**Economics and Strategy**
**3 March 2014**

# Turkey

## Assessing external financing risk

**With a possible improvement in its current account balance due to a growth slowdown and rebalancing of the economy, we expect a sizable reduction in the external financing need for Turkey this year. However, we still believe that the structure of corporate debt as a risk indicator should be closely monitored in 2014.**

Taking into account the expected slowdown in economic activity and what should be an improvement in the trade balance on the back of better exports to the EU, a significant correction in the C/A deficit looks on the way. Yet country-specific factors such as political risk and weak macro indicators, exposing external financing fragilities, are leading to differentiation across countries – as Turkey has already witnessed with slowing portfolio flows. Despite the narrowing C/A deficit and a relatively manageable financing outlook even under conservative assumptions for Turkey, the reliance on short-term capital for funding as well as expected higher global funding rates will still be a risk factor.

**Domestic debt:** The CBT's latest interest rate decision, which has triggered an inverted yield curve, has also contributed to the upward movement in bond yields since mid-December. We expect yields to remain in the double-digit zone for the rest of the year, keeping in mind the CBT's ongoing tight policy stance, ending the year close to 10.2% (2 year). With the TRY remaining vulnerable into March elections, we expect the yield curve inversion to remain in place over the coming months.

**FX:** The under-performance of the TRY versus other emerging markets has ended after the CBT's aggressive rate hike. For 2014, we keep our cautious view, especially in the first half as political uncertainties should prevail at least until local elections in March. USD/TRY retesting the 2.30/35 area looks very possible. We envisage a gradual recovery of the TRY in the second half of the year supported by a possible easing of political tension and an improvement in the C/A deficit. For tactical traders, our FX strategy team sees value in buying a two-month USD call/TRY put, strike 2.2725, with an American RKO at 2.4225. Priced off a forward reference of 2.2725, this structure costs 0.49%.

## C/A rebalancing to continue

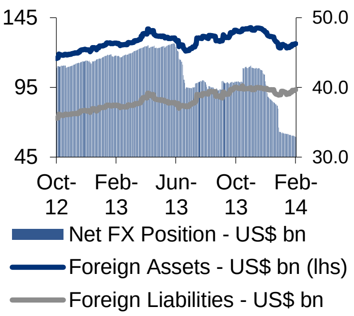
Emerging market economies have recently witnessed a new bout of financial volatility as markets reassess their fundamentals. In addition to the backdrop of the Fed tapering, volatility has stemmed from concerns over Chinese and US growth. Political noise in Thailand, Turkey, South Africa and Ukraine, plus devaluations as far afield as Argentina and Kazakhstan have also hit sentiment. Countries with macroeconomic weaknesses, such as high inflation, unfavourable growth and inflation dynamics, as well as external imbalances suffered the most. Turkey was among the casualties as the TRY sold off aggressively in Jan'14, weakening by more than 30% against the 50:50 EUR:USD basket since mid-May'13, with around 13% of this coming since 17 Dec despite the CBT's direct intervention with record FX sales (at USD3.2bn). The TRY sell-off also sparked contagion among other emerging market peers, such as the RUB and ZAR. 2-year benchmark bond yields, on the other hand, exceeded 11% (from below 9% in mid-Dec'13) when political tension spiked with the graft probe. Despite the CBT's heavy FX sales, the pressure on the TRY remained in place and led the bank to hold an emergency MPC meeting at end-Jan'13, resulting in a significant hike in all policy rates and simplification of the operational

**Cumulative capital flows**

| | May-Dec 13 USDbn | 2013 USDbn |
|---|---|---|
| **C/A Balance** | **-40.3** | **-65.0** |
| **Total inflows** | **28.7** | **69.2** |
| Short term inflows | 3.9 | 34.0 |
| Foreign Portfolio | -4.2 | 5.0 |
| Banks | 5.0 | 20.9 |
| Long term inflows | 24.8 | 35.2 |
| Banks | 9.5 | 9.5 |
| FDI | 7.5 | 10.2 |
| Treasury-Bond | 2.9 | 4.6 |
| **Reserve Change** | **3.4** | **-8.0** |
| Banks | -1.0 | 2.0 |
| CBT | 4.4 | -9.9 |
| Net Error & Omission | 8.2 | 3.8 |

