5 May 2020

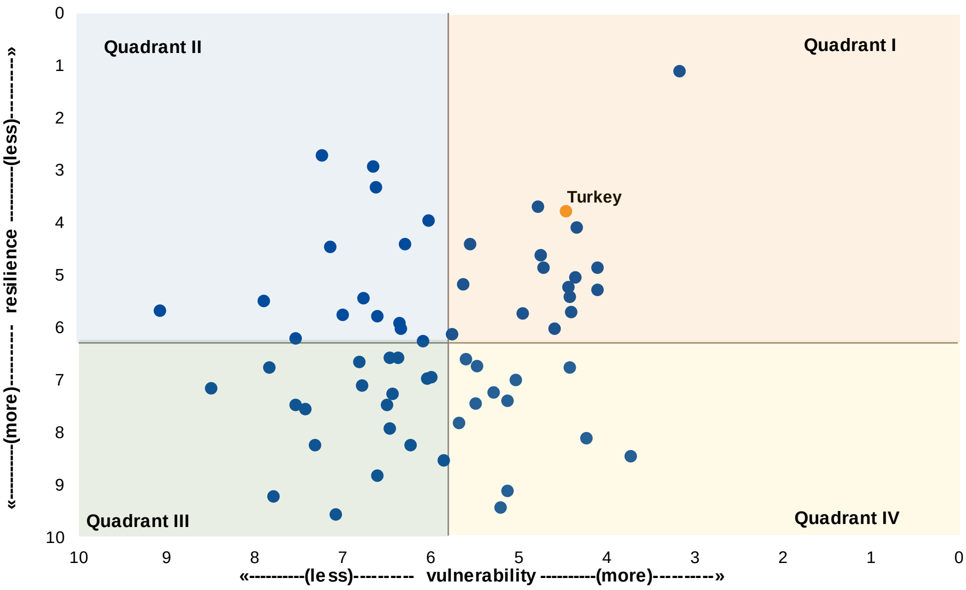
Five charts to explain Turkey's major external sector vulnerabilities in 2020

Turkey's weak external sector, the lira's depreciation to record lows and domestic macro-economic imbalances will test the country's resilience to the Covid-19 crisis this year, especially if reserve adequacy falls further. We now anticipate a GDP contraction of 5% in 2020 (and -10% under a stressed scenario). We look at the critical external sector challenges for Turkey (BB-/Negative) in five charts.

Chart #1: External weaknesses are a threat in periods of global crisis

Turkey stood out as among the 2020 "Risky-3" economies most exposed to external shocks out of a 63-country sample in the 21 April update of Scope's biennial external vulnerability and resilience rankings. Turkey's weak assessment reflects factors such as a historical trend of exchange-rate volatility, high foreign-exchange debt outstanding and inadequate reserves. The ranking's two axis presentation is reproduced in **Figure 1**. Turkey is a "Quadrant I" economy, among the most vulnerable and least resilient to a balance of payment crisis. Fraught global trading and "risk off" market conditions exacerbated by the pandemic expose externally susceptible economies such as Turkey.

Figure 1: Scope external vulnerability and resilience grid, 2020 global results



Source: Scope Ratings (2020). '2020 External Vulnerability and Resilience rankings for 63 countries: Covid-19 Crisis update'.

#2: The weak lira puts the government and Turkish companies saddled with foreign currency debts in a challenging position

Accommodative monetary policy and declining domestic and foreign investor confidence in Turkish lira-denominated assets have led to a steady weakening in the exchange rate. On Friday, the lira broke past 7 per US dollar and is, at the time of writing, trading 29% weaker compared with an August 2019 peak against the USD. The deterioration in the TRL/USD exchange rate puts the government and Turkish companies in a predicament: 53% of *central government* debt is denominated in foreign currency (with that FX share doubling from 27% of debt per mid-2013), while the private sector also has a net FX debt position (**Figure 2, next page**), the latter which, while trimmed from a February 2018 peak of USD 223bn, nonetheless stood at USD 175bn as of January 2020.

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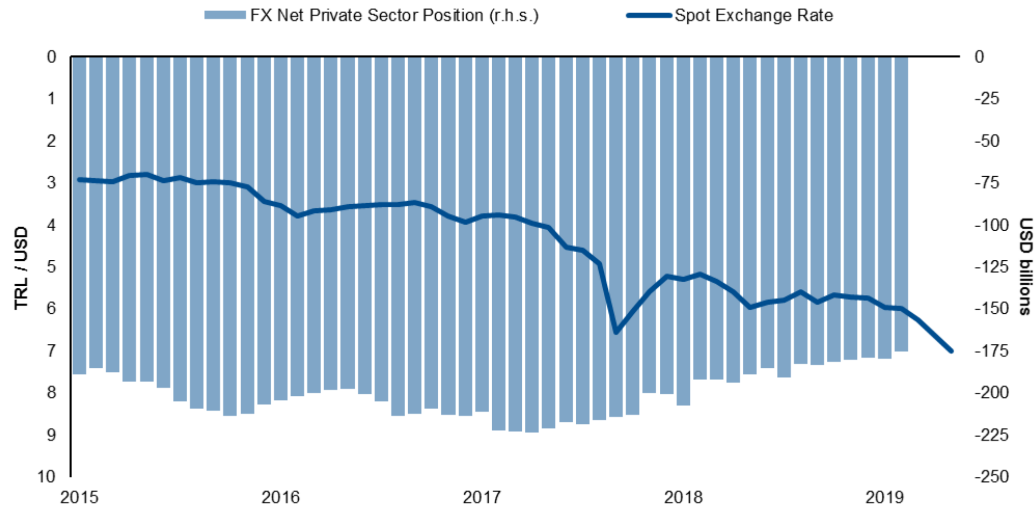
Figure 2: Lira to dollar exchange rate and private sector net FX position (RHS)

