Flash Comment #101

April 4, 2016

Turkey: current cyclical lull and policy complacency increase medium-term financial vulnerabilities

The latest figures on Turkish GDP growth showed an acceleration in economic activity (+5.7% year-on-year in 2015Q4), supported by accommodative policies, both fiscal and monetary, and their translation in rapid credit growth. However, in the absence of significant structural improvements, the effects of simulative policies should progressively fade away, while the newly created distortions could jeopardize the country's financial stability and impose a sharper cyclical adjustment. This is the signal given by our models that switched-on a WatchList Indication on economic activity for Turkey over the near term (2018-2020). Turkish corporates and banks appear more vulnerable than the sovereign, notwithstanding a deteriorating political environment.

Favorable short-term cyclical acceleration

After a long period of average economic growth (+3.0% on average since 2012), Turkish economy accelerated during 2015, up to +5.7% in 2015Q4 after +3.9% in 2015Q3.

GDP Growth

y/y growth, %

Source: TAC ECONOMICS, Datastream

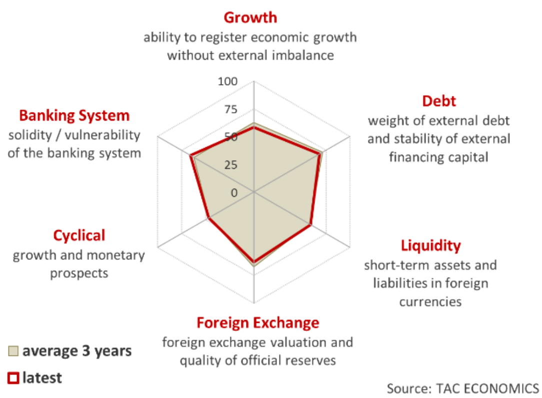
This fits well with the favorable position of our leading index of domestic momentum seen during 2014, and the positive reading of the Cyclical Balance overall performance, as seen in the polygon of risks representing Turkey's economic and financial performances across our six Fundamental Balances.

However, the *real economic pressure* has started to reverse into more neutral territory, and other leading index similarly point to some medium-term weakness (e.g. the PMI index moving back to just a shade below 50 in April 2016).

More worryingly, the favorable reading on the Cyclical Balance is the only bright spot in Turkey's overall country risk metrics: our polygon of risk indeed emphasizes a combination of high risk, where no other fundamental balance (Growth, Debt, Liquidity, Foreign Exchange and Banking System) is favorable, indicating indeed substantial external and financial vulnerabilities.

Economic & Financial Risk Rating - Turkey 59.8-C

from 0 (lowest risk) to 100 (highest risk)



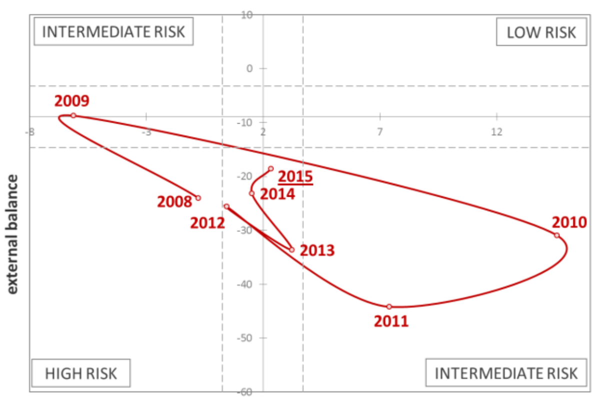
Source: TAC ECONOMICS

The unfavorable polygon translates into a high overall Economic & Financial Risk Rating (59.8-C, just below the 60-D reading), which has deteriorated since mid-2014. Moreover, a WatchList Indication on Economic Activity is switched-on for the period 2018Q2-2020Q1, suggesting higher vulnerabilities ahead.

Insufficient improvement in external account while fx funding remains vulnerable

The Growth Balance has modestly improved from *high risk* to *intermediate risk* in 2015, thanks to accelerating growth and lower commodity prices reducing the value of imports. Unlike other net oil-importing countries (e.g. India, Poland), Turkey has however not fully taken advantage of lower oil prices to improve external balances, and the current account deficit remained excessive (USD -33 bn estimated for 2015). Without structural improvement in competitiveness or a further depreciation of the currency, any sustained economic acceleration starting from the current position in our Growth Balance would imply rapidly increasing borrowing requirements.