Source: CBT, ING Bank

**Net CBT Reserves**




Source: CBT, ING Bank

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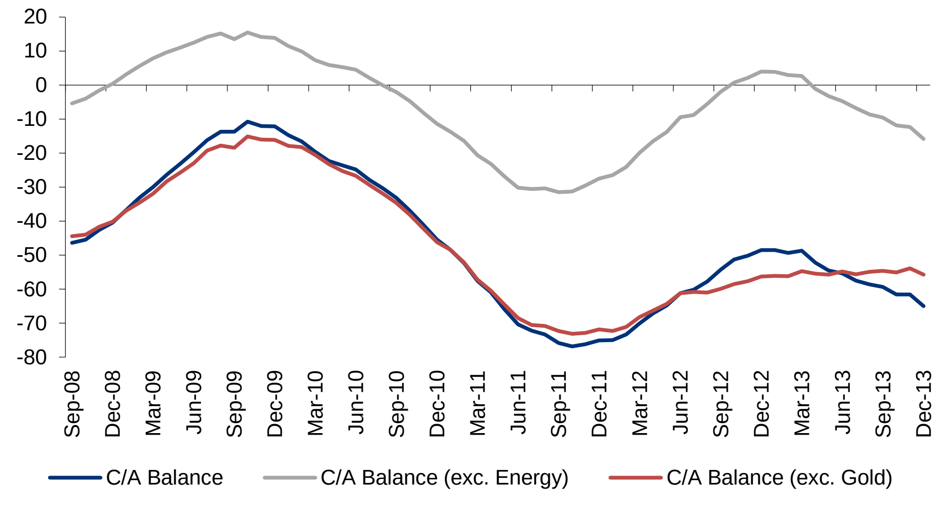
framework that, although it is still too early to be positive, should at least improve credibility.

Current account deficits and the associated macro financial risks have been closely followed by investors and stood out as one of the major determinants of the falling risk appetite for Turkish assets. Given the strong relationship between the C/A balance and the growth in credit stock, the CBT achieved good results in 2012 by cutting the current account deficit from 9.7% of GDP in 2011 to 6.1% in 2012 on the back of a tightening cycle that started in late 2011 and continued until mid-2012. However, Turkey posted a large current account deficit in 2013 worth USD65bn (7.9% of estimated GDP), stemming from reviving capital flows and easing monetary conditions. The reversal of the contribution from gold trade also distorted the C/A picture last year, adding USD9.3bn to the deficit after narrowing the headline deficit by USD7.8bn a year ago. However, even if we temporarily exclude the gold impact, the deficit is still high by all metrics. Although the C/A deficit was high in 2013, the financing of the deficit did not create a risk as the maturity breakdown had improved in favour of long-term assets, and Turkey had succeeded in attracting capital. Into year-end 2013, however, we did see some weakening in flows, but there is also a composition change, including a declining share of short-term financing.

**Fig 1 C/A deficit excluding gold maintained its improvement trend**




Source: CBT, ING Bank

We expect slowing loan growth (along with high short-term rates) and slowing economic activity from 1Q14 onwards to help narrow the C/A deficit, as well as the improvement in the trade balance. The latter should be driven by a better EU growth environment for Turkish exports and weakening imports due to the high level of USD/TRY. Overall, we look for a USD44bn deficit (5.5% of GDP) as our base case at the end of 2014. But a positive surprise of a deficit inside 5% of GDP is less likely, as the CBT, adjusting for "transitory movements of domestic demand, external demand, and terms of trade to obtain the cyclically adjusted current account[1]", quantifies the underlying trend of the C/A balance as hovering at around 5% in recent years.

