TURKISH TROUBLES

For emerging economies, the balance prospects/risks has been deteriorating since end-2021. For 2022, a bigger than expected growth slowdown is very likely, sometimes with social instability as already seen in Kazakhstan. Over the last three months, Turkey has experienced a mini financial crisis again. Monetary and exchange rate policy is betting on exports and investment to support growth and rebuild the major economic balances over the medium term, albeit at the price of short-term financial instability. This is a daring gamble that could force the authorities to introduce genuine foreign exchange controls instead of the incentive measures they have implemented so far.

Threats to growth in emerging economies increased at the end of 2021 with the economic slowdown and the real estate sector crisis in China, the widespread acceleration in inflation over commodity price effects and the extension of monetary policy tightening, non-resident investment outflows from domestic bond markets (China excepted), geopolitical tensions, and the emergence of new waves of Covid-19 infection with the Omicron variant. In 2022, therefore, economic growth will very likely slow more than expected. There are also risks of social unrest such as was seen recently in Kazakhstan.

Over the last three months, Turkey has been on the spotlight. Since mid-November, the lira has depreciated by 28% against the euro-dollar basket, yields on domestic government bonds have increased from 18.5% to 24% and the 5-year CDS premium has widened from 440 to 560 basis points.

TURKEY: SURPRISES AND TREMORS

Turkey has caused surprise and concern in equal measure. Surprise because economic growth proved to be very resilient in 2021, including during the financial shock at the end of the year, with the Markit PMI and MUSIAD indexes remaining above 50 through to December. The current account deficit is unlikely to have been more than 2% of GDP in 2021, despite the increase in oil prices, and the budget deficit was probably only 2.5%, despite above-inflation increases in primary spending over the second part of the year.

Turkey has raised concerns because inflation appears to be spiralling out of control. Between October and December it jumped from 21.3% to 36.1%, a bigger increase than would have been expected from the usual statistical relation between the exchange rate and prices. Although the central bank (the TCMB) has limited its interventions, forex reserves have fallen by USD 17 billion since mid-November and deposit dollarization accelerated through to the end of the year.

The series of emergency measures adopted by the authorities to stop the renewed decline in forex reserves have also raised questions on how severe was the situation. The measures have been notably aimed at i) protecting savings of households and companies whilst encouraging them to increase their lira-denominated assets; ii) attracting foreign investment[1]. Other measures can even be considered as 'soft' foreign exchange controls (requirement for companies to repatriate and convert 25% of their revenue in USD, euro or sterling, increased monitoring by the TCMB of sizeable purchases of foreign currency by companies), although President Erdogan has ruled out strict capital controls.

Since the last week of December, pressures on the exchange rate, interest rates and the TCMB's forex reserves have eased somehow. By mid-January, forex reserves were estimated at USD 109 billion, including around USD 70 billion in foreign currency. TCMB's weekly monitoring suggests that the dollarization trend has even been reversed (after correction for exchange rate effects, foreign currency deposits of individuals and companies fell by nearly USD 5 billion). Also in mid-January, the Ministry of Finance indicated that some USD 9.7 billion were covered by the indexation mechanism. Meanwhile, non-resident positions in the offshore swap market were estimated at just USD 2 billion on 9 January, from USD7 billion in mid-November and USD 21 billion at the start of 2021.

However, this very recent de-dollarization is far from assured, as the indexation mechanism has mainly attracted TRL deposits and more marginally those in dollars. Most importantly, official forex reserves look low in net terms (i.e. after deducting foreign currency placed by banks in reserve with the TCMB), at just USD 15 billion[2]. On 9 January, the value of equities & government securities in TRL held by non-residents was still USD 22 billion, from USD 28 billion in mid-November.

TURKEY: FOREIGN EXCHANGE RATE & DOMESTIC BOND YIELDS

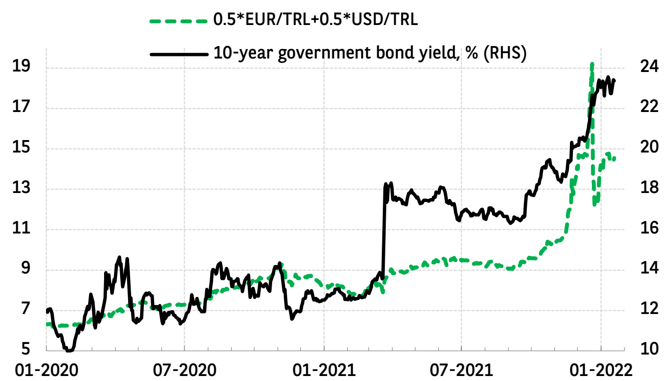

CHART 1

SOURCE: MACROBOND, BNP PARIBAS

1 Introduction of a indexation mechanism of deposits and investment funds of individuals and companies indexing deposits and investment funds to the USD/TRL rate, introduction of a forward exchange rate instrument for exporters and importers (with compensation for any TRL losses by the TCMMB), temporary removal of the withholding tax on TRL-denominated government bond income, making Turkish nationality available to non-residents who undertake to invest in real estate or a TRL-denominated financial investment and to retain this investment for at least 3 years

2 Indeed they were significantly negative if no account is taken of currency swaps between banks and the central bank, which are a liability for the latter. However, unless the banks have an urgent need for dollar liquidity, this foreign currency can be used by the central bank.

