CEEMEA Views – Turkey: External Financing Challenges Persist

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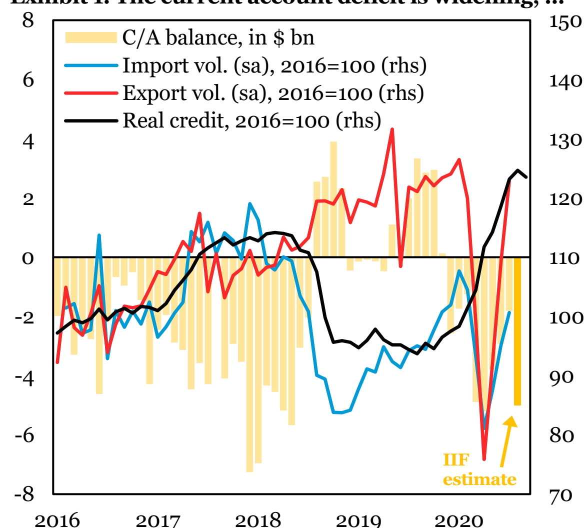
- Turkey's current account balance will shift to a sizable deficit in 2020.
- Meanwhile, non-residents remain reluctant to finance the external gap.
- Residents' strong FX demand adds to depreciation pressure on the Lira.
- Falling reserves constrain the CBRT's ability to provide further stimulus.

In this ***CEEMEA Views***, we analyze Turkey's near-term external financing challenges. These appear to have intensified in the context of a widening current account deficit and sizable FX reserve losses. Export volumes fell much more sharply than import volumes during January-April. In addition, tourism revenues collapsed due to COVID-19 containment measures. As a result, the current account deficit reached $22 bn during January-July compared to a $2 bn surplus over the first seven months of 2019. Monthly trade data shows that the goods trade deficit year-to-date increased from $20 bn in July to $26 bn in August. This indicates a further widening of the c/a deficit—to around $27 bn (or roughly 4% of GDP) over the first eight months of the year (Exhibit 1).

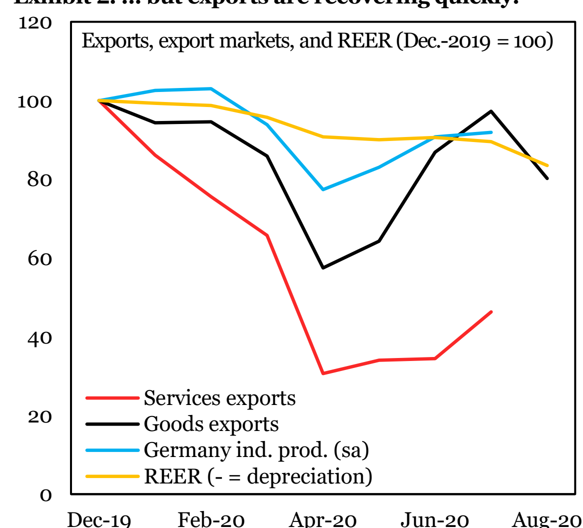
With credit growth slowing and the Lira having weakened markedly since mid-July, import growth should moderate during the remainder of the year. At the same time, the recovery in exports has been quite impressive since the height of COVID-19-related disruptions in April (Exhibit 2). It remains to be seen if the recovery in Turkey's most important export markets—led by the Euro area—will continue in coming months. A strong bounce back in these countries should help boost Turkey's exports and lead the current account to shift to a small surplus during September-December. A further normalization of tourism revenues would also support services exports. We project the full-year current account deficit to come in around $25 bn or 3.8% of GDP —with risks to the upside as a second wave of COVID-19 infections may lead to renewed disruptions. The shift from a surplus of 1.1% of GDP in 2019 will likely reflect one of the largest deteriorations among major emerging markets.

Exhibit 1. The current account deficit is widening, ...



Source: Haver, IIF

Exhibit 2. ... but exports are recovering quickly.



Source: Haver, IIF

The current account's shift into deficit was accompanied by sizable outflows of non-resident capital, mainly in the form of portfolio investment. Such outflows extended into August and early September and led to historically low non-resident holdings of Lira-denominated assets—with only $20.9 bn in stocks and $5.8 bn in bonds remaining. Since non-residents' positioning in Lira assets declined much faster than FX reserves fell (-$31 bn during January-July), the reserve coverage ratio relative to foreigners' portfolio assets reached 3.3 in early September—nearly triple the 1.3 in late 2017 (Exhibit 3).

In addition to nonresidents' net selling of Lira-denominated assets, residents' strong FX demand has also intensified depreciation pressures on the Lira. As part of its policy response to the COVID-19 shock, the CBRT eased Lira liquidity conditions aggressively during March-early July. This led the CBRT's average cost of funding to remain below median annual inflation expectations during April-July, which appears to have encouraged residents to add roughly $6 bn to their FX deposits since April (Exhibit 4).