Growth Balance



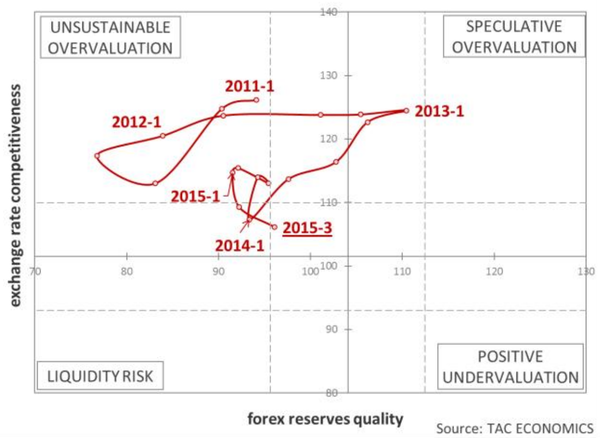
Source: TAC ECONOMICS

This challenge is compounded by a *high risk* position in the Debt Balance, i.e. a combination of a substantial external debt servicing obligation, most of it from corporate and banks, while foreign direct investment remains moderate. The shorter-term vulnerability is also shown by the large *maximum potential service* in our Liquidity Balance, i.e. a potential strain on the country's international reserves if refinancing of short-term fx obligation becomes difficult.

Despite the past depreciation, the Turkish Lira (TRY) is not yet competitive enough

On our Foreign Exchange Balance, the TRY *exchange rate competitiveness* index has visibly improved since the clear *unsustainable overvaluation* showed in 2011-2012. Over a more recent past however, the improvement has stalled, leaving the index above the neutral threshold, probably by 10% at the end of 2015. Taking into consideration the challenges revealed by the Growth Balance, it is fair to suggest that the TRY should move below the main threshold and towards the lower level of the neutral band, i.e. a medium term requirement of at least 20% depreciation from the current levels, and a likelihood of moving towards TRY 3.2 at the end of 2016 (against TRY 2.82 on April 1st, 2016).

Foreign Exchange Balance



Source: TAC ECONOMICS

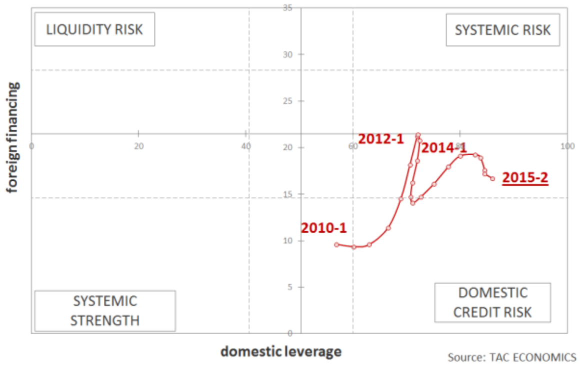
Notwithstanding the slightly better dynamic of *forex reserves quality*, Turkey's position coupled with a decline in the level of foreign currency reserves held by the central bank (from USD 103bn In July 2015 to USD 94bn in February 2016) is not solid enough to prevent a further potential depreciation.

Indeed, high fx funding requirements and the sensitivity to potential swings in international investors' sentiment in a context of uncertain US monetary normalization and regional / geopolitical risk create conditions prone to risk materialization.

Policy bias and credit expansion fuel medium-term risks

A very specific characteristic of Turkeys' recent cyclical performance has been the very rapid increase in credit distribution. Despite a recent and modest deceleration, domestic credit to the private sector (households and corporates) grew by 22% year-on-year in 2015Q4. This is increasing the vulnerability of the Banking System Balance and reflects both excessive household leverage and large corporate credits (including a substantial proportion in foreign currency). Simultaneously, Turkish banks use more foreign funding, putting Turkey dangerously close to a *systemic risk* position.

Banking System Balance



Source: TAC ECONOMICS

In parallel, the lax monetary policy (policy rates below inflation) and absence of fiscal tightening (allowed by a significant budget primary surplus) combine with the rise in minimum wage in January 2016 to feed inflationary pressures, with headline inflation expected to remain close to 8.0% at the end of 2016.

The current stimulus on growth jeopardizes further financial stability ahead

To sum it up, structural weaknesses persist on Growth and Debt Balances, the improvement on external situation (Liquidity and Foreign Exchange Balances) remains inadequate despite past depreciation while domestic conditions (Cyclical and Banking System) are likely to deteriorate towards an overheating position with current accommodative policies.

Issues and questions about policy direction are likely to intensify with the end of governor Basci's mandate in April 19, 2016, when the independence of the Central Bank has seemed to be challenged by political pressures from Turkish President Erdogan.

Turkish absorption capacity from an exogenous shock is modest, with low foreign reserves, persistent current account deficit and large fx financing requirements. These factors of financial fragility will prevail notwithstanding the sovereign's strength and credit quality, summarized by an aggregate public debt at 32% of GDP and a fiscal deficit estimated at -1.4% of GDP in 2015.

Conversely, any reversal in economic activity (which should be expected) will highlight corporate vulnerabilities, especially for those have a clear mismatch between funding currency and their revenues. Similarly, Turkish banks may face roll-over tensions and increase in funding conditions, especially if geopolitical / political uncertainties and risks were to weigh down on international sentiment.