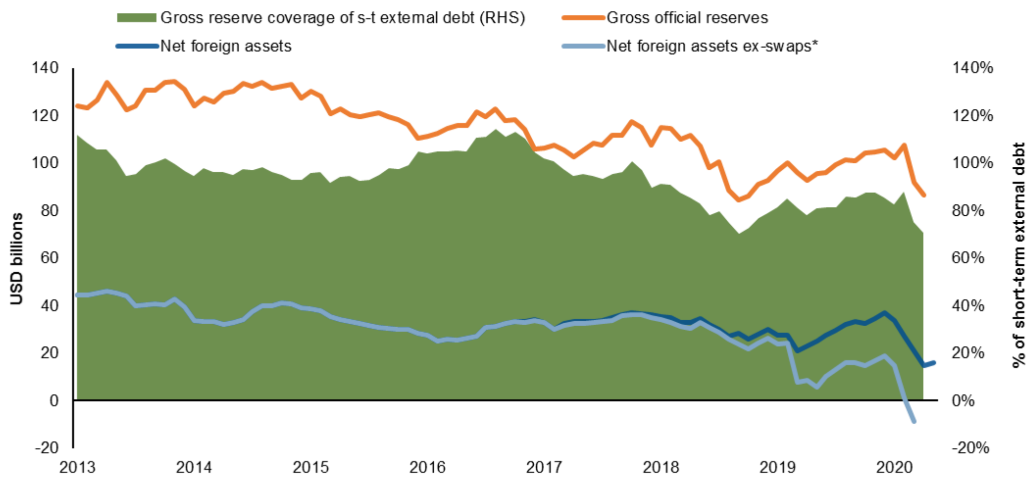


NB. The net foreign exchange position reflects that of Turkish non-financial companies.
Source: Haver Analytics, Scope Ratings GmbH

#3: Central bank FX reserve erosion poses risk of deeper balance-of-payments crisis

Official reserves declined to USD 86.4bn as of 24 April 2020 compared with a 2013 peak at USD 135bn, while – netting out central bank FX liabilities to domestic banks (such as bank FX deposits) – net foreign assets fell to USD 16.1bn as of 1 May, from USD 37.1bn at end-2019. Adjusting for short-term FX swap liabilities that are being excluded from central bank FX liability data, true net foreign assets have, however, turned negative since March (**Figure 3**). Turkey's official reserves in gross terms cover a little above 70% of short-term external debt, down from 114% as of 2016 and below an IMF adequacy threshold of 100%. Outstanding short-term external debt was USD 122.5bn in February, mostly representing Turkish bank and corporate liabilities. With diminishing reserves, Turkey is less resilient if capital outflows pick up or if lira depreciation gets worse. Aggressive exchange-rate intervention by state-owned banks to stabilise the exchange rate proved insufficient to prevent the lira's devaluation to above 7 per dollar, depleting reserves in the process.

Figure 3: Reserve levels, gross and net, USD billions



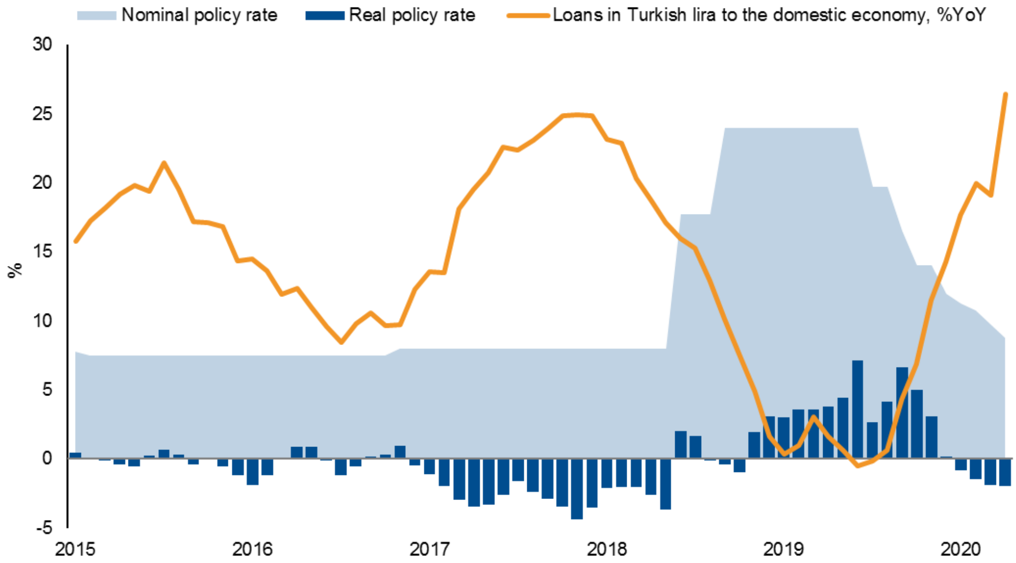
'Net foreign assets excluding short-term FX swap liabilities, calculation method of the Financial Times.
Source: Haver Analytics, Scope Ratings GmbH

