20 December 2021

Turkey

'Catch me if you can' – no end in sight for lira's freefall

- **Lira's meltdown continues after the CBRT cut the repo rate by another 100bp to 14% on Thursday. The CBRT has now cut rates by 500bp since September. In this paper, we discuss the implications of the policies and three scenarios going forward.**
- **With limited buffers, the CBRT's recent interventions are nothing short of a sign of desperation and, hence, more likely to undermine their credibility rather than halt lira's slide. More extreme measures, such as capital controls, cannot be ruled out.**
- **For now, there are no signs of a policy reversal, and unless Erdogan is deterred by the threat of a bank run or a snap election, we think lower real rates, weakening fundamentals and tighter global financial conditions will drive lira further down.**

Erdogan's policy experiment is a losing battle

Since mid-2019, President Erdogan has sacked three central bank governors who disagreed with his unconventional view of high rates fuelling (not containing) inflation. As a result, the Central Bank of the Republic of Turkey (CBRT) has shifted its focus from inflation management to current account and exports promotion led by an expansion of credit. The central bank has cut the repo rate by 500bps to 14% since September despite inflation exceeding 20% in November. As a response, the Turkish lira has lost around half of its value in 2021 with the USD gaining more than 30% against TRY over the last month only. With a negative real rate of lower than -6%, the Turkish market now offers one of the lowest returns in real terms for investors in the EM universe. Furthermore, in addition to lower central bank rates, he has instructed state-owned banks to expand credit to companies. Furthermore, the government has raised minimum wages by 50%. These things add to inflation pressures in the economy.

Given increasing external and domestic headwinds the "policy experiment" presents a huge gamble with the stability of the Turkish economy. While Turkey and other emerging markets have benefited from an ultra-easy global monetary policy following the onset of the COVID-19 crisis in 2020, fortunes are now changing as the Federal Reserve and many other central banks are moving on rapid monetary policy tightening. This increases the pressure on emerging markets to follow suit or even go further to avoid seeing significant capital outflows and exchange rate weakness than can trigger sharp rises in inflation. Hence, going against the tide by *lowering* policy rates Turkey creates even bigger capital outflows pressures and exchange rate weakness

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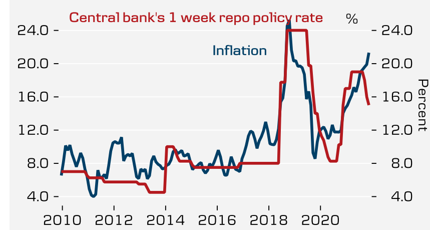
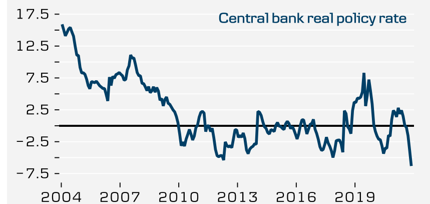
Central bank cutting policy rate while inflation is surging



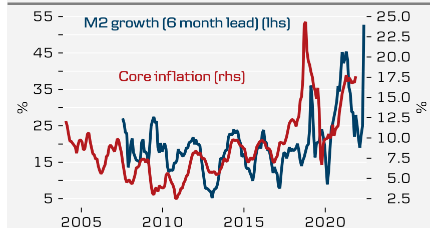
Source: Bloomberg, Macrobond Financials, and Danske Bank

...Causing highly negative real rate and fuelling credit expansion



Source: Bloomberg, Macrobond Financials, and Danske Bank

Money explosion to fuel higher core inflation...



Source: Bloomberg, Macrobond Financials, and Danske Bank

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Basically President Erdogan is trying to fight the "impossible trinity" which states that a small open economy like Turkey's cannot run an independent monetary policy with an open capital account and also have a stable exchange rate. So unless Erdogan wants to see the USD/TRY keep rising (generating higher or even hyperinflation) Turkey needs to either tighten monetary policy i.e. abandon its independent monetary policy or close its capital account through capital controls (or implement price controls, which would lead to goods shortage in the economy).

