Investment Research

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Turkey risking a sovereign downgrade to high yield

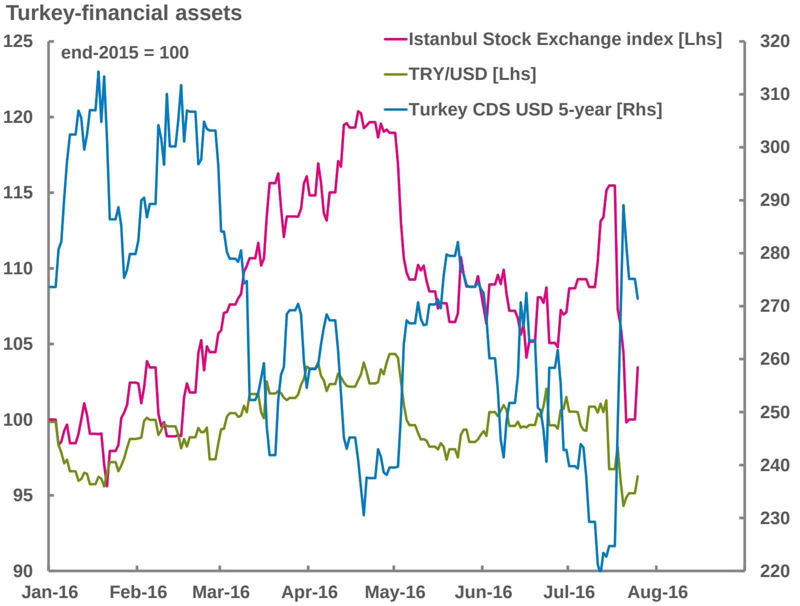
Weak growth, high inflation and elevated external financing risk

Key points

- Turkey had its fifth coup in the 93-year history of the Republic of Turkey on 15 July. The elected government quickly took control and imposed a 3-month state of emergency period.
- Risks to political and financial stability have increased, evident in the sell-off of Turkish assets.
- External financing tops the list of risks the country faces, confronted with significant FX denominated debt redemptions of US$170bn over the next 12 months.
- Failure to rollover maturing debt would challenge the financing of the current account balance.
- Rekindling the refugee crisis is also a non-negligible event, as the EU/Turkey deal over refugees may be revoked on concerns over human rights violations.
- We revised downwards our GDP growth and upwards our inflation forecasts in 2016 to 2.6% (from 3.1%) and 10% (from 8.1%), respectively.
- We affirm our conviction that the downgrade to the non-investment grade is highly likely by year-end as the high country risk premium would intensify the external financing risk of the country.
- Moody's and Fitch have already scheduled Turkey's sovereign rating review for 5 and 19 August, respectively.

Exhibit 1

Turkish assets badly hammered



Source: Bloomberg and AXA IM Research

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Elevated political risk

Earlier this year, we articulated the view that Turkey would be downgraded by rating agencies on rising political and national security risks.[1] Turkey had its fifth coup in the 93-year history of the Republic of Turkey on 15 July. Following the coup, the elected government assumed full control of the power, Article 120 of the Constitution was invoked and a 3-month period of state of emergency has been imposed.

President Erdogan may use the favourable momentum his government attained after the coup to push forward the constitutional changes necessary to extend his presidential authority. The probability of snap elections which could help the AKP[2] to achieve constitutional majority and avoid a referendum necessary to ratify the constitutional changes is high. Hence, political uncertainty will remain high, weighing on the country's risk premium proxied by the Turkish lira (TRY), and challenging the external financing of the economy.

This report highlights the principal economic challenges that the country faces in the near future.

