

Turkey outlook – what comes next after
the change in CBRT leadership?

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Contents

01

**Executive
summary
pp 03**

02

**Macro implications
pp 04-09**

03

**FX implications
pp 10-14**

Executive summary – old risks resurface

Policy uncertainty amplifies risks

1

Key takeaways

- President Erdogan's abrupt dismissal of the central bank of Turkey's (CBRT) governor Agbal on 19 March marks a return to unorthodox policies that will fuel uncertainties and hamper investor confidence
- Agbal returned to mainstream textbook economic practices much to the markets delight – hiked rates aggressively and rebuilt FX reserves – and his policies paid off with the Lira appreciating 18% against USD
- Much is uncertain but the appointment of governor Kavcioglu risks a return of the credit-boom, currency-bust cycle that has characterised Turkey in recent years

2


Macro

- At face value, the unexpected replacement of the CBRT governor introduces additional uncertainties to inflation and interest rates outlook, which does not bode well for macroeconomic visibility
- Following a stimulus driven growth in 2020, the CBRT faces a challenging economic backdrop – unwinding of the strong monetary expansion, containing inflationary pressures and keeping the current account deficit in-check remain among the challenges
- We highlight four core areas to monitor as next steps: (i) inflation; (ii) dollarisation; (iii) external balances and; (iv) the CBRT's reserve position

3

FX

- Former CBRT Governor Agbal helped to restore investor confidence in the Turkish assets and the lira. The lira was by far the best performing emerging market currency under his tenure
- A sharp and abrupt reversal lower for the lira is now underway following his sacking. Strong capital inflows over the last 3-4 months are likely to reverse
- The sooner the CBRT begins to lower rates, the faster the pace of lira depreciation will be. We expect the lira to fall to new record lows and become more deeply undervalued again

|  MUFG | Q2-21 | Q3-21 | Q4-21 | Q1-22 |
|--|-----------|-----------|-----------|-----------|
| Policy rate (%) | 17.0% | 16.0% | 15.0% | 14.0% |
| CPI (% y/y) | 15.9% y/y | 15.4% y/y | 12.6% y/y | 11.8% y/y |
| Real rate (%) | 3.1% | 1.6% | 2.5% | 2.2% |
| USD/TRY | 8.750 | 9.500 | 9.250 | 9.000 |

