

Flash Comment

Turkey: external pressures, emergency hike and the outlook for the TRY

- This note summarises our impressions from a recent fact finding trip to Turkey as well as reflections after the emergency hike by the central bank yesterday.
- The TRY has been hit by a combination of expansionary domestic policies, a structurally weak current account position and large corporate and household external FX position, coupled with uncertainty about independence of the central bank and challenging geopolitical environment.
- While the sizable emergency interest rate hike by the central bank yesterday will take the pressure off the lira in the near term and improve confidence in the central bank's ability to act, we think the pressure on the TRY will remain high until the elections on 24 June. However, we expect another rate hike at the monetary policy meeting on 7 June, if not earlier, should the lira continue to remain under pressure.
- Given the challenging external financing environment, we raise our short-term forecast for the USD/TRY to 4.40 in 1M and 4.45 in 3M (4.25 and 4.25 previously), but keep our 6M and 12M at 4.35 and 4.50, respectively, as we expect the USD to lose some of its current momentum.

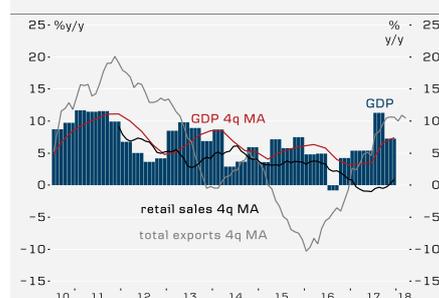
Economic outlook

The Turkish economy shows clear signs of overheating: the output gap is closed and inflation remains firmly in double-digit territory, while the current account (CA) deficit continues to widen. According to the IMF's article IV, Turkey's potential growth is 4%, while the economy grew 7.3% y/y in Q4 17 and 11.3% y/y a quarter earlier. Yet, looking at the current account deficit excluding gold and energy, it has improved. However, industrial production growth has started to moderate due to slowing domestic demand.

We remain more bearish on Turkey's GDP growth versus Bloomberg consensus, primarily as we think that decelerating loan growth, tightening monetary policy, the rising cost of construction and more moderate private consumption growth combined with shrinking fiscal expansion will weigh on the economy. We estimate Turkey's GDP will expand as follows: +3.5% y/y in 2018 (consensus +4.2% y/y), +3.0% y/y in 2019 (consensus 4.0% y/y) and +2.7% y/y in 2020 (consensus +3.8% y/y).

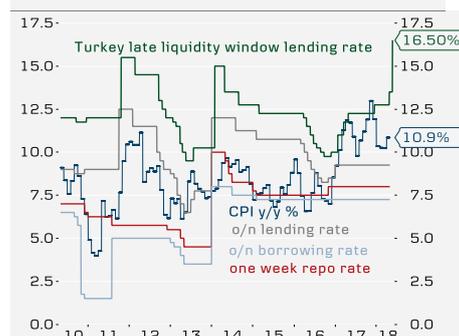
The key concern for the Turkish economy is the large external financing need, estimated at 26% of GDP annually. While a wide current account deficit has been a long story in the Turkish economy, it has deepened structurally in recent years, when the country lost its big markets for exports such as Iraq, Libya and Syria. Before 2010, Turkish exports to Libya were around USD4bn. Another big factor weighing on the current account balance is the country's high dependence on energy imports, which is hitting the trade balance on rising oil price. Furthermore, the expansionary nature of current macroeconomic policies giving rise to fast import growth has increased external imbalances further. The weakening of the currency has therefore not led to an improvement in the current account balance due to the large import content in domestic demand.

Turkey's GDP growth is set to moderate



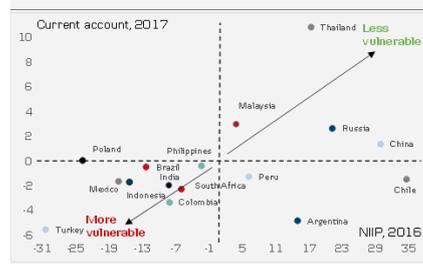
Source: Macrobond Financial, Danske Bank

Turkey's emergency tightening will start weighing on inflation in the long run



Source: Bloomberg, Macrobond Financial, Danske Bank

Turkey's net international investment position has been the weakest among EM



Source: IMF, Danske Bank

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In addition to the current account deficit, the Turkish corporate and household sectors have amassed large amounts of foreign loans through the Turkish banking sector. The Turkish international investment position (measuring external assets against foreign liabilities) is over -25% of GDP (by far the biggest negative position among major emerging markets). The annual roll-over of foreign loans amounts to 20% of GDP. Especially, the corporate sector is exposed with large open FX positions. These positions have been kept afloat by low USD rates and fast domestic growth, but with the current rise in the USD/TRY and higher US rates, the companies are more vulnerable, and there are signs of financial distress emerging in the corporate sector.