External financing risk

Immediately after the attempted coup, Turkish financial assets sold out at rates last seen during the Lehman debacle. We see in *Exhibit 1* that the 5-year Credit Default Swap (CDS) has shot up while the stock exchange fell almost to the level at the start of the year. The TRY depreciated against the dollar by 5% year-to-date (YTD) and fuelled concerns that headline inflation will increase due to the high passing through coefficient.[3]

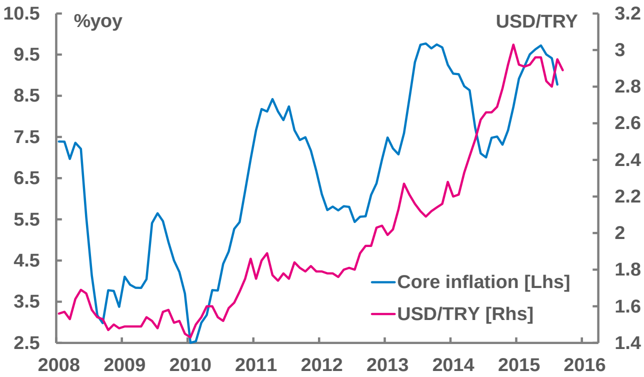
The economy has grown accustomed to high inflation rates above the 5% inflation target. We see in *Exhibit 2* that the TRY and core inflation are moving in lock-step. In most cases, the passing through of a currency depreciation to higher inflation materialises almost instantly.

The high current account deficit is contributing to the depreciation of the currency, as the latter is needed to rectify the former. Turkey, together with Brazil, India, Indonesia and South Africa, formed the group of the fragile five emerging markets (EM) whose currencies depreciated the most during the May 2013 market tantrum episode. These were the EMs with the highest current account deficit, which EM investors signalled as the most sensitive to US monetary policy normalisation and the decline in global liquidity.

The private sector in Turkey prefers not to save, as high inflation erodes the purchasing power of money sitting in the bank. Simultaneously, the Turkish economy is an EM in the middle of a catching-up process which requires investment to improve its growth potential. The investment rate (investment at 20% of GDP) is above the saving rate (saving at 16% of GDP), implying that the country spends more than it saves, triggering a current account deficit as it has to borrow from abroad.

Exhibit 2

Inflation and the TRY dancing together



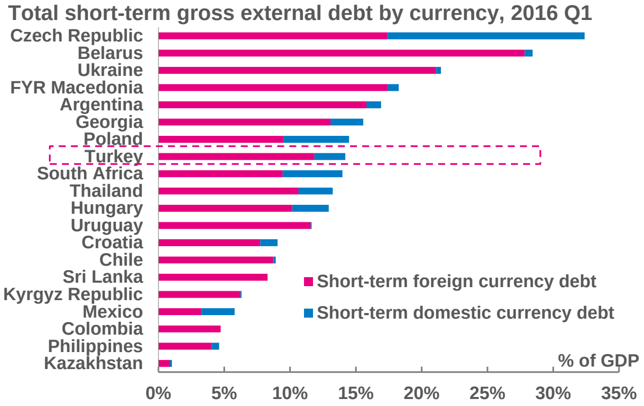
Source: Datastream and AXA IM Research

Turkey's current account deficit has corrected significantly since end-2013 on the TRY depreciation after the 2013 market tantrum episode. The currency depreciated by almost 10% in half a year, making exports cheaper, compounded by the drop in the oil price. The part of the current account deficit financed by portfolio investment, proxied by the basic balance or the current account plus the net Foreign Direct Investment (FDI) balances, remains significant at 1.2% of GDP. This part was more significant in the past, but stable FDIs at 2.6% of GDP helped to finance the 3.7% of GDP current account deficit (May 2016).

With Turkey's foreign exchange reserves at US$32bn and an average annualised current account deficit of US$35bn per month, reserves are sufficient to cover current account deficit payments up to a month, which is low by other EM standards. The high current account deficit is further mirrored in the country's high gross external debt, equal to 54% of GDP. Foreign currency denominated gross external debt alone stands at 51% of GDP. The gross external debt due in the next twelve months or the short-term gross external debt equals 14% of GDP, almost exclusively denominated in foreign currency (*Exhibit 3*).

Exhibit 3

Sizeable foreign currency denominated short-term debt



Source: World Bank and AXA IM Research

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[1] Davradakis, M., "Emerging markets: the next shoe to drop", AXA IM Research, 10 February 2016.
[2] Adalet ve Kalkinma Partisi, the Justice and Development Party of Turquey
[3] According to our analysis, Turkey has the fourth highest passing through coefficient (the increase in inflation a year after a 10% currency depreciation): Brazil: 2.2; Philippines: 1.8; Indonesia: 1.4 and Turkey: 1.