[1] Cyclically Adjusted Current Account Balance, (http://www.tcmb.gov.tr/research/ekonominotlari/2013/eng/EN1318eng.php)

**Fig 2 C/A balance to improve sharply in 2014**

| | 2009 USDbn | 2010 USDbn | 2011 USDbn | 2012 USDbn | 2013 USDbn | 2014F USDbn | Ratio to GDP % |
|---|---|---|---|---|---|---|---|
| **C/A Balance** | -12 | -45 | -75 | -48 | -65 | -44 | 5.5 |
| *Trade Balance* | -25 | -56 | -89 | -65 | -80 | -60 | 7.5 |
| Exports | 110 | 121 | 143 | 163 | 163 | 187 | 23.5 |
| Imports | -134 | -177 | -233 | -229 | -243 | -247 | 31.0 |
| *Services* | 19 | 17 | 20 | 23 | 23 | 25 | 3.1 |
| Tourism | 18 | 17 | 20 | 21 | 23 | 25 | 3.1 |
| *Income (net)* | -8 | -7 | -8 | -7 | -9 | -10 | 1.3 |
| *Current transfers* | 2 | 2 | 2 | 1 | 1 | 1 | 0.2 |

Source: CBT, ING forecasts

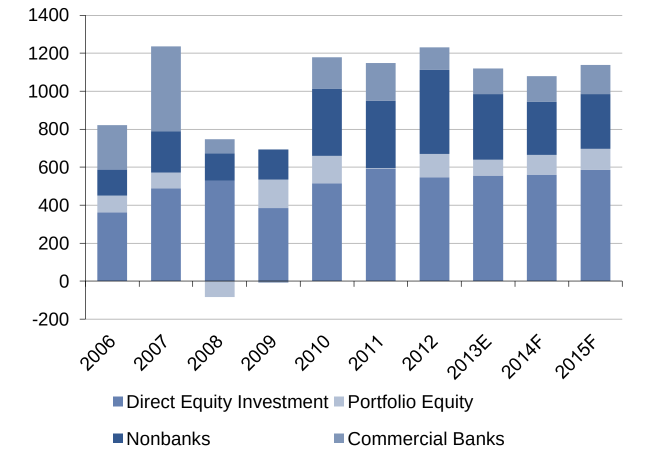
The CBT does not see Turkey's stock vulnerabilities (NIIP, private and public sector debt stock, and loan growth all relative to GDP) as being as severe as market movements recently suggested. Overall, we can argue that there has been a significant monetary adjustment coupled with sizable TRY depreciation since May'13 that should help rebalance the economy quite significantly in 2014 – but external imbalances, both stock and flow wise, should continue to be challenging.

## Trends in Global Capital Flows in 2014

Following the significant slowdown in private capital inflows to emerging markets in mid-2013 due to Fed tapering concerns, markets started to stabilise in the fall of last year as the reduction in the asset purchase programme was mostly priced in and expectations regarding the acceleration of global economic momentum started to strengthen. However, in early 2014, EM inflows went back to their volatile path again. Looking at the whole year, a gradual rebound in capital flows is still expected.