There are signs that the quality of foreign financing of external imbalances is deteriorating in the sense of becoming more short term. The main financing components are now portfolio flows and drawdown of foreign reserves.

External demand remains strong due to global expansion and revoked economic sanctions by Russia. Travel and transportation revenues are growing on higher tourist arrivals.

Fiscal policy

Both fiscal and quasi-fiscal policies have been expansionary in the past year supporting the rapid growth in the Turkish economy. The credit guarantee fund (quasi-fiscal obligations) witnessed lending rates of 40% or expanding loans to the equivalent of 7% of GDP in 2017. However, the Turkish authorities have taken steps to curtail lending.

Inflation and monetary policy outlook

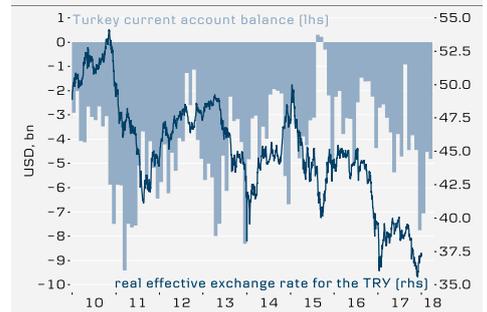
Both headline and core inflation in Turkey remain elevated due to ongoing TRY devaluation, which is pushing imports prices up. We hardly see that the average headline inflation could drop permanently into single-digit territory in 2018. Already since 2013, inflation expectations have been crawling higher. Given the current gap to the 5% inflation target, Turkish central bank's (the TCMB) monetary policy was considered too loose, causing additional pressure on the TRY. Yesterday's emergency hike of the late liquidity lending rate by 300bp to 16.50% was the only tool capable to stop TRY's free fall ahead of the snap election on 24 June.

Given the sour sentiment in emerging markets globally, a 300bp hike could be a temporary measure to halt TRY's rapid depreciation. Thus, we do not exclude another tightening at the monetary policy meeting on 7 June. The USD/TRY rate is a very important 'wealth' indicator for ordinary Turkish voters and any approach of the currency pair to 5.00 would trigger another emergency rate hike ahead of the election, we believe similar to yesterday's hike.

The snap election

On 24 June 2018, both parliament and president will need to be elected. This time, the major focus in the pre-election campaign in Turkey has been on economics and less on politics. The current president Recep Tayyip Erdoğan's announcement of an early election was received positively by the markets, as his victory would stop the actual fiscal stimulus (and economic populism) after the election and support the TRY further. However, the country remains very polarised politically and the number of swing voters could be up to 20%, which raises the likelihood of there being a second round in the election. It is also important to see who will gain the majority in parliament after the election, as it is still stronger than the president despite recent changes leading to fortified presidential power.

Turkey's wide CA deficit keeps pressure on the TRY in the long-term



Source: Macrobond Financial, Danske Bank

Turkey's major trade partners: Russia is back as geopolitical situation has changed since 2015 deterioration

2017		Total trade (USD, mrd)
1	Germany	36.98
2	China	27.15
3	Russia	22.89
2016		Total trade (USD, mrd)
1	Germany	36.29
2	China	28.22
3	United States	18.93

Source: Bloomberg, Danske Bank

Banking system

There has been no tightening in FX borrowing, while loan growth has slowed down, causing lower needs for funding loans. The TCMB sees local banks having FX liquidity shields to serve short-term liabilities. Non-performing loans remain below 3.0%, while there has been a rise in restructured loans. Yet, the IMF sees the situation with liquidity in banking sector as the system's Achilles heel. Thus, any sudden brake in Turkey's economic growth or more limited external financing conditions would hit the banking system.

Geopolitics

Geopolitics remain a significant risk factor for both the economy and the TRY. Deterioration in diplomatic issues with the US is a clear downside risk for the currency, while a restored relationship with Russia is notably helping exports of Turkish goods and services.

Another significant factor weighing on Turkish economy is US withdrawal from the Iran deal and looming anti-Iran sanctions, which would hit Turkish exports to Iran and the CA balance through increase in energy prices.

Turkish lira

While we have been bearish on the TRY for several years, in 2018 the currency was hit by a perfect storm, where both macro fundamentals and global environment, local politics and geopolitics, net reserves and portfolio flows stroke all together. While yesterday's emergency hike brought the USD/TRY closer to its fair value, we raise our short-term forecast for the USD/TRY to 4.40 in 1M and 4.45 in 3M (4.25 and 4.25 previously), seeing another emergency hike ahead of the election. We keep our TRY forecast unchanged in mid- and long-term seeing USD/TRY at 4.35 in 6M and 4.50 in 12M as our mid- and long-term view on the USD stays bearish.

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

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None.

Date of first publication

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