31 May 2022

Emerging Markets Monthly

'Perfect storm' looming for Turkey and TRY

- **The rising stagflation fears combined with tightening financial conditions, negative terms of trade shock, and no signs of a turnaround in domestic economic policies indicate further weakness for the lira. We see USD/TRY at 20 in 12M.**
- **However, risks are tilted towards even further TRY weakness as the intervention policies, which have supported the currency over the past months, begin to lose steam.**

The weakening in global economic growth outlook and tightening in financial conditions with still elevated commodity prices is a toxic combination for many EM economies, and not least Turkey. Rising energy and food prices are causing a negative terms-of-trade shock, which is amplified by the close trade relations with Russia and Ukraine.

The difficult position in the global context is aggravated by Erdogan's unorthodox economic policies, and as CBRT's unchanged decision last week underlined, we see no signs of a regime shift ahead of the June 2023 election. With inflation running at 70% y/y, the lira has remained surprisingly stable through early 2022, even though we have seen most commodity importers such as JPY or the CEE currencies weakening vis-à-vis USD.

This largely reflects the government's intervention policies: 1) the scheme for FX-guaranteed lira deposits announced in December has increased the attraction of lira-denominated deposits compared to typically popular FX deposits, 2) interventions by either the central bank or by state-owned banks have supported lira and 3) the mandatory conversion rate of exporters' FX revenue was raised from 25% to 40%.

Especially the FX-guaranteed deposits leave Turkey exposed to a fiscal crisis in the event of rapid TRY weakening, and the high amount of foreign debt in the corporate sector causes further difficulties as global financial conditions tighten. This is also reflected in the latest rise in the 5y CDS to 728 bps, the highest since 2003.

As global stagflation risks have risen over the past weeks, lira's stability has given in to a new wave of weakness, and **we see a clear risk of further strong depreciation as the intervention appears to be running out of steam**. Next round of the FX-guaranteed deposits will mature in June, likely leaving the depositors disappointed with double-digit negative real yields despite the latest round of lira weakness and nominal yields above the 14% policy rate. In addition, larger-than-normal FX debt maturities at the corporate sector over the summer may create market turbulence and lead to a reduction in FX liquidity if Turkish businesses struggle to roll over their maturing debt.

Gross international reserves have declined due to the FX intervention, and the current figures likely overestimate the net reserves, as they have both been supported by swap lines with a range of friendly central banks, such as China, Qatar, South Korea and UAE. While the swap lines boost central banks' gross reserves, 'borrowed money' has no impact on net hard currency reserves. **With the combination of adverse global outlook, weakening intervention, and no signs of a turnaround in domestic economic policies, we see USD/TRY at 20.00 in 12M horizon with risks clearly tilted to the upside.**

Quick view

- **EUR/PLN** Although CB has now become more hawkish, including favouring a stronger Zloty to drive down inflation, we doubt it will be vigilantly enough and see a slight upward drift in the cross.
- **EUR/HUF** quasi-managed by the CB: likely to add a bit of resistance at current levels. Given 6-12M, spot will probably drift higher
- **EUR/CZK** should go lower. Risks are tilted towards slightly more CZK strength as economy recovers and central bank raises interest rates. The CB credibility also supports CZK.

- **USD/RUB** we have suspended coverage on RUB.
- **USD/TRY** to move higher as quasi-peg to USD is unlikely to be sustained in the current global environment. Target 20.00 in a year.
- **USD/ZAR** has slowly bottomed, in line with our expectation. We see upside risk to the cross on 6-12m.
- **USD/CNY** to continue gradually higher towards 7.10 in 12M.
- **USD/INR** to trend gradually higher on overall USD strength.

- Find our most recent *FX Forecast Update* for G10 and emerging markets *here*.