Contents

01

Executive
summary
pp 03

02

Macro implications
pp 04-09

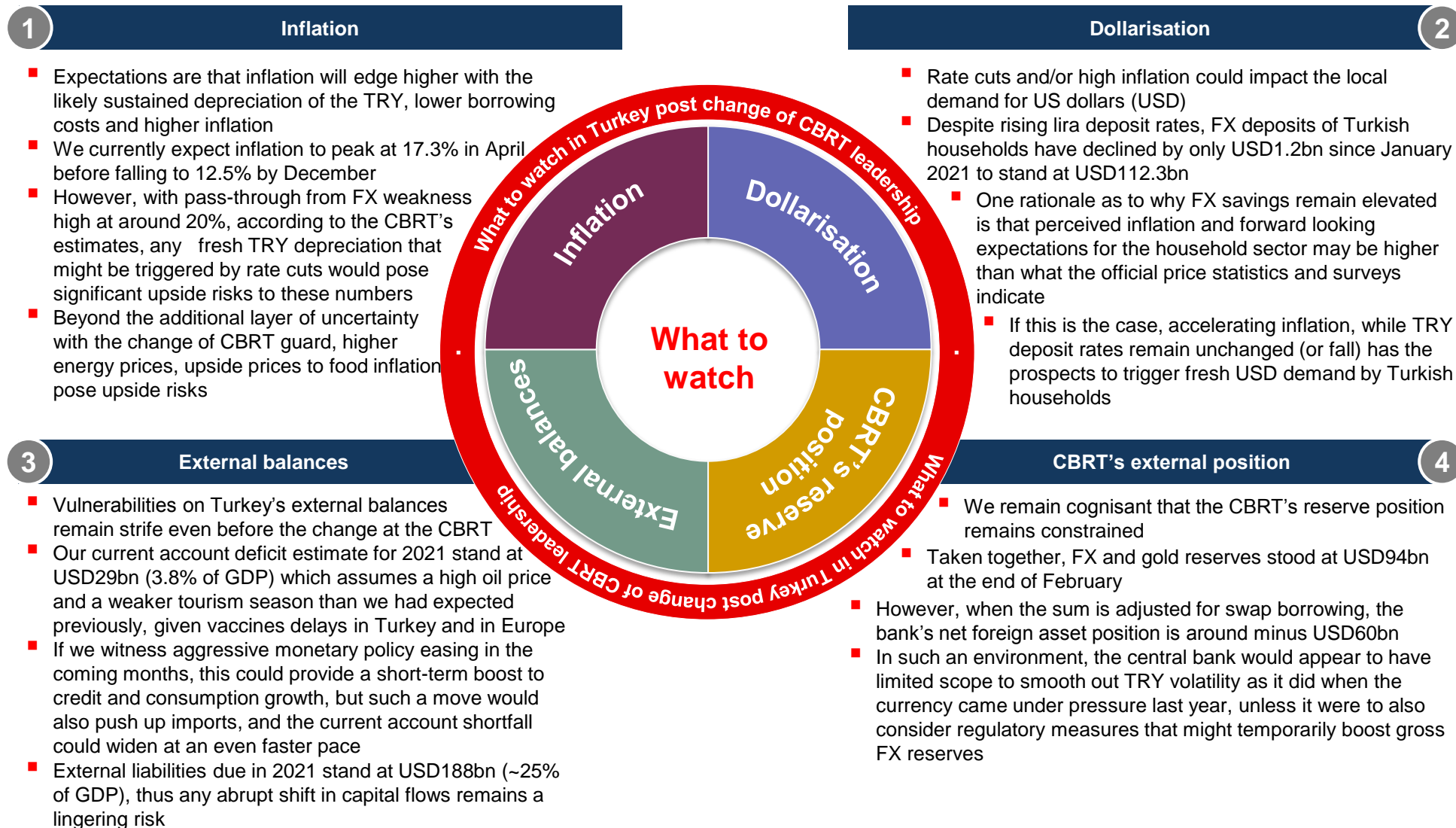
03

FX implications
pp 10-14

What to watch – four core considerations to monitor

Once the dust settles we monitor four areas

- Beyond the structural challenges, the key source of near-term uncertainty is the question of how much macro adjustment will authorities tolerate
- Balance of payments dynamics face ongoing strains with external debt repayments putting pressure on CBRT reserves with capital outflow risks



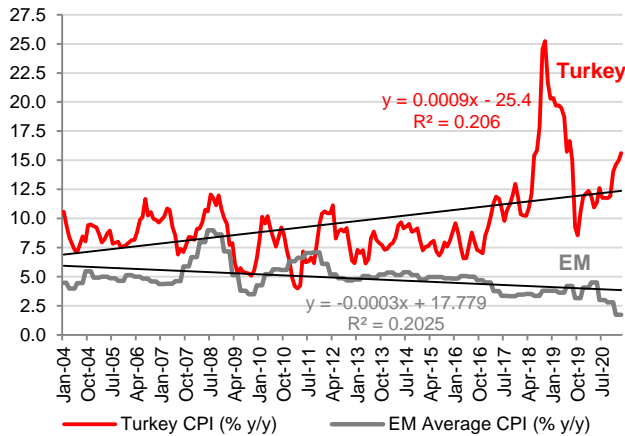
Inflation – FX pass-through into CPI will be large

Yet to reach the peak

- Expectations are that inflation will edge higher with the likely sustained depreciation of the TRY, lower borrowing costs and higher inflation
- With pass-through from FX weakness high (~20%), any fresh TRY depreciation triggered by rate cuts would pose upside risks to consumer prices

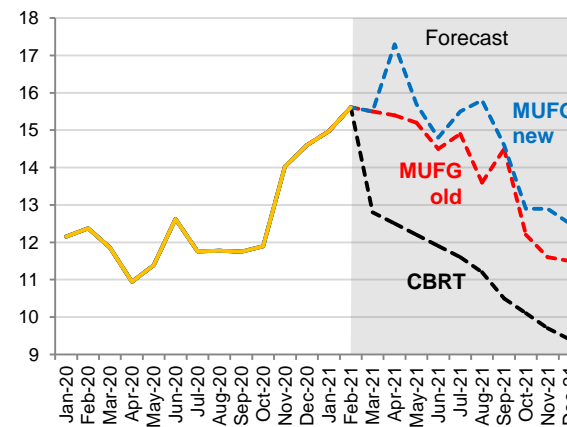
Inflation deviation with EM peers is striking

Turkey and EM headline inflation rate (% y/y)



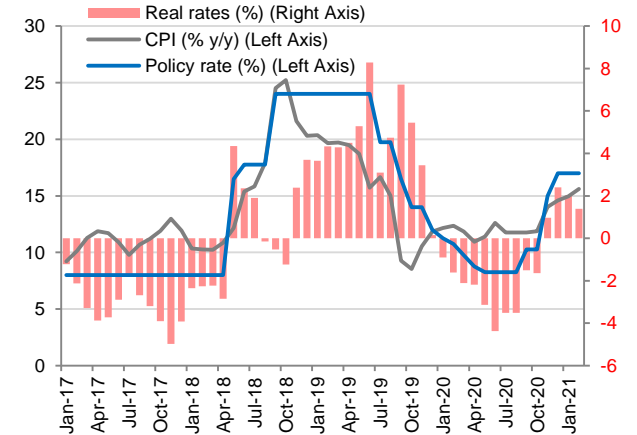
Inflation likely to peak now in June not April

Turkey CPI (% y/y)



Real policy rate remains wide but will narrow

Turkey CPI (% y/y) and Turkey one-week repo (%)



Weak TRY will pose upside risks to inflation

Inflation impact assuming 20% pass-through into CPI

| FX depreciation assumption | Inflation impact from FX depreciation |
|----------------------------|---------------------------------------|
| 10% | 2.2pp increase in inflation |
| 20% | 4.3pp increase in inflation |
| 30% | 6.4pp increase in inflation |
| 40% | 9.7pp increase in inflation |

Mark-to-market our inflation figures up and policy rates down

Inflation and one-week repo forecasts (end of quarter)

| | Q1-21 | Q2-21 | Q3-21 | Q4-21 | Q1-22 | Q2-22 | Q3-22 | Q4-22 |
|-----------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Policy rate (%) | 19.0 | 17.0 | 16.0 | 15.0 | 14.0 | 13.0 | 12.0 | 12.0 |
| CPI (% y/y) | 16.1 | 15.9 | 15.4 | 12.6 | 11.8 | 10.8 | 11.1 | 9.9 |
| Real rate (%) | 2.9 | 3.1 | 1.6 | 2.5 | 2.2 | 2.2 | 0.9 | 1.1 |