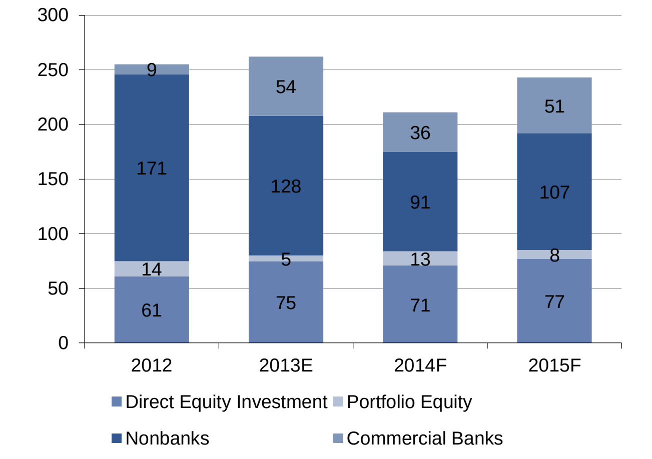
According to the IIF, private capital inflows to EMs are estimated to fall to USD1,079bn in 2014 from USD1,119bn in 2013. Checking the details, we see the main reason for the fall in inflows as the contraction in non-bank private borrowing. On the flip side, portfolio equity inflows are expected to grow in 2014 after posting a sharp contraction in 2013. Finally, direct equity investment should continue to post stable moderate growth, whereas commercial bank borrowing should remain almost unchanged compared to previous year.

**Fig 3 Private Cap. Flows to EMs (USDbn)**




Source: IIF

**Fig 4 Private Cap. Flows to Emerging Europe* (USDbn)**



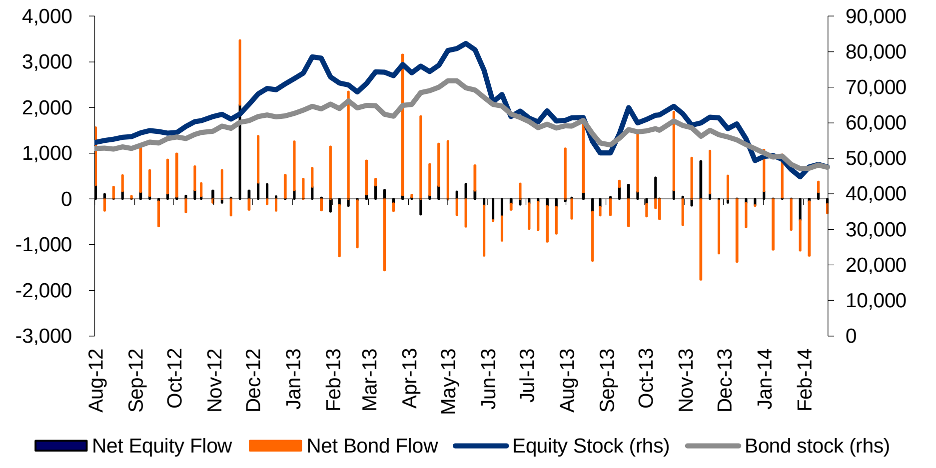

*Countries in this group are Bulgaria, Czech Rep. Hungary, Poland, Romania, Russia, Turkey, Ukraine

Source: IIF

On the flipside, the contraction in capital flows for the emerging Europe country group is expected to be more significant for 2014, again primarily due to tightening in non-bank sector borrowing followed by a fall in inflows via commercial bank channels.

All in all, aggregate flows to EMs are expected to start growing moderately in 2014, but turn to positive for the whole year in 2015. Despite expectations of no significant deterioration in EM flows, we believe country-specific uncertainties such as political risks and weak macro indicators that could also trigger external financing fragilities will lead to a differentiation across countries. Turkey has already witnessed this since mid-December 2013, with total outflows of USD0.5bn and USD2.3bn from the equity and bond markets, respectively. The share of non-residents in total local government debt stood at 24.9% as of 21 February, still above the end-2012 level, but lower than the 28.2% of May 2013.