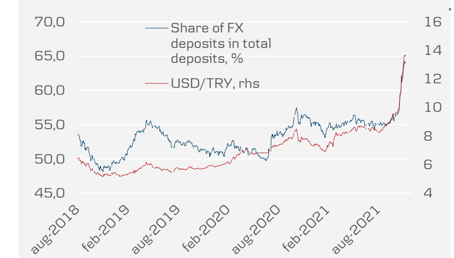
Turkey's significant external vulnerabilities makes this gamble even more risky. By several measures, the Turkish economy is in a weaker position than after the global financial crisis. In Q2-2021, Turkey ran a current account deficit of -3.1% of the GDP. While, the weaker lira will aide exports, the benefits to tourism will be smaller than normal given a smaller boost than normal to tourism given the continuing pandemic-related problems. In addition, Turkey is quite vulnerable to the high oil prices. Furthermore, Turkish companies and banks have considerable amount of FX debt, of which quite a large share needs to be rolled over in the next 12 months. Turkey's net international investment position, which measures the gross foreign assets against liabilities, amount to USD280bn at the end of Q2 2021 (equivalent to more than a third of Turkey's GDP). Short-term foreign debt falling due in the next 12 months account for about half of the amount, with most of it related to banks and corporates. With a significant weakening of the exchange rate, the cost of servicing the debt increases. Thus far, Turkish entities have enjoyed a resilient access to global financial markets, but in the event that Turkey is struck by an economic chaos, these entities may face considerable rollover risks. On the other hand, households have quite a large FX deposits, which they have increased over the past months so they account for more than 65% of total bank deposits (see chart above).

The credit driven expansion with highly negative real interest rate and exchange rate depreciation is leading to growing macroeconomic instability. Inflation has surged to 21% in November. While a considerable part of it is driven by energy and food prices, core inflation has also climbed to almost 18%. With the significant exchange rate depreciation, we expect inflation to hit 25% in December and could go as high as 40% in Q1 2022. Assuming unchanged monetary policy or even lower rates, real rates will continue a rapid decline, adding further downward pressure on lira.

Erdogan's pain thresholds

Recent communication by President Erdogan and other officials does not give any indication that the CBRT is considering a policy reversal any time soon. On the contrary, this week, Finance Minister and former central bank deputy Nureddin Nebati explicitly said that the central bank would not raise the interest rate. On the baseline, we think Erdogan will be persistent this time around and not easily persuaded, but there are some potential game-changers.

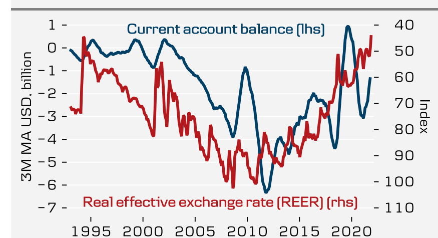
...and rapid dollarization of the Turkish economy.



Note: Past performance is no guarantee of future performance.

Source: IIF, Macrobond Financials, and Danske Bank

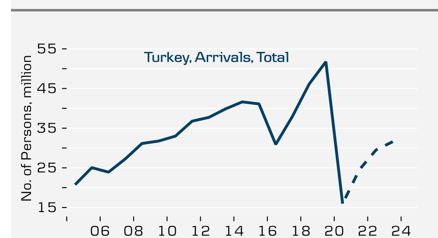
The weaker exchange rate is going to help Turkey's external balance



Note: Note reverse scale for REER. A lower REER index generally imply stronger competitiveness.

Source: Bloomberg, Macrobond Financials, and Danske Bank

...but the boost is going to be smaller due to corona headwinds for the tourism sector



Source: Bloomberg, Macrobond Financials, and Danske Bank

Pressure from business community: *Anecdotal stories* from Turkey signal that low-income households and small business owners are already struggling with the collapse in lira. Erdogan's master plan has been to promote exports through a weaker exchange rate but the extreme volatility in lira is *hurting the export industry as well*, as businesses struggle to price their products while they are also negatively affected by the rising energy and raw material prices. We think the country's business community does have some leverage, particularly as Erdogan's public support has been waning recently, but persuading him would require a strong and broad-based pressure from the country's most prominent and influential businesses.