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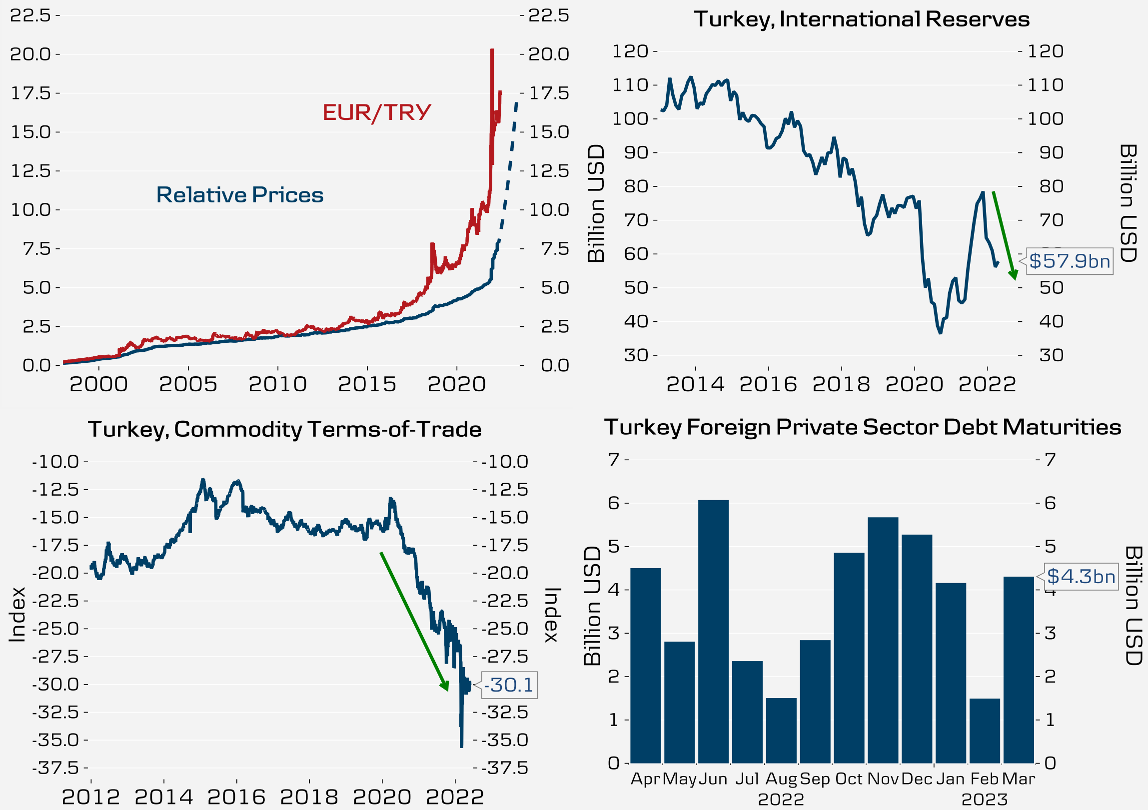
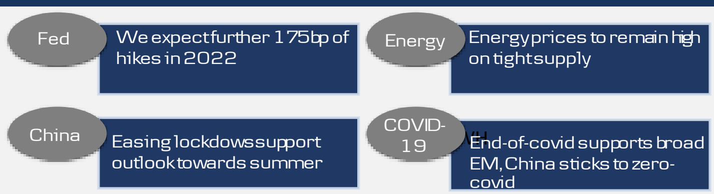
With inflation at 70% y/y and a significant negative terms-of-trade shock, further lira weakness seems likely as intervention loses steam. Tightening financial conditions pose risks over the summer with weakening government fiscal position and large foreign private debt maturities



Source: Macrobond Financial, TCMB, Turkish Ministry of Treasure & Finance, Citi, Relative prices projected based on stable m/m development from April