**Fig 5 Weekly flows to bond and equity markets (USDm)**

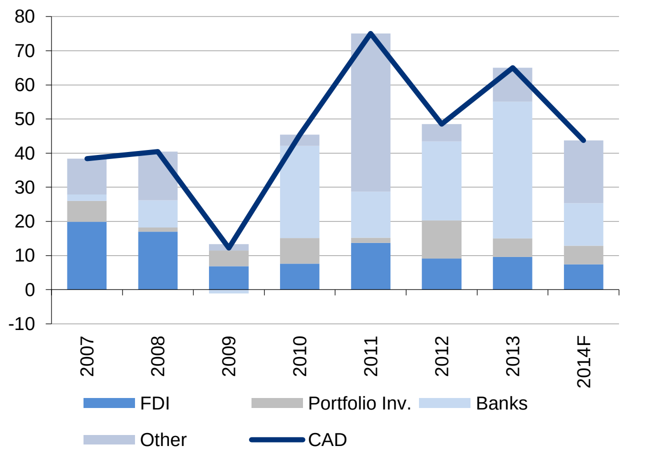



Source: CBT, ING Bank

## Financing outlook for Turkey

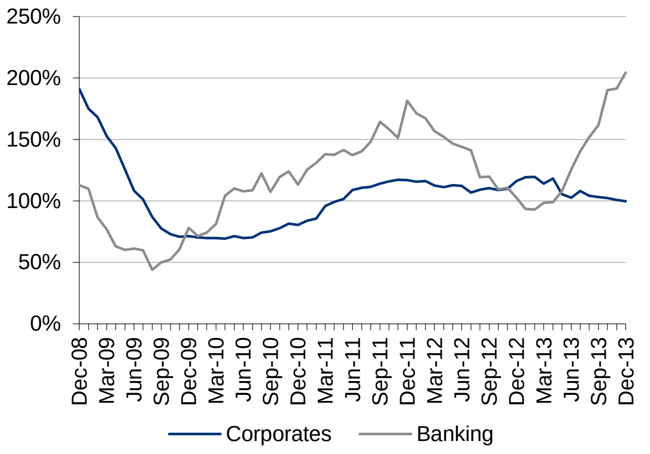
Turkey's C/A deficit, a major structural problem, is an outcome of a saving-investment gap and is mainly financed by private borrowing. This private borrowing shows a heavy reliance on banks, more evident especially in the second half of 2013 as the share of the banking sector in total flows exceeded 60% on the back of volatile portfolio flows. The share of more stable funding, namely foreign direct investment, remained low, floating within 15-20% since 2010 and causing deterioration in the quality of the funding structure.

**Fig 6 Low FDI and decelerating portfolio inflows**




Source: CBT, ING Bank

**Fig 7 Debt rollover remains unharmed so far**




Source: CBT, ING Bank

Having seen the global picture for capital flows and foreseeing a notable correction in the C/A, we have revisited our external financing scenario for Turkey in 2014.

As a breakdown:

- In our view, the financing outlook looks generally manageable, even if we make conservative assumptions on long-term loan rollover ratios for firms and banks with 85% and 105% amounting to c.USD20.7bn and USD8.3bn principal long-term debt payments due in 2014, down significantly from 100% and 205% in 2013. Although we presume considerable declines in rollover ratios, especially in the banking sector, in our view it would not be too optimistic to assume that the ratios will be higher than the bottom levels of 70-75% in 2009, impacted by the Lehman crisis. Historical figures suggest that banks and corporates will likely be rolling over most of their medium-term external obligations with relatively higher risk premiums if conditions in global markets deteriorate.
- It is also plausible to assume that non-residents will roll over 40% of local bonds redeeming in their portfolios this year with USD6bn. With an additional USD1bn net inflow into the equity market, along with USD7bn in FDI inflows, the need for reserve depletion is likely to be limited to USD5bn.