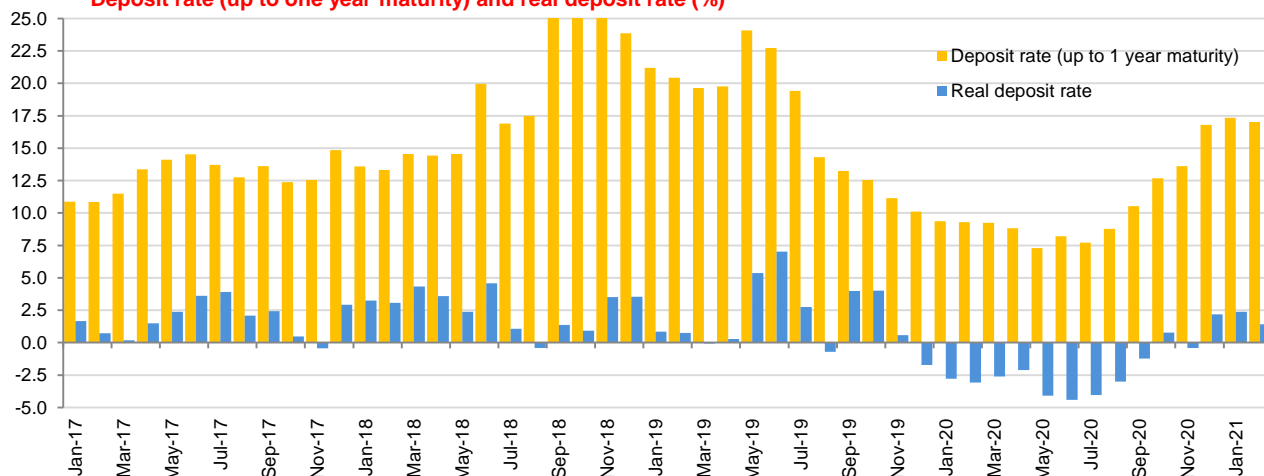
Dollarisation – weaker TRY and higher inflation will raise US dollar demand

Demand for dollars will rise

- Beyond inflation, rate cuts and/or high inflation could materially raise the local demand for US dollars, further exacerbating TRY depreciations
- On top of the prospects of households switching to dollars, corporates will be just as likely to dollarise deposits should confidence deteriorate

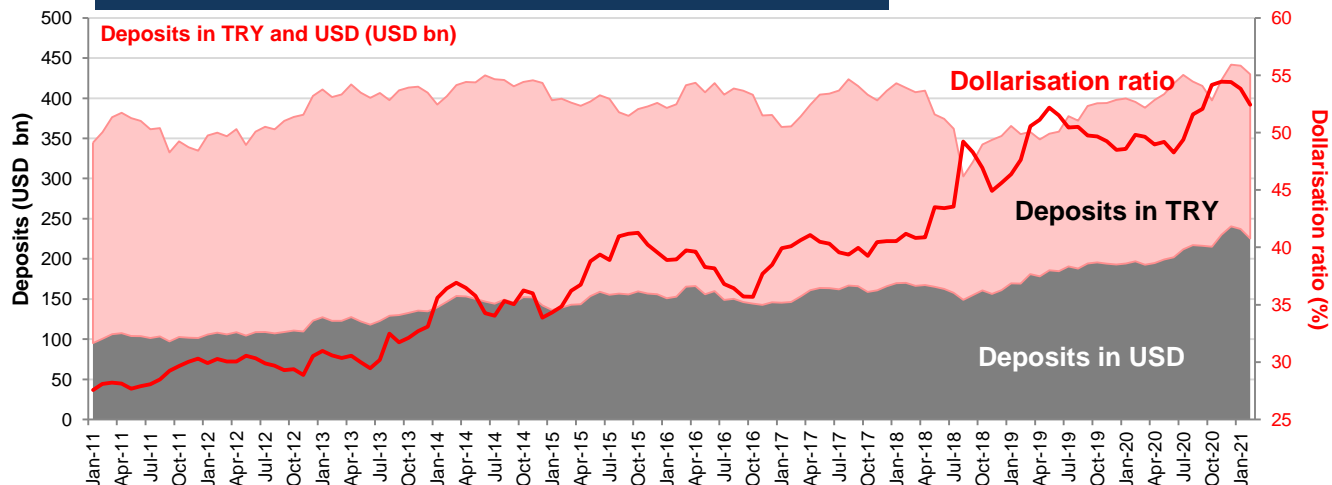
Real TRY deposit rates are currently around 2% ...

Deposit rate (up to one year maturity) and real deposit rate (%)



... with dollarisation now above 50% of total deposits

Deposits in TRY and USD (USD bn)



Comments

- Rate cuts and/or high inflation could impact the **local demand for US dollars (USD)**
- Despite rising lira deposit rates, FX deposits of **Turkish households have declined by only USD1.2bn since January 2021 to stand at USD112.3bn**

Comments

- One rationale as to why FX savings remain elevated is that **perceived inflation and forward looking expectations for the household sector may be higher** than what the official price statistics and surveys indicate
- If this is the case, accelerating inflation, while TRY deposit rates remain unchanged (or fall) has the **prospects to trigger fresh USD demand by Turkish households which currently stand above 50% of total deposits**

External balances – funding squeeze calls are rising

Funding shock prospects akin to 2018 could be on the table

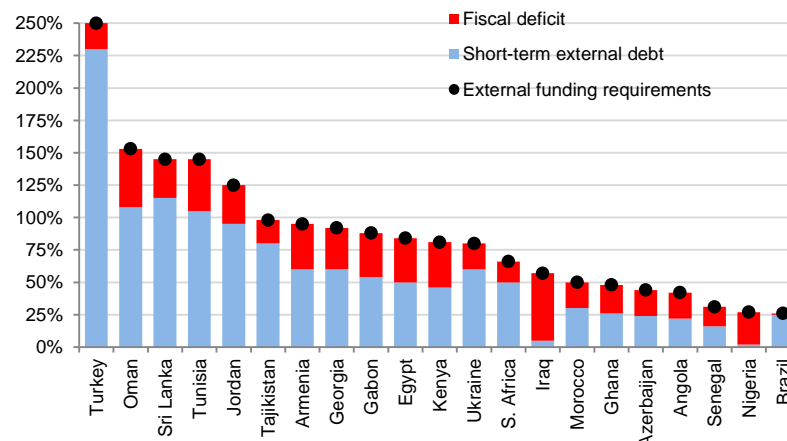
- External liabilities due over the course of 2021 stand at USD188bn (~25% of GDP), and marking a USD20bn increase compared to last year
- A closer look at Turkey's near-term risks, a benign sovereign bond maturity profile exists, but "all-in" external funding risks are higher

