

International Commentary — April 2, 2024

Tur-key'ed In On A Long-Term Lira Recovery

Summary

Around the turn of this year, we formally expressed an outlook of long-term cautious optimism on the Turkish lira, a notable shift in view after years of pessimism. With local elections now in the past and a commitment to policy and economic orthodoxy intact, we are reiterating our long-term constructive view on the Turkish lira, but with an increased degree of conviction.

Economist(s)

Brendan McKenna

International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

Turkish Lira Has Reached It's Inflection Point

"In Turkey, President Erdogan has appointed a technocratic team to decide economic and monetary policy. New cabinet members have delivered significant monetary tightening in an effort to contain inflation, a stark shift in monetary policy ideology from what President Erdogan had put in place prior to elections. A more orthodox stance on monetary policy has attracted foreign investors back to Turkish government bonds and has brought Turkish assets back onto investor radars. Up until now, the lira has not recovered as the implementation of technocratic policy needs to build a longer track record of success and "Erdogan risk" hovers over the currency; however, we do believe the lira is on the brink of a rebound in 2024. Turkey will host local elections in March 2024, and while the outcome is not particularly meaningful, President Erdogan's recent ability to relinquish monetary policy to central bankers will be tested pre- and post-election. In our view, the central bank will now maintain its independence leading into the election and after the election. Interest rates will remain high, inflation will gradually recede, sovereign credit rating upgrades will be delivered and the lira will begin its recovery, although likely along a rocky and non-linear path. In that sense, we now believe the Turkish lira will outright strengthen starting in Q2-2024 and lira strength will continue through early 2025. Conviction in this new lira outlook is not strong, however, and should the policy backdrop change, our view would snapback to forecasting lira depreciation." — [Wells Fargo International Economics 2024 Outlook](#)

The above commentary is a direct quote from our 2024 Global Economic Outlook published toward the end of last year. Our cautiously optimistic outlook on the Turkish lira was the first bit of positivity we expressed toward the Turkish currency in years, and for good reason, generated an influx of questions. While we explained our rationale for long-term lira strength in detail, corporates and investors alike mostly responded with their own degree of caution and skepticism. Fast-forward to Q2-2024, the quarter when we believe the lira will reach its turning point, and our cautious optimism has shifted toward having greater conviction in a lira recovery.

Our optimistic lira thesis was, and still is, centered around a return to an orthodox approach to monetary policy and Turkey's central bank (CBRT) gathering credibility as an independent monetary policy authority. In our view, progress has been made on both fronts. As far as shifting back to orthodoxy, President Erdogan has seemingly handed over control of monetary policy and broader economic policy to his technocratic team of cabinet members. CBRT policymakers have delivered 41.50 percentage points of cumulative rate hikes since June 2023—the most aggressive pace of tightening under Erdogan's leadership—that are clearly designed to contain inflationary pressures. While CBRT monetary tightening has been substantial up to this point, in our view, President Erdogan's full support of rate hikes is the force that arguably has had, and will continue to have, the most positive impact for Turkey if sustained. Since the beginning of the current tightening cycle, Erdogan has continuously defended decisions to raise interest rates to contain inflation, a deviation from his previous view on the relationship between interest rates and inflation, and an approach that has allowed for renewed investor interest in Turkey and lira-denominated assets. President Erdogan relinquishing influence over interest rates has also allowed Turkey's central bank to develop a track record of making independent monetary policy decisions. In our view, the CBRT's track record of implementing orthodox and technocratic monetary policy has now been sufficiently developed for Turkey's central bank to recapture a degree of perceived credibility from global financial markets participants.

In addition, we believe President Erdogan's conciliatory approach toward recent local elections will act as a source of strength for the Turkish lira. This past weekend, President Erdogan's Justice and Development Party (AKP) lost municipal elections in major jurisdictions such as Istanbul and Ankara. While the outcome of local elections is certainly interesting, in our view, the more important takeaway is Erdogan accepting defeat and offering no indication that he will look to challenge or overturn any election result. We interpret Erdogan's decision not to challenge election results as obviously positive for the democratic process in Turkey, but also that Erdogan is willing to sacrifice short-term AKP policymaking in major cities for longer-term electoral support via potentially lower inflation and improved economic conditions. While recent local elections could be perceived as a referendum on President Erdogan, the next presidential election is not scheduled until 2028, providing ample time for Erdogan to rebuild voter support as the economy stabilizes and consumer purchasing power improves. We also believe that municipal election defeats will not result in Erdogan looking to regain influence over monetary or economic policy, and the newfound independence and credibility of the central bank will remain intact going forward. Under these assumptions, we continue to believe credit rating agencies will move forward with additional positive actions on Turkey in the near future. Fitch already

upgraded Turkey's sovereign credit rating in March of this year, while also assigning a “positive outlook” to the rating. Moody's and S&P also flipped to positive outlooks on the credit toward the end of 2023 and early 2024, leading us to believe rating upgrades are imminent from both agencies. We also believe that, while Turkey is still far from regaining investment grade status, multiple notch upgrades from each agency could materialize this year, barring any setbacks in the recent policy progress.