**Fig 8 Selected balance of payments developments**

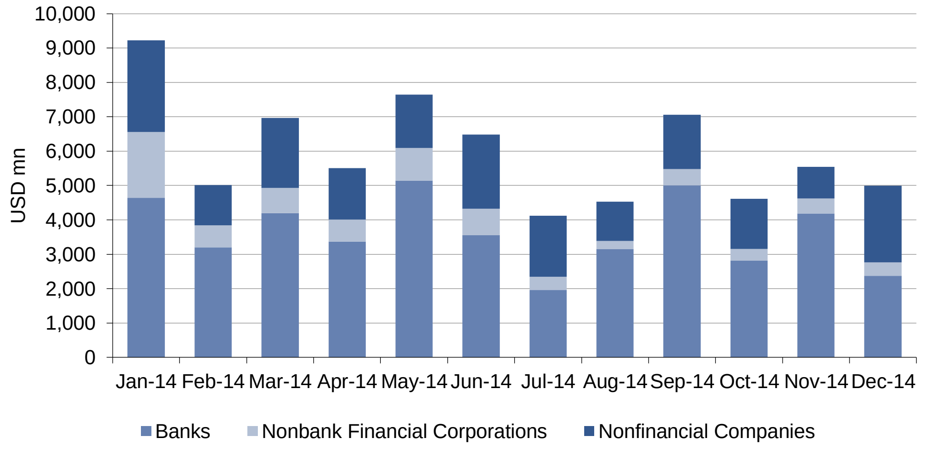
| | 2009 | 2010 | 2011 | 2012 | 2013 | | 2014F | |
|---|---|---|---|---|---|---|---|---|
| | USDbn | USDbn | USDbn | USDbn | USDbn | Ratio to CAB % (abs.) | USDbn | Ratio to CAB % (abs.) |
| **Current Account Balance** | **-12** | **-45** | **-75** | **-48** | **-65** | **100** | **-44** | **100** |
| **Total Registered Capital Inflows** | **3** | **43** | **61** | **64** | **69** | **106** | **38** | **86** |
| Net FDI | 7 | 8 | 14 | 9 | 10 | 15 | 7 | 17 |
| Net security purchases of foreigners | 1 | 14 | 14 | 23 | 5 | 8 | 7 | 16 |
| *Stock Exchange* | *3* | *3* | *-1* | *6* | *1* | *1* | *1* | *2* |
| *Local Bond Market* | *-2* | *11* | *15* | *17* | *4* | *6* | *6* | *14* |
| Net foreign borrowing* - Banks | -4 | 13 | 13 | 5 | 21 | 32 | 5 | 12 |
| *Long term* | *-2* | *1* | *6* | *0* | *9* | *15* | *0* | *1* |
| *Short term* | *-3* | *12* | *7* | *5* | *11* | *18* | *5* | *11* |
| Net foreign borrowing* - Real Sector | -10 | -5 | 7 | 7 | 2 | 3 | -3 | -6 |
| *Long term* | -10 | -6 | 4 | 4 | 0 | 0 | -3 | 7 |
| *Short term* | -1 | 1 | 3 | 3 | 2 | 3 | 1 | 1 |
| Net foreign borrowing - Treasury | 1 | 2 | 0 | 3 | 4 | 6 | 5 | 10 |
| Deposits at banks | 5 | 14 | -2 | 10 | 10 | 15 | 4 | 9 |
| Other | 4 | -3 | 17 | 7 | 18 | 28 | 12 | 27 |
| **Change in reserves** | **6** | **1** | **4** | **-17** | **-8** | **12** | **6** | **14** |
| Banks | 6 | 13 | 2 | 4 | 2 | 3 | 1 | 2 |
| Official | 0 | -13 | 2 | -21 | -10 | 15 | 5 | 11 |
| **Net error & Omissions** | **5** | **3** | **9** | **1** | **4** | **6** | **0** | **0** |
| **Non-bank sector long-term rollover (%)** | *71* | *81* | *117* | *116* | *100* | | *85* | |
| **Banking sector long term rollover (%)** | *78* | *113* | *182* | *103* | *205* | | *105* | |
| **Trade credits rollover (%)** | *98* | *103* | *103* | *101* | *105* | | *95* | |

* Excluding trade loans
Source: CBT, ING Bank

- Net short-term borrowing of the corporate and banking sectors, on the other hand, is assumed to be more than halved in 2014.
- On the supportive point of external finance, we expect an inflow from repatriation of private sector currency and deposit holdings abroad into the country, covering c.27% of the estimated C/A deficit in 2014. Repayments of cash collateralised external borrowing should be the main driver, in our view. According to the latest corporate FX position data, firms' deposits abroad stood at USD17bn as of November 2013.