Potential external financing scenario in 2021

| | USD bn | Rollover assumption |
|---|-------------|---------------------|
| 1 Financing scenario for 2021 | | |
| 2 External financing requirement [1] | 217.7 | |
| 3 Current account deficit* | 28.9 | |
| 4 External liabilities** | 188.8 | |
| 5 Deposits at CBRT and banks | 70.5 | |
| 6 Trade-related borrowing | 56.7 | |
| 7 All other borrowing | 61.6 | |
| 8 Public sector | 5.9 | |
| 9 Banks | 36.9 | |
| 10 Corporates | 18.8 | |
| | USD bn | Rollover assumption |
| 11 Financing items [2] | 198.7 | |
| 12 Net FDI*** | 5.5 | |
| 13 Net portfolio investment*** | 10.0 | |
| 14 Deposits at CBRT and banks | 70.5 | 100% |
| 15 Trade-related borrowing | 56.7 | 100% |
| 16 All other borrowing | 61.6 | |
| 17 Public sector | 5.9 | 100% |
| 18 Banks | 33.2 | 90% |
| 19 Corporates | 16.9 | 90% |
| 20 Potential financing shortfall [1] – [2] | 19.0 | |

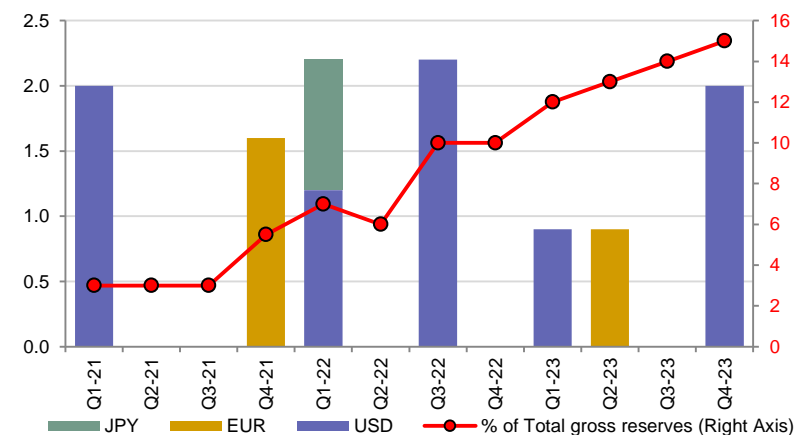
Turkey has the highest external funding amongst EM HY

External funding requirements = fiscal deficit + short-term external debt, % of FX reserves



Promisingly Turkey comprises a benign bond maturity profile

International bond maturity profile (USD bn)



8 (Source) Bloomberg, CBRT, CEIC, IMF, Macrobond, Turkey Statistical Institute, MUFG Research; * 2021 full year; ** external liabilities with a maturity of less than one year irrespective of original maturity; *** not official forecasts but assumptions to a possible funding scenario

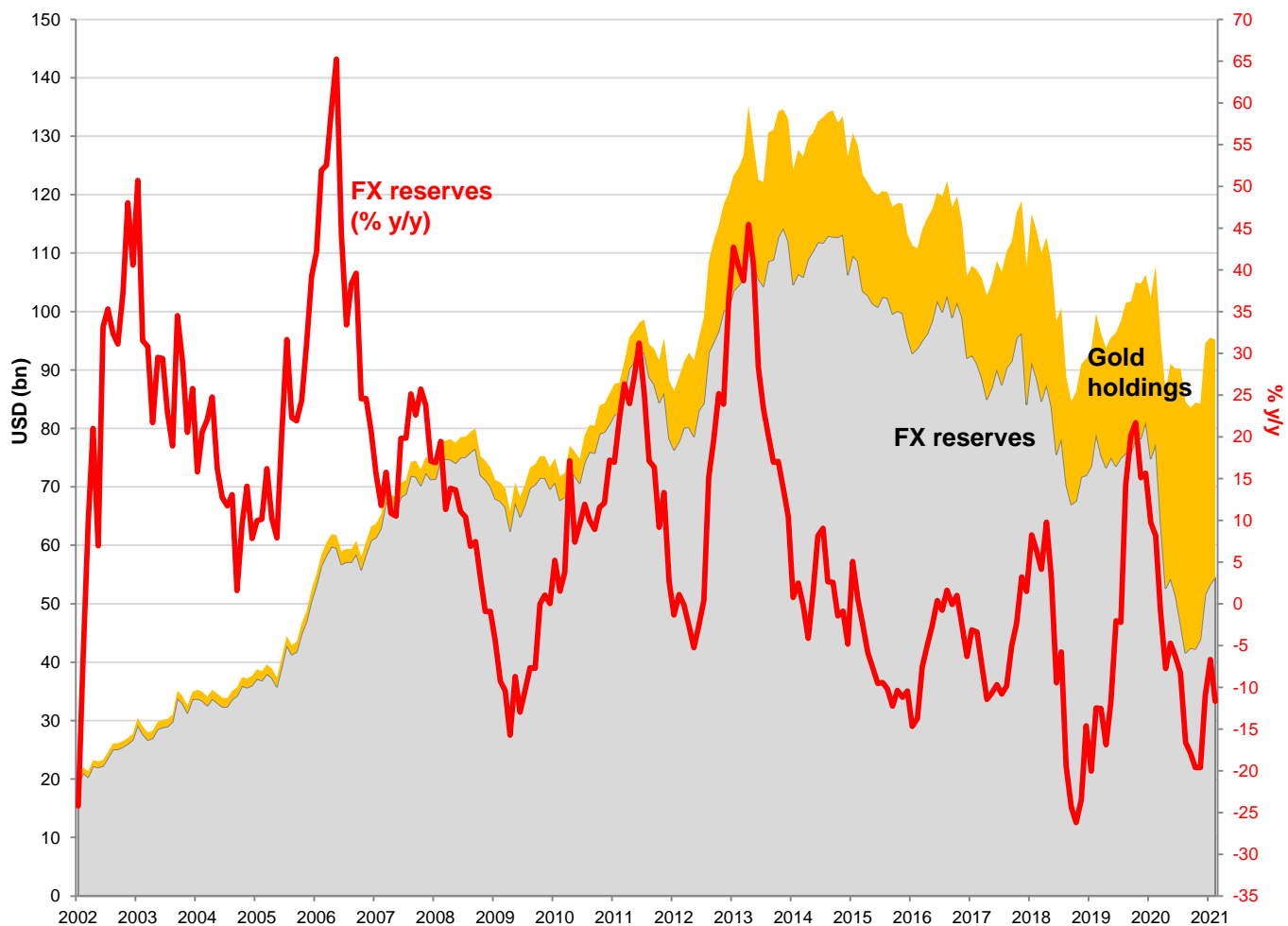
CBRT's reserve position – well recognised CBRT priority is reserve replenishment