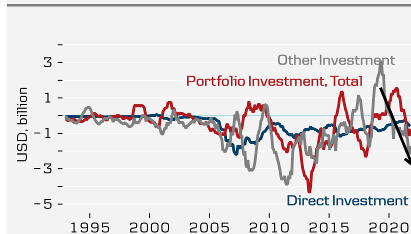
Emerging signs of a bank run: Thus far, the Turkish banks have enjoyed a resilient access to global financial markets, which is crucial considering the significant external refinancing needs of the banking sector. For long, wealthy Turks have preferred exchanging their lira savings into FX, which has led to a rise in banking sector FX deposits, and for now, it seems the Turks maintain a strong confidence in their banking system. A mass movement by the Turks to withdraw FX deposits could quickly jeopardize financial stability, not only because of the banks' large FX liabilities but also because the banks use these client deposits in FX swaps transactions with the central bank. The FX swaps, in turn, are critical for the central bank, which uses the proceeds from the swaps to beef up its foreign reserves. Hence, we think any indications of a bank run on FX deposits would force Erdogan and the CBRT to resort to a rapid policy reversal.

Threat of a snap election: In the Turkish election system, a presidential candidate needs to collect more than 50% of the votes in the first round in order to be elected. With Erdogan's chances of winning considered slim in the second round, he would be much comfortable winning in the first round. However, heading into 2023 general election, Erdogan's ruling alliance that includes his own AKP party and the far-right nationalist MHP party, currently only *has around 40% public support*. Simultaneously, *Erdogan's approval ratings have plummeted to all-time lows*, meaning that Erdogan is likely to do his everything to avoid an early election scenario. We think it is likely that policymakers' dissent towards Erdogan will grow as the public unrest continues and politicians will fear losing votes, which could increase the chances of the MHP reaching out to opposition in an effort to strike a new alliance. However, as the current public support for MHP, according to media reports, is also low, a snap election is hardly on MHP's wish list. In any case, if there are any signs of a rapprochement between the MHP and the opposition and the threat of a snap election becomes more real, we think Erdogan could be deterred to make a policy U-turn.

Three scenarios: whatever happens, lira will remain under pressure

We see three scenarios unravelling over the next 3-6 months. We highlight that regardless of the CBRT actions, other negative factors such as the looming monetary policy tightening in the US and Turkey's weakening economic fundamentals are likely to weigh on lira in the short to medium term. For example, with the negative impacts of the massive TRY depreciation weighing on Turkey's import-driven economy with a lag, a recession similar to 2018-19 next year is likely, a further negative factor for TRY over the next six months. Given that Erdogan has his eyes fixed on the election in 2023 and keeping economic growth high, this will also influence his choice of actions toward keeping a looser monetary policy than he normally would.

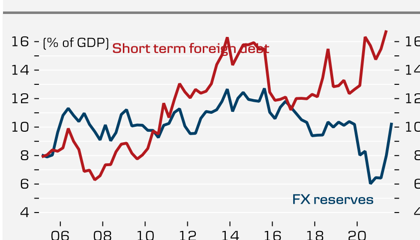
Hot money and portfolio investments running for the exit



Note: The series are 12M moving average

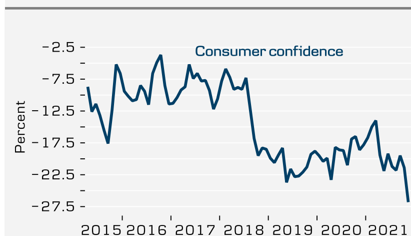
Source: Bloomberg, Macrobond Financials, and Danske Bank

