currency:
    - **The Central Bank is unable to deliver on its mandate:** political pressure for low interest rates has fanned worries in the markets. President Erdogan has staunchly supported low interest rates aimed at boosting economic activity. Apart from this being directly negative for the lira, it has raised doubts about the Central Bank's independence and concerns over CBT falling significantly behind the curve.
    - **Meanwhile, the Central Bank had followed over the last few years a rather unorthodox monetary policy framework**, which was based on a combination of policy instruments rather than a single benchmark policy rate. This seems to have stirred investor confusion in interpreting Central Bank action, possibly putting additional pressure on Turkish assets. More importantly, FX reserves are at relatively low levels (the relevant metric stands below IMF standards for EMs). Recent comments by President Tayyip Erdogan signaling plans for a tighter grip on monetary policy, if he wins the June 24 election, exacerbated these concerns, as he supports lower borrowing costs in return for higher economic growth rates.
    - **Geopolitical risks remain in the background:** Geopolitical risks remain key to the lira's

performance. Worries over President Erdogan's power concentration and mounting frictions with the US and EU, as well as tensions near the country's border with Syria remain in the forefront. Along these lines, the EU accession process appears to have been derailed.

- **Major Central Banks' monetary policy normalization course poses downside risks to EM assets.** Setting aside the country's idiosyncratic risks, the external environment of a firmer US dollar over recent months and the ongoing monetary policy normalization of major Central Banks around the globe do not bode well for the lira, weighing on risky assets and their high yield allure. The country's high external vulnerabilities deem the Turkish assets more vulnerable than other EM peers on sudden bouts of increased risk aversion.

- **Macroeconomic policies have been primarily guided by electoral considerations.** An excessive emphasis has been placed on growth in an effort to increase the probability of the ruling party leader to get reelected in the President's post and concentrate more executive powers around him under the new constitutional amendments. Pro-cyclical government stimulus, which is bound to eventually fade away, supports growth at the expense of higher inflation. The latter erodes the purchasing power of households and corporates, undermines their confidence in domestic financial assets, deters them off their investment decisions, and increases external vulnerabilities at a time of a deteriorating global financing environment.

  - **The economy is overheating:** The strong GDP performance of 2017 (+7.4% YoY, above potential) proved to be unsustainable, given it was mostly driven by fiscal stimulus and buoyant credit expansion and favored by base effects, giving way to a sharp slowdown in 2018 (4-4.5% YoY). The first quarter GDP growth is illustrative of Turkey's unbalanced and unsustainably strong economic story. The Statistical Service announced that GDP growth came at 7.4% /7.1% YoY in Q1- 2018 in unadjusted/seasonally adjusted terms, with private consumption (+11.0% YoY), government consumption (+3.4% YoY) and gross fixed capital investment (+9.7% YoY) strengthening further. In contrast, net exports performance entered further in the red as exports performance continued to be weak (+0.5% YoY) against that of imports (+15.6% YoY). As a result, net exports trimmed 3.6ppts off the headline figure, which is the largest negative contribution since Q2-2011. The reading came in above analysts' expectations of 7.0%. High frequency indicators have already hinted towards growth moderation in Q2.

  - **Any tightening of fiscal policy can only take place after the elections.** The fiscal position of Turkey is broadly healthy, anchored by a low -for EM peers standards- public debt (28.5% of GDP in 2017) and a relatively low fiscal deficit (general government deficit at 2.2% of GDP). In an election year, with fiscal risks skewed to the upside, the general government deficit is expected to end around 1ppt of GDP higher in 2018. On the negative side, the growing size of contingent liabilities arising from the PPP activities and the Credit Guarantee Scheme (7% of GDP) is a medium-term concern that necessitates attention and future action. In any case, a shift away from expansionary fiscal policy can only take place after the elections.

  - **Rising external imbalances make it harder to refinance:** Higher oil prices also bear potential to undermine the lira via an increase in the country's external imbalances as well as via a rise of inflation. The country has a high energy import dependency, mainly oil and natural gas, with only 26% of total energy demand met domestically. Indicatively, the current account deficit already widened to a 6-year high in 2017 (5.6% of GDP), wider compared to most EM peers, and is expected to rise further above 6% in 2018. On the other hand, financing relies heavily on portfolio inflows, which are highly volatile and subject to sudden shifts in investor sentiment. Gross external financing requirements are elevated, hovering around levels of 30% of GDP, with gross external debt penciled in near 70% of GDP, mostly earmarked towards short-term maturities and with its bulk concentrated around private creditors.

  - **Inflation has been rallying in double digits**: Headline inflation has remained in double-digits since early 2017 (headline CPI at 1.62% MoM/12.15% in May) and well above the 5% official target, having reached a 14-year high of 12.98%YoY in November 2017. Core inflation climbed to an all-time high at 12.6% YoY in May, up from 12.2% YoY in April. Moreover, end-year, 12-month ahead and 24-month ahead inflation expectations rose significantly to 11.1% YoY, 10.2% YoY and 9.0% YoY, respectively, in May from 10.1%, 9.6% and 8.6% in April.