Sufficient (for now)

- The new governor's policy preference concerning the replenishment of FX reserves – a widely recognised priorities – will be closely monitored
- Given the CBRT's net foreign asset position is around minus USD60bn, scope to smooth out TRY volatility could become challenging

CBRT's reserves remain adequate for now but are depleting

CBRT's international reserves (USD bn)



Comments

- We remain cognisant that the **CBRT's reserve position remains constrained**
- Taken together, **FX and gold reserves stood at USD94bn at the end of February**
- However, when the sum is adjusted for swap borrowing, the **bank's net foreign asset position is around minus USD60bn**
- In such an environment, the **CBRT would appear to have limited scope to smooth out TRY volatility** as it did when the currency came under pressure last year, unless it were to also consider regulatory measures that might temporarily boost gross FX reserves

Contents

01

Executive
summary
pp 03

02

Macro implications
pp 04-09

03

FX implications
pp 10-14

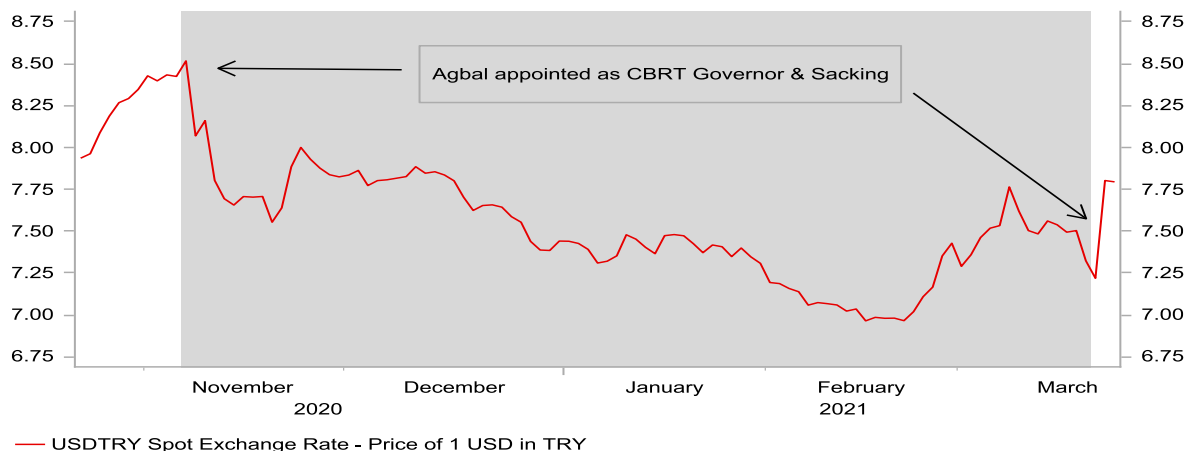
TRY – former Governor Agbal played a key role in restoring confidence in lira

Depreciation trend was temporarily halted

- When former Governor Agbal was appointed as CBRT Governor on 7th November, the lira was deeply undervalued.
- The lira strengthened sharply as the CBRT aggressively tightened policy.

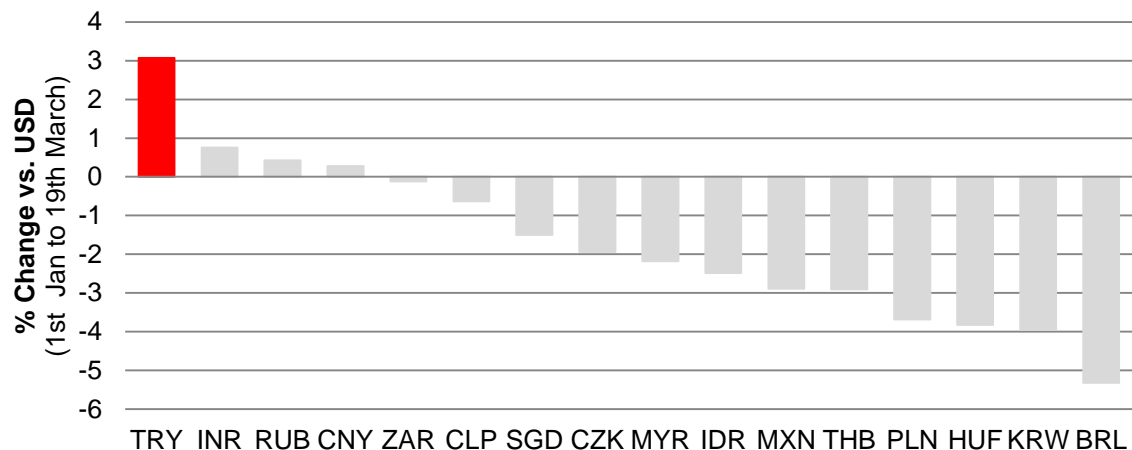
Former Governor Agbal helped to restore confidence in the lira