But turkey is vulnerable from a high external debt refinancing risk



Source: Bloomberg, Macrobond Financials, and Danske Bank

Consumer confidence plummeting to record low levels



Source: Bloomberg, Macrobond Financials, and Danske Bank

Base scenario: No change in policy/muddling through – 50% likelihood:

We see a high likelihood that the CBRT, pressured by President Erdogan, will maintain its current policy stance and keep the rates on hold over the next 3-6 months. In its December statement, the CBRT said they decided to '*use the limited room'* for policy easing. We take this as a signal that, in the absence of further pressure by Erdogan, the CBRT is done with cutting rates for now. We still expect the CBRT to keep the rates on hold over the next 3-6 months, as policymakers have emphasized that the positive effects from the rate cuts will not be visible until Q1. With unchanged (or lower) rates and higher inflation (as mentioned above inflation could increase to 40% or higher depending on how much TRY weakens in Q1), real rates will fall even lower driving further depreciation in lira, while weaker economic fundamentals and tighter global financing conditions will start to add to downward pressure. Under this scenario, the CBRT is likely to continue occasional interventions in desperate attempts to halt the depreciation but abstain from more extreme measures unless any of the above mentioned pain thresholds are reached. In addition, the Turkish government could impose price controls in an effort to tame inflation. Their economic and social impacts could be devastating as supply for several imported products would collapse, and acute goods shortages would disrupt business activity and everyday life with again the most vulnerable households disproportionately affected.

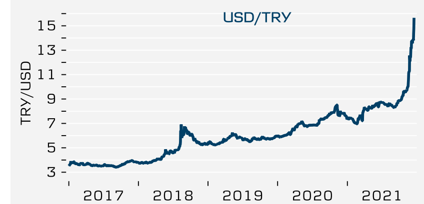
Scenario 2: A policy turnaround – 30% likelihood:

We think a policy reversal is the only scenario that would help stabilise the lira, and we consider this scenario less likely than the *status quo* scenario in the short term as Erdogan seems very persistent this time around, and he still seems to enjoy some support amongst like-minded public officials. The likelihood of a policy reversal would increase if any of the above mentioned pain thresholds were reached, namely, if Erdogan was to encounter increasing pressure from the business and banking community, if there were any signs of a bank run or a banking crisis emerging, or if there was a risk of an early election. Given the loss of credibility and de-anchored inflation expectations, the central bank would have to hike rates by more than the 16 pp hike implemented during the last currency crisis in 2018. While a policy reversal would help stabilise lira in the short term it would also exacerbate economic woes as higher rates are likely to further dampen economic activity in an already recessionary environment. Considering other, external, lira-negative factors at play, the outlook for lira is challenging even in this 'policy reversal' scenario.

Scenario 3: Further rate cuts accompanied by extreme policy measures, such as price and capital controls – 20% likelihood:

We see a lower likelihood for further rate cuts by the CBRT as they have now communicated they have used the '*limited scope'* for easing. However, considering the unpredictability of Erdogan's decision-making and the possible weakening of the economy in H1 2022, further cuts are possible. We think lira would be under massive depreciation pressure in this scenario, which would lead to skyrocketing inflation, forcing CBRT to resort to more extreme policy measures. Soft capital controls, such as rising fees for residents on currency exchange transactions, are one possibility. Their impact on lira would depend on the size of the fee since residents would weigh the cost of holding a value-losing currency against the cost of exchanging their savings into dollars. Hard capital controls, such as limits imposed on FX withdrawals or cross-border transactions, are more unlikely as they would effectively cut Turkey off from international markets. Also, any expectations or signals of these kind of measures being considered could trigger a panic leading to a bank run.

Skyrocketing USD/TRY following the rate cuts



Note: Past performance is no guarantee of future performance.

Source: Bloomberg, Macrobond Financials, and Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Jakob Ekholdt Christensen, Chief Analyst and Minna Kuusisto, Chief Analyst.

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Report completed: 17 December 2021, 17.00 CET

Report first disseminated: 20 December 2021, 6.45 CET