What-to-watch: Fed, energy prices, China and the pandemic



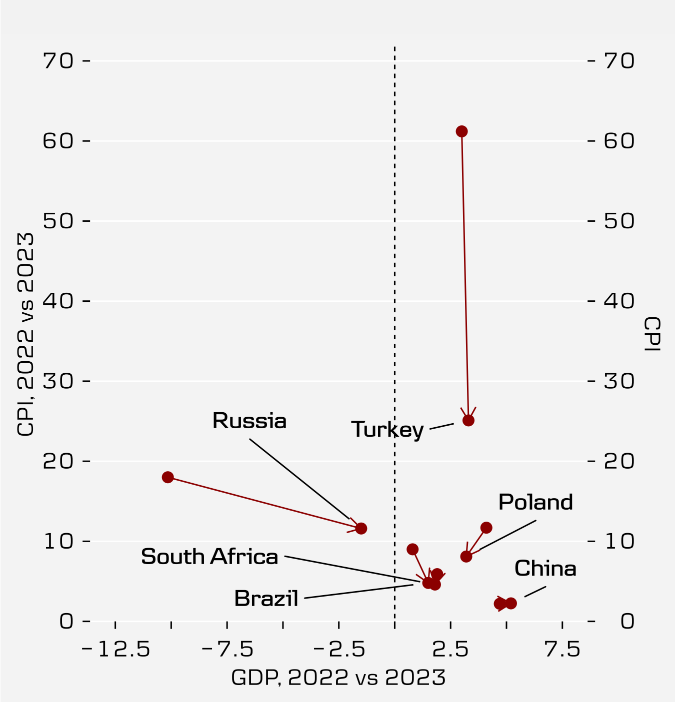
Source: Danske Bank

Significant tightening in financial conditions and high inflation as key risks

	2021				2022			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
China	China curbs credit, pace of growth comes down			Easing	Renewed lockdowns		Further easing	
Global financing conditions	Fed relatively sidelined				250bp worth of Fed hikes, first ECB hike			
Commodities	tensions are to stay but more gradual and less disruptive				Commodity prices to remain elevated, further upside risks			
CEE		Gradual recovery in CEE, inflation to stay			War impact	Rate hikes and intervention		Recession risks
Latin America	Econs to remain in low-growth environment				End-of-covid and high commodity prices balance social unrest			
Asia	Asia remains relatively strong, tailwind from China fades				Stabilizing growth			

Note: Green reflects optimistic outlook, red is negative and grey is a neutral view; colours reflect a broad macroeconomic view and are not necessarily FX specific.
Source: Danske Bank

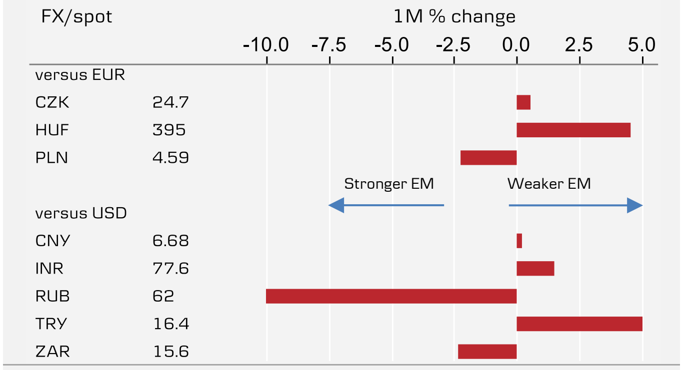
2022 generally brings higher inflation versus 2021



* Note: Arrows indicate the change in Bloomberg consensus forecasts for growth and inflation from 2021 to 2022

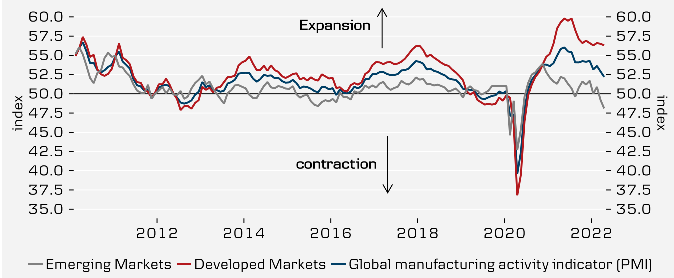
Source: Bloomberg

Mixed performance in EM currencies last month



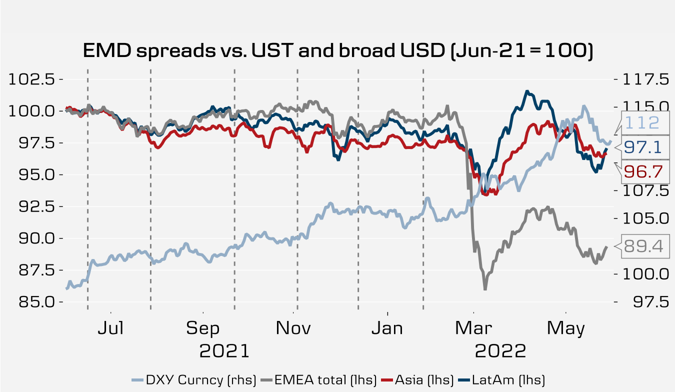
Note: An increase reflects a weaker currency versus EUR or USD.
Source: Bloomberg

Emerging markets fall in contractionary mode



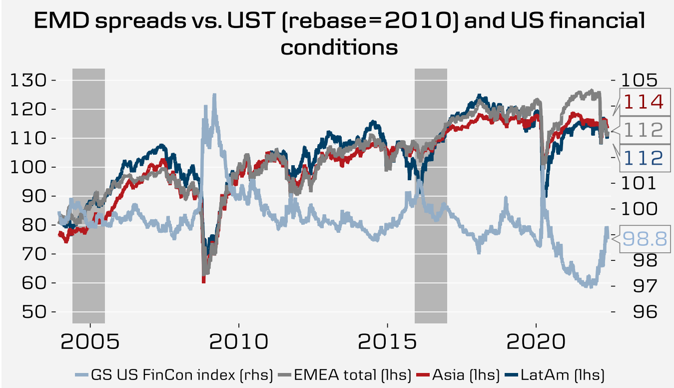
Source: Bloomberg

EMD spreads vs. UST widened substantially in early March while broad USD has strengthened, but Asia and LatAm have broadly recovered. Vertical lines are FOMC meeting dates.