Almost 35% of total loans to the private sector are denominated in foreign currency, while more than 40% of total corporate loans are denominated in foreign currency as of May 2016. **The spike in political risk and the country risk premium, as reflected in the depreciation of the currency, will challenge Turkey's ability to rollover pending external debt**. According to Standard and Poor's, [4] Turkey has to rollover nearly 42% of its total external debt, almost **US$170bn which is five times its usable reserves or 24% of estimated 2016 GDP in the next 12 months.** Turkish banks[5] have to rollover US$99bn of debt maturing in less than 12 months owed to non-residents or 12% of total liabilities including shareholders' equity. With 43% of the total outstanding lending to Turkish corporates denominated in foreign currency and the corporate debt to equity ratio rising to 205% from 161% after a 20% TRY devaluation (IMF's country report on Turkey, April 2016), containing the TRY volatility is of paramount importance for financial sustainability.

Turkey's ability to service its external debt is challenged by the significant currency mismatch evident in the high net foreign liabilities at 56% of GDP (end-2015), the highest since 1990. The banking sector has net foreign liabilities at 8% of GDP, while those of corporates equal 24% of GDP. The destinies of Turkish corporates and banks are intertwined, since the former prefer mostly credit from domestic creditors than external creditors. The ability to service external debt is further complicated by the fact that there is a non-negligible foreign ownership of Turkish assets. For example, 42% of the issued in local currency public debt is held by foreigners. Foreign investors may chose not to rollover maturing debt concerned by the rise in political risk.

Geopolitical risk

In western politician's eyes, Turkey is a vital part in the peace process in Middle East, given its geographical position, NATO membership and secularism despite its Islamic religion. Having said that, an unstable Turkey would result in instability in the region more broadly. Turkey is already very much involved in the regional conflicts. **Turkey's involvement in the Syrian civil war and the lift of the ceasefire with the Kurdish PKK have sparked a wave of terrorist attacks in the country, targeting the county's tourist industry.** The latter, contributing almost 3% to GDP, has witnessed tourist arrivals dropping by 25% year-on-year in May 2016 after dropping by 19% a month earlier on fears relating to national security. During the ongoing reorganization of the Turkish security forces and the judicial, militant Islamic groups and PKK may seize the opportunity to launch more terrorist attacks and destabilise the country further.

[4] Standard and Poor's, *Republic of Turkey Foreign Currency Ratings Lowered to 'BB/B'; Outlook Negative,* press release, 20 July 2013.

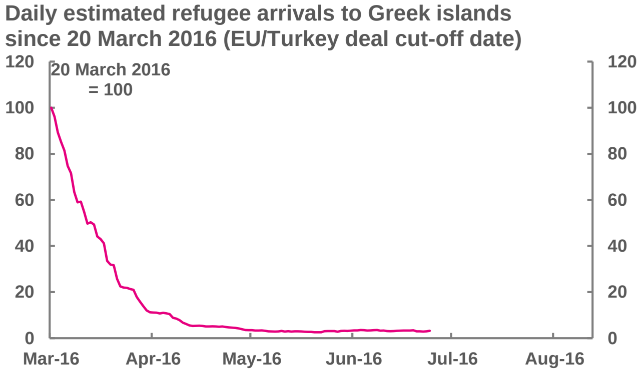
[5] Akbank, Garanti and Isbank are the largest domestic lenders by market cap. Akbank is owned by Citigroup and Garanti by BBVA. UniCredit owns 41% of Yapi Kredi. HSBC also retains its wholesale unit and is in the process of restructuring the retail business in Turkey. BNP and ING have some Turkish exposure, too.