USD/TRY performance between 7th November & 21st March



TRY had been best performing EM currency prior to sacking

EM FX Performance YTD against USD (%) until 19th March



- **Prior to the appointment of Agbal as CBRT Governor in November, the lira has trending sharply lower.** In the previous two years, the lira lost around 38% of its value against the US dollar **in spite of aggressive intervention** to support the lira.
- **The appointment of former Governor Agbal marked a sharp turnaround in fortunes for the lira.** The lira strengthened by around 24% against the US dollar from the early November lows to recent highs from mid-February. **It was the strongest period of lira performance since late 2018** following the peak of the currency crisis from the summer of that year.
- **The lira was boosted both by the favourable shift in domestic policies** which helped to strengthen the lira, **and the broader improvement in investor sentiment towards emerging markets following the US election** result in November. The lira had clearly outperformed other emerging market currencies until the sacking of Agbal.

TRY – Lira quickly falls back to pre-Agbal levels following sacking

Negative lira reaction was abrupt and sharp

- The lira quickly plunged in value following the sacking of former Governor Agbal.
- USD/TRY initially rose back towards pre-Agbal levels from late last year at just above 8.5000.

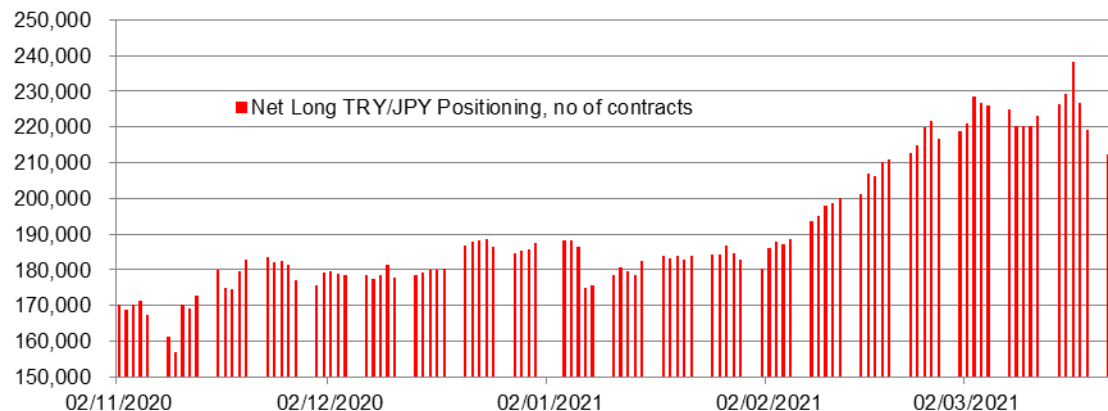
Confidence in the lira quickly reversed following sacking

USD/TRY performance between 19th March & 23rd March



Role of Japanese margin traders in lira sell off

TFX positioning until 22nd March



- The lira quickly plunged in value following the sacking of former Governor Agbal. At the worst point, the lira lost almost 14% of its value against the US dollar. It resulted in USD/TRY hitting an intra-day high of 8.4707 as the pair moved back to within touching distance of pre-Agbal levels from towards the end of last year. The high for USD/TRY prior to the appointment of Agbal as CBRT Governor was 8.5793 from 6th November.
- The sharp initial pace of lira depreciation was likely exacerbated by less liquid trading conditions during the Asian trading session. It has also been speculated that position liquidation amongst Japanese margin traders played a role. Long TRY/JPY carry positions are by far the largest held by margin traders and have increased by almost 50% since Agbal was appointed. There has been some modest liquidation of long TRY/JPY positions. However, it is unlikely to have been a key driver behind the initial scale of lira weakness.

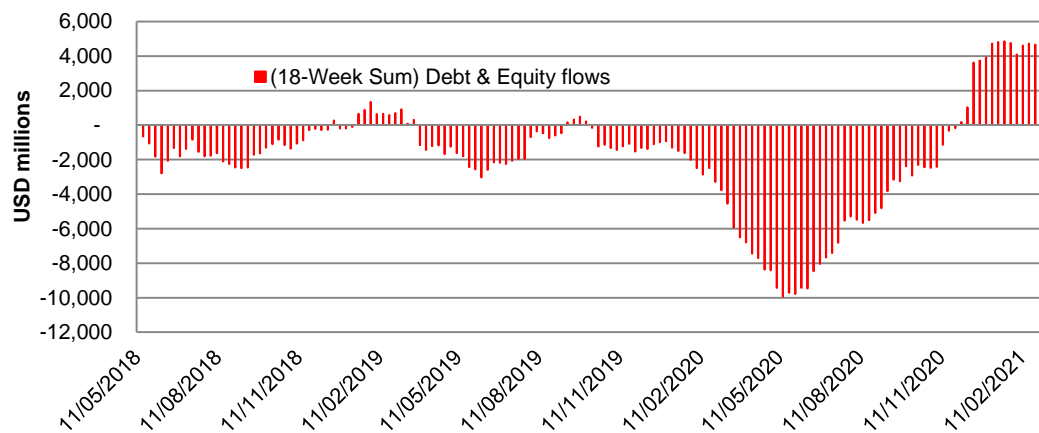
TRY – a shift back to capital outflows & weaker lira trend