Source: Bloomberg, Macrobond Financial, Danske Bank

Tighter US financial conditions tend to trigger broad-based EM FX weakness but Fed hikes (grey areas) have not led to sustained tightening in conditions



Source: Bloomberg, Macrobond Financial, Danske Bank

Danske Bank EM FX forecast vs majors: USD and EUR

EM	Spot	+1m	+3m	+6m	+12m
USD/PLN	4.224	4.25	4.33	4.43	4.51
USD/HUF	335	343	343	354	362
USD/CZK	22.312	22.18	22.41	22.64	22.86
USD/RUB	103.695	SUSP	SUSP	SUSP	SUSP
USD/TRY	14.714	14.70	14.90	17.00	19.00
USD/ZAR	14.955	15.00	15.50	16.00	16.50
USD/CNY	6.35	6.35	6.40	6.45	6.50
USD/INR	75.81	75.50	76.50	77.00	78.00

EM	Spot	+1m	+3m	+6m	+12m
EUR/PLN	4.683	4.68	4.68	4.70	4.74
EUR/HUF	371	370	370	375	380
EUR/CZK	24.7	24.4	24.2	24.0	24.0
EUR/RUB	115.7	SUSP	SUSP	SUSP	SUSP
EUR/TRY	16.33	16.2	16.1	18.0	20.0
EUR/ZAR	16.58	16.5	16.7	17.0	17.3
EUR/CNY	7.04	6.99	6.91	6.84	6.83
EUR/INR	83.8	83.1	82.6	81.6	81.9

Source: Danske Bank

Danske Bank EM FX forecast vs Scandies: DKK, SEK and NOK

EM	Spot	+1m	+3m	+6m	+12m
PLN/DKK	1.59	1.59	1.59	1.58	1.57
HUF/DKK	2.01	2.01	2.01	1.99	1.96
CZK/DKK	0.30	0.31	0.31	0.31	0.31
RUB/DKK	6.47	SUSP	SUSP	SUSP	SUSP
TRY/DKK	0.46	0.46	0.46	0.41	0.37
ZAR/DKK	0.45	0.45	0.44	0.44	0.43
CNY/DKK	1.06	1.07	1.08	1.09	1.09
INR/DKK	0.089	0.090	0.090	0.091	0.091
EM	Spot	+1m	+3m	+6m	+12m
PLN/SEK	2.23	2.22	2.18	2.15	2.15
HUF/SEK	2.81	2.81	2.76	2.69	2.68
CZK/SEK	0.42	0.43	0.42	0.42	0.43
RUB/SEK	0.09	SUSP	SUSP	SUSP	SUSP
TRY/SEK	0.64	0.64	0.63	0.56	0.51
ZAR/SEK	0.63	0.63	0.61	0.60	0.59
CNY/SEK	1.484	1.489	1.476	1.477	1.495
INR/SEK	0.125	0.125	0.123	0.124	0.125
EM	Spot	+1m	+3m	+6m	+12m
PLN/NOK	2.08	2.09	2.14	2.13	2.11
HUF/NOK	2.63	2.65	2.70	2.67	2.63
CZK/NOK	0.39	0.40	0.41	0.42	0.42
RUB/NOK	0.08	SUSP	SUSP	SUSP	SUSP
TRY/NOK	0.60	0.61	0.62	0.55	0.50
ZAR/NOK	0.59	0.59	0.60	0.59	0.58
CNY/NOK	1.386	1.403	1.447	1.463	1.465
INR/NOK	0.116	0.118	0.121	0.123	0.122

Source: 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 Minna Kuusisto, Chief Analyst, Antti Ilvonen, Analyst, Lars Merklin, Senior Analyst and Jakob Christensen, Head of Emerging Markets Research

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Report completed: 31 May 2022, 13:50 CET

Report first disseminated: 31 May 2022, 14:05 CET