THE RISKS OF THE NEW ECONOMIC POLICY

This financial instability is a by-product of the authorities' strategy, which is to support growth through exports, thanks to a weak currency, and stimulate investment through a deliberate relaxation of monetary policy to support domestic lending (the TCMB's main policy rate has been cut from 19% in September to 14%, leading to significantly negative real interest rates). By boosting competitiveness, authorities expect to foster the current account balance and to stabilize the exchange rate, indirectly reducing inflation. In the meantime, liquidity support from Gulf States would be a possible option to foster forex reserves.

However, this strategy carries a number of risks. As inflation accelerates, household confidence has historically fallen, despite measures adopted to offset the loss of purchasing power (such as the exceptional 50% increase in the minimum wage on 1 January, which will be likely followed by a further increase in the second half).

True, the impact of currency depreciation on the current account is significant: between 0.5 and 1 point of GDP of improvement in the underlying current account balance (i.e. excluding energy and gold) for a depreciation of the real exchange rate of 10%. But any gains would be largely offset by the increased price for net energy imports (5% of GDP in 2021) and net imports of gold, which act as a hedge against inflation. Above all, maintaining gains in currency competitiveness in real terms will require recurrent TRL depreciations.

BALANCE SHEET IMPACT OF THE DEPRECIATION

Currency depreciation also affects the balance sheets of banks and corporates

The direct exchange rate risk for banks is limited, as they have to balance their on-balance sheet debtor position with an off-balance sheet creditor position, mainly through currency swaps. Moreover, the counterparties to these swaps have changed; since the end of 2019, non-residents have withdrawn (from the offshore market) and the central bank has filled the gap. As a result, banks' off-balance sheet positions are deemed to be more stable. Moreover, foreign currency bank deposits from residents and non-residents (USD 261 billion at the beginning of January) are 37% covered by foreign currencies in blocked accounts and the value of currency swaps with the TCMB (USD 96 billion in total).

However, the foreign-currency exposure of corporates is substantially negative (of about USD 166 billion in October 2021). The debt ratios of exporting companies (i.e. external debt including import financing loans to revenue from exports of goods and services) has trended upwards over the past decade and now stands at 93%. This is a matter of concern even if there are some risk mitigating factors (at least in the ST); corporates' short-term foreign currency position is positive (USD 63 billion) thanks in particular to the high level of deposit dollarization (66%). The rollover rate of medium and long-term loans was still above 100% up to November. Lastly, domestic debt denominated in foreign currency has been stable at around 20% of GDP since 2015.

The government's exposure to currency risk is also very high, with foreign-currency debt accounting for two-thirds of its total debt. Fortunately, total government debt remains modest at 40% of GDP.

TURKEY: CENTRAL BANK INTERNATIONAL RESERVES (USD BN)

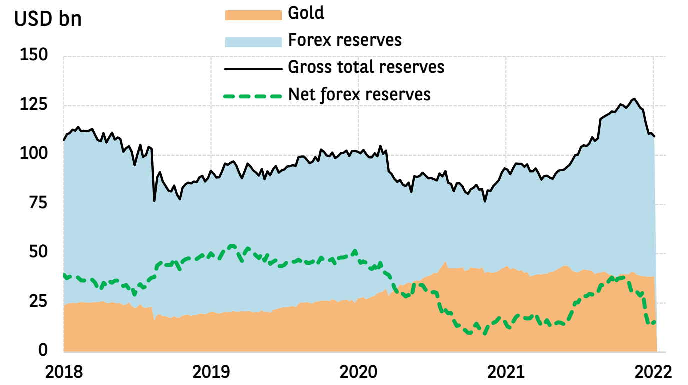

CHART 2 SOURCE: TCMB, BNP PARIBAS

In summary, the Turkish authorities' strategy is based largely on winning export market shares as the main engine of growth (as a matter of fact, exports of goods increased by 30% in dollar terms in 2021, around twice the average growth for the main countries of Central Europe).

But this strategy will also need corporates to invest and households to maintain consumption levels. Strongly negative real interest rates and indexation measures are expected to help them. But President Erdogan is also appealing to the population's sense of economic patriotism. In economic terms, this strategy is an uncertain bet on an adjustment through flows (mainly exports), whilst the analysis of stocks (forex reserves, foreign-currency debt of corporates and the government, bank deposit dollarization) highlights potential risks. The fear is that this adjustment may lead to a temporary recession or genuine foreign exchange controls and thus be more a constraint than a choice.

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