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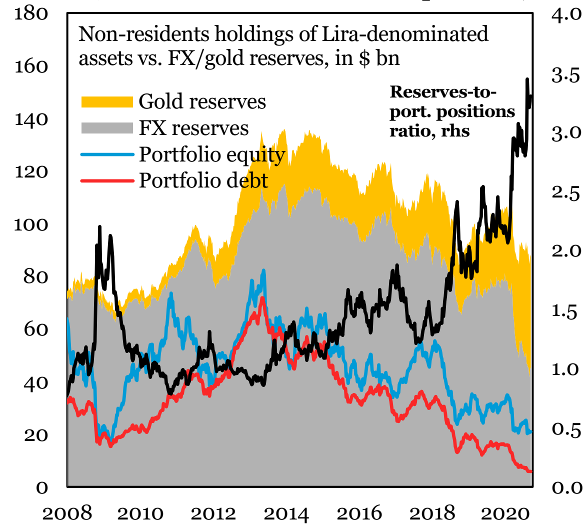
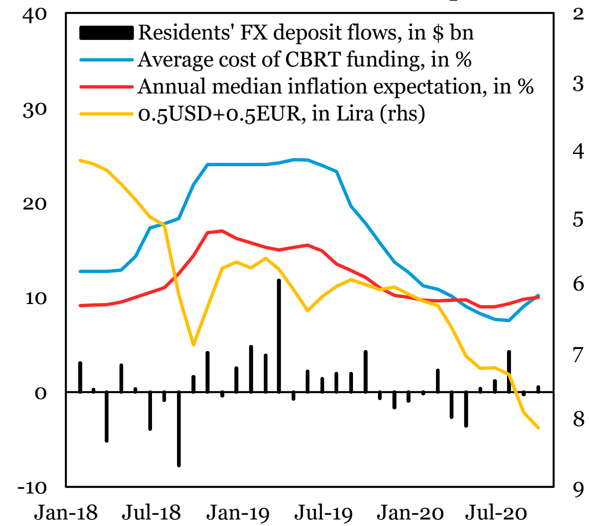
Exhibit 3. Non-residents cut their Lira positions, …



Source: Haver, IIF

Exhibit 4. … while residents add to FX deposits.



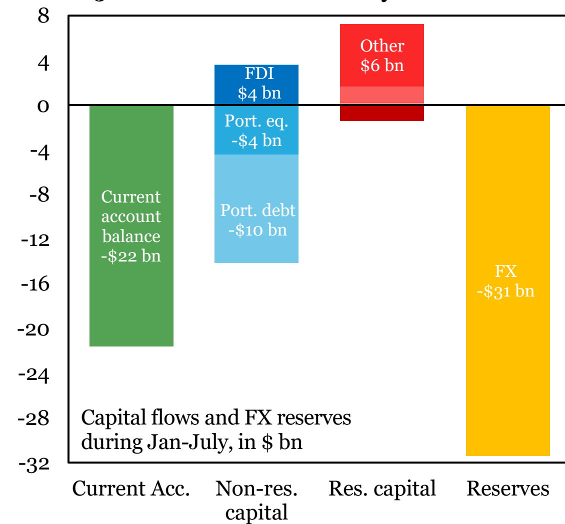
Source: Haver, IIF

The widening current account deficit and intensified depreciation pressures prompted the CBRT to tighten Lira liquidity substantially since mid-July, leading the average cost of funding from the CBRT to rise from 7.3% in early July to 10.6% in mid-September. A more forceful tightening in the form of shifting ex-ante real interest rates meaningfully positive should help improve market sentiment and risk-appetite for Lira-denominated assets. This could not only trigger net inflows of non-resident portfolio capital but also contain residents' FX purchases during the remainder of the year.

If non-resident capital inflows do not materialize in a meaningful way, we will likely see inflows of resident capital to finance some of Turkey's external financing needs—similar to the developments during January-July (Exhibit 5). Such net resident capital inflows would likely be in the form of private sector withdrawals from deposits abroad in order to make repayments for maturing external debt in the case of external debt rollover rates staying below 100% (Exhibit 6). As of end-July, Turkish banks and other sectors have $47 bn and $19 bn, respectively, in their bank accounts abroad from which they can withdraw.

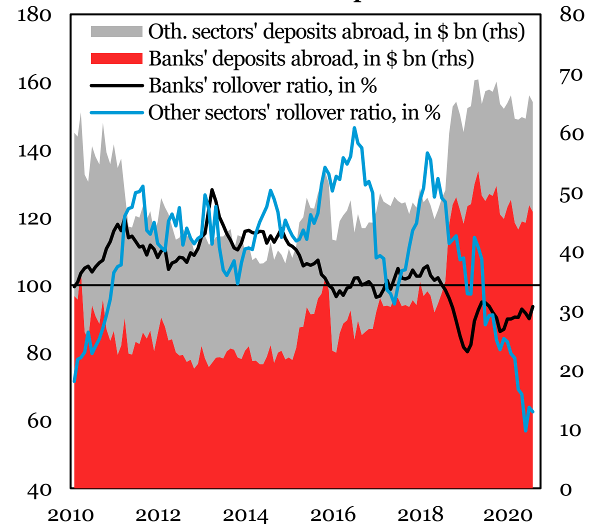
A further decline in Turkey's FX reserves would exacerbate its already-high external vulnerability relative to other major EMs. However, a shift to a more orthodox policy set-up could swiftly reverse the ongoing risk-off sentiment for Turkish assets into a search-for-yield sentiment, triggering sizable net inflows of non-resident portfolio capital. Finally, a rise in external debt rollover ratios in line with the economic recovery cycle into 2021 would allow Turkey to accumulate some FX reserves next year.

Exhibit 5. The deficit was finance by reserve losses.



Source: Haver, IIF

Exhibit 6. Banks have sizable deposits abroad.



Source: Haver, IIF

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