  - **The banking sector is increasingly confronted with higher funding costs, constraining credit growth**

dynamics. The relaxation of macro-prudential standards in the post-coup period, relatively low foreign currency borrowing costs and the sizeable Credit Guarantee Fund have led domestic banks (both private and public) to increase credit supply significantly (+21.2% YoY in FY2017 vs. 16.2% YoY in FY2016). The rising funding costs stemming from the lira's depreciation, higher FX borrowing costs in global markets and the fading impulse of credit guarantees are expected to put a break on credit dynamics in 2018, and subsequently on economic growth, a trend which is already evident in the numbers of Q1. Although the domestic banking sector is in relatively good shape with high capital buffers, it will likely be the first to suffer in the downturn.

- **The post-election landscape still entails significant downside risks for the macro outlook:** News about the looming snap presidential and parliamentary elections on June 24th somewhat eased worries over a prolongation of domestic political uncertainty, an earlier than previously expected withdrawal of fiscal stimulus, and stirred hope that the Central Bank would take action to ensure currency stability ahead of the ballot. In our view, downside risks from the Presidential and parliamentary elections conclusion will most probably subside but they will not vanish. On the positive side, the elections outcomes will shape policy outcomes, thus reducing policy uncertainty and bringing more policy clarity. From that point of view, the leadership of Turkey will have to respond to current investor concerns by providing a new coherent and credible macro framework. On the other hand, the elections' outcomes will neither signal the end of the political cycle, nor will they eliminate political tensions. Firstly, municipal elections are scheduled for the first quarter of 2019. Secondly, political tensions between the ruling AKP party and the opposition parties will remain elevated because the transition to the Presidential system is widely seen as an attempt to increase the concentration of executive powers around the President. In any case, it currently seems that the political landscape has become increasingly polarized.

- **Rating agencies have raised the red flag over Turkey's economic vulnerabilities.** Reflecting the ongoing deterioration in Turkey's domestic macroeconomic fundamentals, S&P unexpectedly downgraded in early May the country's long-term sovereign rating to BB- from BB, with a stable outlook. Later that month, Fitch warned that greater erosion of monetary policy independence would put further pressure on Turkey's sovereign credit profile, particularly if it contributed to serious external financing stresses and a deterioration in the macroeconomic environment, or undermined wider economic policymaking credibility and the country's business environment. Meanwhile, senior S&P analyst Frank Gill highlighted his concerns in a Reuter's interview over the rapid deterioration in the country's balance of payments which has already started to take a hit on growth. Last but not least, Moody's placed the Ba2 long term sovereign rating under review for downgrade. According to Moody's, the decision to place the current rating under review reflects mounting uncertainty regarding the future direction of macroeconomic policy, in the context of the country's already vulnerable external position that will, if sustained, raise the risk of severe pressures on Turkey's balance of payments to a level that is no longer consistent with the current rating.

- **Outlook ahead: Change in the government/Central Bank policies balance mix urgently required in the post-elections era.** Unless there is a fundamental change in the government/Central Bank policies balance mix after the elections, risks for the assets remain skewed to the downside in the months ahead. Investor sentiment towards Turkish assets remains contained, while there is an increasing awareness of the inappropriate macroeconomic policies' mix and more light is being shed on the long-term structural problems of the Turkish economy.

Figure 1
The Turkish Lira has come under intense depreciation pressure in the last months

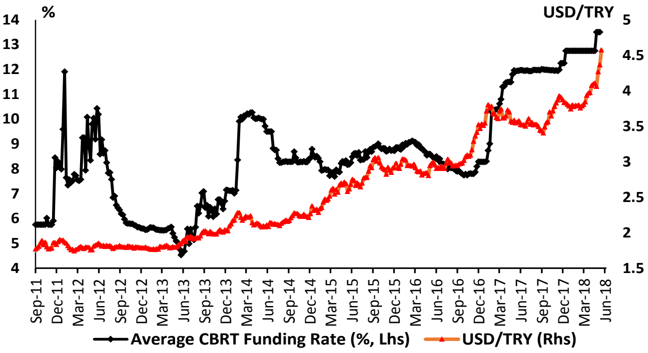
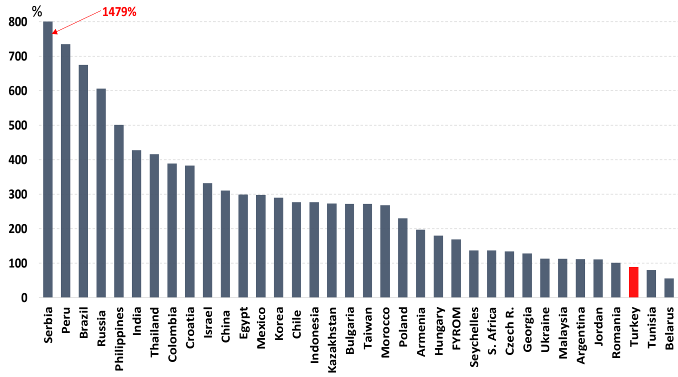


Figure 2
FX Reserves (%) of External Debt Repayments



Source: National Statistics, IMF, Eurobank Research, Reuters,

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