Since the start of the CBRT tightening cycle, market participants have responded positively toward Turkish assets. Credit default swap spreads on Turkish government debt have narrowed considerably, and have converged toward the emerging markets sovereign dollar-debt CDS spread index (Figure 1). In fact, since the CBRT tightening cycle started, Turkish spreads have narrowed over 205 bps, while the EMBI index has only narrowed by 91 bps. Also, political uncertainty existed ahead of municipal elections and that uncertainty led to a premium for the U.S. dollar, relative to the official USD/TRY exchange rate, when exchanging lira for the U.S. currency. However, with local election-related uncertainty in the past, that dollar premium has diminished, and the official and unofficial exchange rates have converged leaving only a small, but normal, premium for U.S. dollars (Figure 2). In our view, the convergence of exchange rates and diminished dollar premium reflects a growing optimism in the future value of the lira (i.e. more confidence in the stability of the currency). For the lira, the combination of improved local political dynamics, independence of a credible monetary authority, and no interference in Turkey's democratic system should all result in a stronger currency over time. In that sense, as mentioned, we reiterate our constructive outlook for the Turkish lira, this time with a higher degree of conviction, and believe the worst of Turkey's currency issues are likely in the past. With that said, we do believe sporadic bouts of volatility could still hit the lira. However, we believe lira volatility—assuming no major political disruptions or backtracks on recent policy implementation—will be temporary and the currency will trend on a strengthening trajectory through the end of our forecast horizon, which for now is through the end of Q3-2025. In that sense, we believe the USD/TRY exchange rate has peaked this year, and by the middle of 2025 will break below TRY30.00.

Figure 1

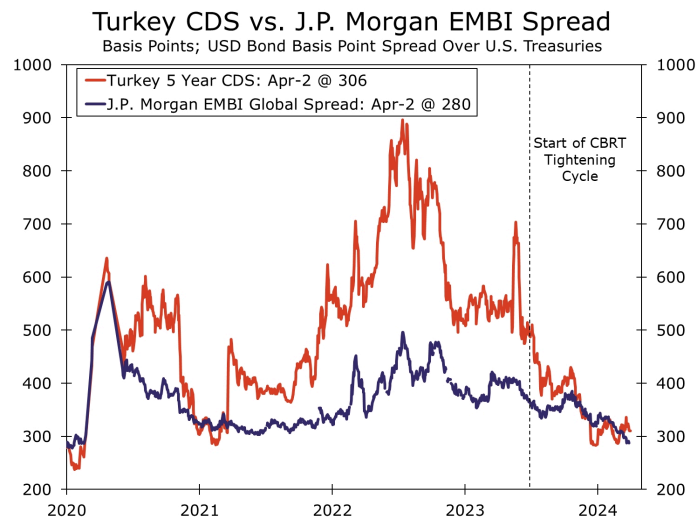
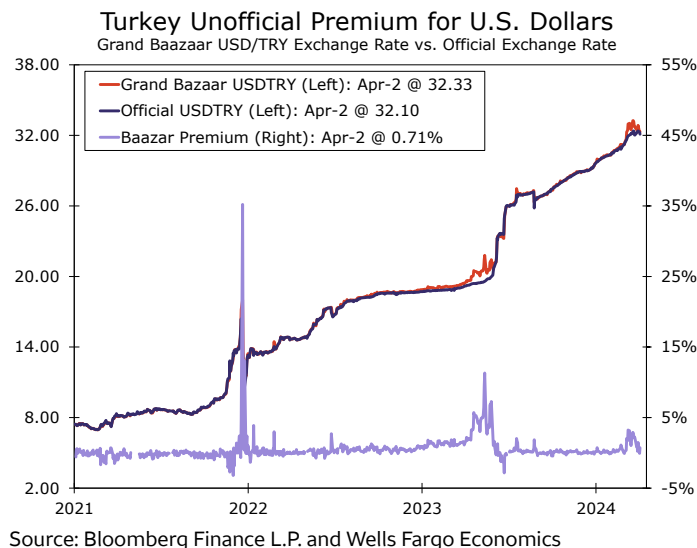


Figure 2



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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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