Inflows recorded during Agbal's tenure as Governor are now likely to reverse

- A shift back towards more unorthodox policy settings will encourage a return to capital outflows & a weaker lira
- Market yields have jumped sharply helping to dampen initial lira weakness

Sacking to trigger reversal of capital flows

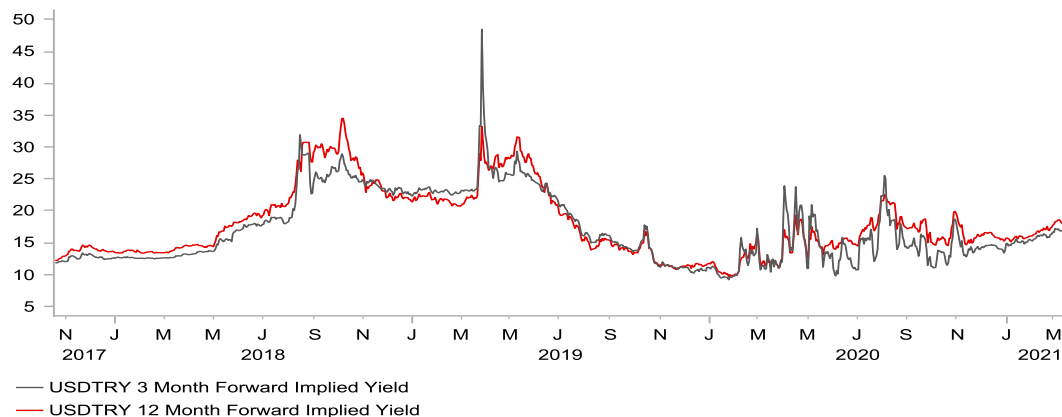
IIF weekly estimates for Turkey portfolio flows



Source: IIF

Market yields surge higher providing support for the lira

Implied yields on TRY forwards, %



- **The lira was supported under former Governor Agbal by a period of strong capital inflows into Turkey.** According to the IIF's weekly estimates, Turkey received net portfolio inflows into both debt and equities totalling just under USD5 billion between November and early March.
- **Those flows have already started to reverse** following the sacking of former Governor Agbal. It is more likely going forward that Turkey will revert back to capital outflows that were evident in the years prior to his appointment as Governor. **The sooner the CBRT begins to lower rates, the faster the lira will depreciate.**
- According to our local Treasury team, **public banks in Turkey have been active in helping to push down USD/TRY. Implied market yields have also surged higher providing more support for the lira in the near-term.** The implied yield on the one-year USD/TRY forward has jumped back to its highest levels since the currency crisis in 2018/19.

TRY – negative spill-overs have been limited so far

However, the 2018 TRY currency crisis highlights that spill-overs could increase.

- The sharp plunge in the lira has had limited spill-overs so far. EM FX has held up relatively well.
- Recent correlations and past performance suggest ZAR and RUB likely to be amongst most sensitive to acute TRY weakness.