In Scope's opinion, Turkey could not sustain an *extended* balance-of-payments crisis with current reserves without calling upon external funding support. However, any external support in such a scenario is more likely to derive from bilateral lenders (such as Qatar or China) than from the IMF – given the Turkish President's aversion to IMF help.

#4: Rate cuts put real policy rates in negative terrain, while lending growth booms – exacerbating macro imbalances

External sector risks in Turkey are also exacerbated by mismanagement of the economy, in part due to ongoing consolidation of power in the hands of President Recep Tayyip Erdoğan. The policy one-week repo rate was cut an additional 100bps to 8.75% mid-April (the eighth consecutive cut from 24% as of July 2019), resulting in a negative real policy rate of 2.0% against still elevated inflation of 10.9% YoY as of April (**Figure 4**). Turkey's real interest rates are among the world's *lowest* at present. Given the deep economic contraction anticipated in 2020, additional rate cuts are possible if not probable. Turkish policy makers are betting that increasingly easy monetary policy will amplify bank lending to support the domestic economy, with lira lending rising an elevated 26.4% YoY in April. Growing macro-economic imbalances like this and longer-standing questions surrounding the quality of Turkey's macro-economic management sap investor confidence, already weakened by impacts of the pandemic.

Figure 4: Policy rate, %, and lending in lira to the domestic economy, %YoY

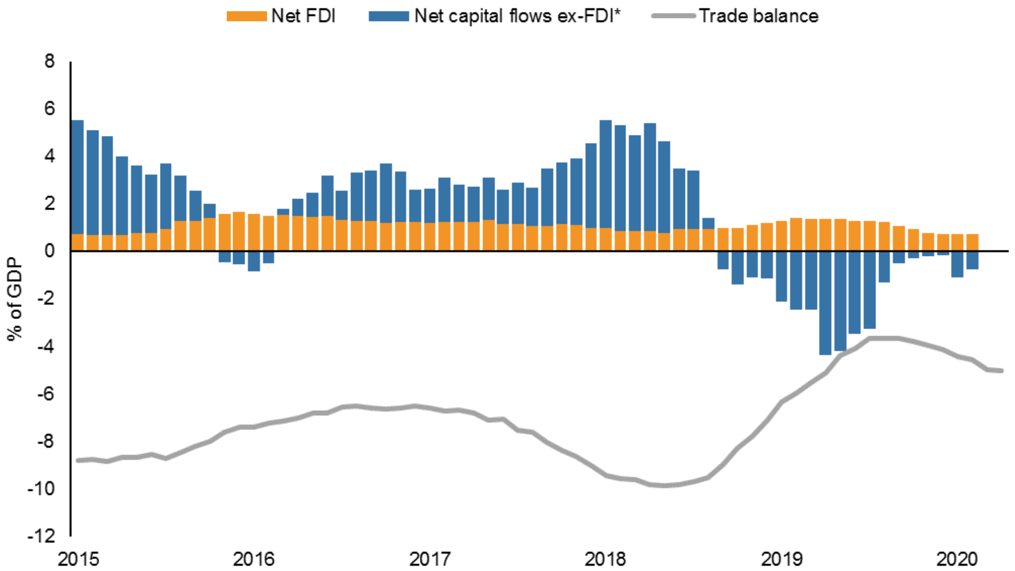


Source: Haver Analytics, Scope Ratings GmbH calculations

#5: Vulnerability to short-term capital outflows a longer-term risk

Turkey's vulnerability to further capital flight is a vital area to monitor after emerging market outflows intensified in March. The country's inherent external sector vulnerabilities, severe macro-economic imbalances, economic recession and rising unemployment present challenges to resilience, especially if risk-off market sentiment were to transform into any broader emerging market crisis in 2020. Net foreign direct investment eased to 0.7% of GDP in the year to February 2020, down from 1.4% in the year to February 2019 (**Figure 5, next page**). As such, the financing of Turkey's structural trade deficits remains contingent upon short-term types of capital inflows (alongside dependence on services surpluses). Longer term, a key rating-relevant issue relates to the domestic economy's reliance on more volatile portfolio and loan inflows and how substitution of such hot money with steadier foreign direct investment might be facilitated to engineer a more sustainable economy and ease a record of economic volatility.

Figure 5: Trade balance and capital flows, rolling one-year, % of GDP



*Net portfolio inflows + net other investment inflows.
Source: Haver Analytics, Scope Ratings GmbH

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