According to CBT data, the total external debt due in the next twelve months (regardless of the original maturity) stood at USD166.7bn as of end-2013. Of this total, 59% is owed by financial institutions and 20% is trade credits. About USD60.7bn of the total will be external loan payments by private firms (including trade credits of US$32.5bn) and the monthly redemptions schedule shows after January that March, May and September will be relatively heavy repayment months. In our view, this part is clearly the biggest risk for the country's external balance owing to the recent developments in global financial markets.

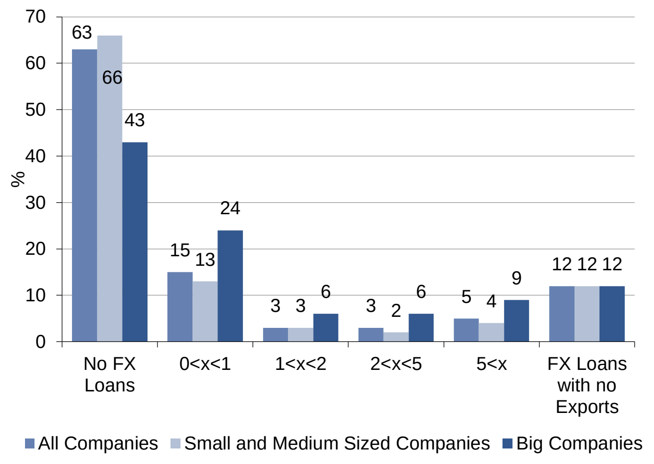
**Fig 9 Private sector loans from abroad on remaining maturity basis for next 12M**




Source: CBT, ING Bank

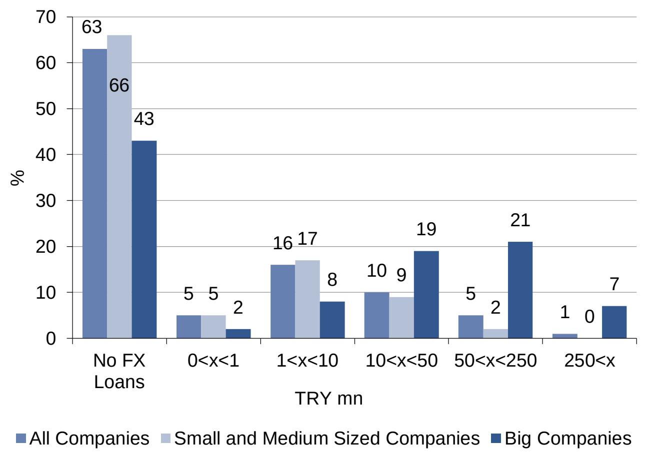
However, according to the CBT survey that included close to 10,000 firms with a net sales volume accounting for 71% of 2012 GDP, a majority of the firms either do not use FX loans or have a natural hedge from exports. It is also noted from the CBT's database that small and medium-sized companies tend to have lower FX exposures; both are relief factors for the corporate sector.

**Fig 10 Distribution of firms with different FX loans to exports ratios**




Source: CBT

**Fig 11 Distribution of firms with different amounts of FX loans**




Source: CBT

Looking ahead, activity should moderate further, stemming not only from the recent macro-prudential measures taken by the BRSA and from weak capital flows, but also from the current monetary policy stance that in return should help to lower the deficit. Despite the easing C/A deficit and the relatively manageable financing outlook, the nature of funding on the back of reliance on short-term capital as well as expected higher global funding rates may continue to put pressure on the TRY – particularly in the shorter term. However, the improvement in investor sentiment after CBT rate hikes may relieve concerns about Turkey's external financing requirement and allow more stability later this year.

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