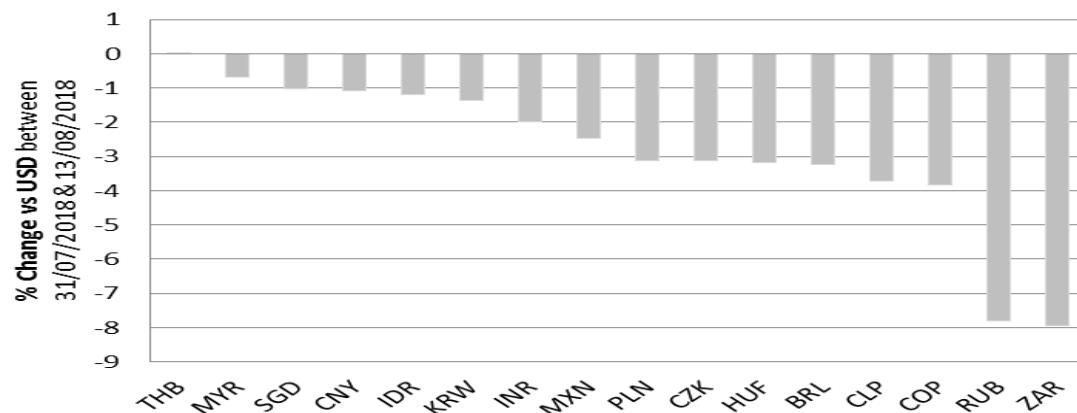
TRY weakness could spill-over to EM FX

EM FX correlations up until 19th March

| 30-day Rolling Correlations Daily % Change | | USD/CNY | USD/KRW | USD/ZAR | USD/TRY | USD/CZK | USD/RUB | USD/MXN | USD/BRL | USD/CLP | S&P 500 | MSCI World | MSCI EM | Brent Oil | Gold | Copper | US 2YR Govt Yld | US 10YR Govt Yld | EMBI Global Sprd |
|---|------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|------------|---------|-----------|-------|--------|-----------------|------------------|------------------|
| FX | USD/CNY | 1.00 | 0.16 | 0.26 | 0.39 | 0.49 | 0.12 | 0.31 | 0.45 | 0.32 | -0.16 | -0.33 | -0.49 | 0.03 | -0.30 | -0.16 | -0.08 | -0.10 | 0.45 |
| | USD/KRW | 0.16 | 1.00 | -0.02 | 0.11 | 0.14 | -0.14 | -0.03 | 0.36 | 0.30 | -0.02 | -0.21 | -0.67 | -0.05 | -0.09 | -0.36 | -0.33 | -0.43 | 0.51 |
| | USD/ZAR | 0.26 | -0.02 | 1.00 | 0.68 | 0.72 | 0.60 | 0.85 | 0.58 | 0.42 | -0.61 | -0.63 | -0.30 | 0.05 | -0.59 | -0.28 | 0.60 | 0.54 | 0.26 |
| | USD/TRY | 0.39 | 0.11 | 0.68 | 1.00 | 0.53 | 0.49 | 0.63 | 0.52 | 0.34 | -0.65 | -0.70 | -0.49 | 0.12 | -0.42 | -0.09 | 0.56 | 0.35 | 0.45 |
| | USD/CZK | 0.49 | 0.14 | 0.72 | 0.53 | 1.00 | 0.34 | 0.62 | 0.55 | 0.29 | -0.24 | -0.43 | -0.43 | 0.15 | -0.71 | -0.31 | 0.25 | 0.27 | 0.33 |
| | USD/RUB | 0.12 | -0.14 | 0.60 | 0.49 | 0.34 | 1.00 | 0.59 | 0.32 | 0.14 | -0.62 | -0.60 | -0.19 | 0.04 | -0.32 | -0.22 | 0.42 | 0.55 | 0.13 |
| | USD/MXN | 0.31 | -0.03 | 0.85 | 0.63 | 0.62 | 0.59 | 1.00 | 0.61 | 0.40 | -0.60 | -0.63 | -0.32 | 0.23 | -0.50 | -0.18 | 0.57 | 0.51 | 0.36 |
| | USD/BRL | 0.45 | 0.36 | 0.58 | 0.52 | 0.55 | 0.32 | 0.61 | 1.00 | 0.59 | -0.36 | -0.43 | -0.58 | -0.19 | -0.38 | -0.36 | 0.30 | 0.00 | 0.54 |
| | USD/CLP | 0.32 | 0.30 | 0.42 | 0.34 | 0.29 | 0.14 | 0.40 | 0.59 | 1.00 | -0.19 | -0.32 | -0.39 | -0.16 | -0.23 | -0.27 | 0.10 | -0.03 | 0.44 |
| | S&P 500 | -0.16 | -0.02 | -0.61 | -0.65 | -0.24 | -0.62 | -0.60 | -0.36 | -0.19 | 1.00 | 0.95 | 0.29 | -0.06 | 0.31 | 0.28 | -0.49 | -0.39 | -0.13 |
| Equities | MSCI World | -0.33 | -0.21 | -0.63 | -0.70 | -0.43 | -0.60 | -0.63 | -0.43 | -0.32 | 0.95 | 1.00 | 0.51 | -0.17 | 0.40 | 0.35 | -0.31 | -0.26 | -0.34 |
| | MSCI EM | -0.49 | -0.67 | -0.30 | -0.49 | -0.43 | -0.19 | -0.32 | -0.58 | -0.39 | 0.29 | 0.51 | 1.00 | -0.12 | 0.12 | 0.25 | 0.02 | 0.11 | -0.61 |
| Commodities | Brent Oil | 0.03 | -0.05 | 0.05 | 0.12 | 0.15 | 0.04 | 0.23 | -0.19 | -0.16 | -0.06 | -0.17 | -0.12 | 1.00 | 0.06 | -0.01 | 0.05 | 0.17 | 0.09 |
| | Gold | -0.30 | -0.09 | -0.59 | -0.42 | -0.71 | -0.32 | -0.50 | -0.38 | -0.23 | 0.31 | 0.40 | 0.12 | 0.06 | 1.00 | 0.44 | -0.15 | -0.25 | -0.08 |
| | Copper | -0.16 | -0.36 | -0.28 | -0.09 | -0.31 | -0.22 | -0.18 | -0.36 | -0.27 | 0.28 | 0.35 | 0.25 | -0.01 | 0.44 | 1.00 | 0.03 | 0.07 | -0.12 |
| FI | US 2YR Govt Yld | -0.08 | -0.33 | 0.60 | 0.56 | 0.25 | 0.42 | 0.57 | 0.30 | 0.10 | -0.49 | -0.31 | 0.02 | 0.05 | -0.15 | 0.03 | 1.00 | 0.71 | -0.06 |
| | US 10YR Govt Yld | -0.10 | -0.43 | 0.54 | 0.35 | 0.27 | 0.55 | 0.51 | 0.00 | -0.03 | -0.39 | -0.26 | 0.11 | 0.17 | -0.25 | 0.07 | 0.71 | 1.00 | -0.36 |
| | EMBI Global Sprd | 0.45 | 0.51 | 0.26 | 0.45 | 0.33 | 0.13 | 0.36 | 0.54 | 0.44 | -0.13 | -0.34 | -0.61 | 0.09 | -0.08 | -0.12 | -0.06 | -0.36 | 1.00 |

RUB & ZAR were hit hardest during most intense phase of TRY sell-off in 2018

EM FX Performance during peak of TRY Ccy Crisis in 2018, %



- In the month to the end of last week, the performance of USD/TRY was more correlated to the other higher yielding emerging market currencies including USD/ZAR and USD/MXN. In contrast, it had little correlation with USD/KRW.

- The negative spill-over impact from the plunge in the lira has been relatively limited so far. Even USD/ZAR is surprisingly little changed in the initial aftermath. Only RUB weakness stands out as more notable at this stage but this more likely reflects heightened concerns over rising geopolitical tensions between the US and Russia, and recent oil price correction lower.

- As we saw in previous years prior to the appointment of Agbal as CBRT Governor, the lira was trending weaker and the spill-overs remained limited for the most part. However, more acute lira weakness as evident during the lira currency crisis in the summer of 2018 can trigger weakness in EM FX more broadly.

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