Risk of intensifying the refugee crisis

Given its vicinity with both Greece and Syria, Turkey has been used as a transit country to the EU for the refugees of the Syrian civil war. The escalation of the Civil war and ISIS assuming control in several Syrian territories intensified the flow of refugees crossing the Aegean Sea to reach European soil in search of a new home. Refugee flows became uncontrollable, with a significant death toll among those crossing the Aegean from Turkey to Greece. The EU intervened and an agreement was signed with Turkey to accommodate the Syrian refugees and those in refugee camps in Greece to return to Turkey. Since 20 March 2016 when the EU/Turkey agreement was enacted, refugee flows have subsided considerably. We see in *Exhibit 4* that **the number of refugees crossing the Aegean Sea to Greece has stabilised to a very low level after skyrocketing at the beginning of the year.**

Exhibit 4

The EU/Turkey deal on refugees slowed refuge flows



Source: UNCHR and AXA IM Research

One of the principal conditions for the EU to consent to the refugee agreement with Turkey, which included lifting visa requirements for Turkish citizens travelling to the EU, related to the upholding of human rights. It is likely that the EU may suspect that human rights are violated during the prosecution of the attempted coup perpetrators. Already the government has signalled its intention to restore the death penalty, the abolition of which is a *sine qua non* for the EU. In that case the EU may revoke the agreement with Turkey, which could intensify the refugee crisis. This time, however, the refugee crisis may result in stronger xenophobic and Eurosceptic attitudes in the EU capitals, now that the Remain camp in the UK referendum won on concerns over migration.

Impact to economic activity

The TRY has depreciated (against the dollar) by 20% on average during the previous four coups[6]. Already the currency has depreciated by 10% YTD in annualised terms. We may witness inflation in 2016 moving up by 2pp at most on currency depreciation, dictating an upward revision in our 2016 inflation forecast to 10% from 8.1% previously.

[6] This is the average percentage change of the TRY/USD between the year of the coup and the year before over the four coups in 1960, 1971, 1980 and 1993.

Previous research[7] on the impact of military coups on economic growth has shown that a coup results in an annual reduction of real GDP per capita by 1.5pp if the toppled government was a democratically elected government. **Applying this sensitivity to Turkey, and assuming a 1% population growth, implies a downward revision in our real GDP growth forecasts of 0.5pp to 2.6% in 2016 from 3.1% previously.**

According to the IMF (IMF's country report on Turkey, April 2016), a one percentage point increase in the coefficient of variation[8] in the exchange rate triggers a 11pp drop in the corporate Interest Coverage Ratio (ICR), defined as the pre-tax profit divided by interest expenses. Similarly a one percentage point increase in real GDP growth is triggering a 9pp increase in the ICR. Putting everything together, our assessment of **the TRY depreciation and the downward revision in real GDP growth implies a significant deterioration in the ICR. The latter would result in a spike in non-performing loans** (currently at 3.3% of total loans, May 2016) that would challenge the soundness of the banking sector.

Sovereign rating downgrade risk

In a previous report this year we flagged the possibility of a sovereign downgrade to the non-investment grade of Turkey (Moody's: Baa3, negative; Standard and Poor's: BB, negative and Fitch: BBB-, stable) by year-end on concerns over political uncertainty.[9] A downgrade to junk by two ratings agencies would be sufficient to force Turkey out of the basket considered for the compilation of the JP Morgan Emerging Markets Bond Index Global Diversified Investment Grade (EMBIG IG), a popular index with a total market capitalisation of US$209bn. Turkey, with a 8% weight in the basket (third highest after Mexico 9.8% and Indonesia 8.2%) would have produced portfolio debt outflows of US$17bn, while Turkey's total portfolio debt outflows stood at US$5bn (12-month trailing sum) in May 2016.

We affirm our conviction that the downgrade to the non-investment grade has a high probability by end-2016 as the high country risk premium will likely intensify the external financing risk. Already, Standard and Poor's has downgraded Turkey one notch. Moody's is scheduled to asses Turkey's rating on 5 August and Fitch on 19 August, underlining the need to assess the potential implications of the failed coup on economic growth, policy predictability/effectiveness, and reduced access to external liquidity. In acknowledging the risk to financial stability the central bank has already pledged to provide unlimited liquidity lenders and allow banks to place foreign exchange deposit as collateral without limits for needed Turkish lira liquidity, while it eased the step of its interest rate cuts which most likely will be put on hold.

[7] Meyersson, E., "Political man on horseback. Coups and Development", Stockholm Institute for Transition Economics, Stockholm School of Economics, 5 April 2016.

[8] The coefficient of variation is the ratio of the arithmetic mean to the standard deviation over a period.

[9] Davradakis, op. cit., p. 2.

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