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Five major threats to Turkey's sovereign creditworthiness

Scope's decision to review Turkey's sovereign ratings for downgrade is reinforced by several factors that jeopardise the sovereign's creditworthiness. While re-iterating its underlying rationale, Scope highlights five major risks to Turkey's ratings.

Scope placed Turkey's BB+ long-term local and foreign-currency issuer and senior unsecured debt ratings, as well as its S-3 short-term issuer rating in local and foreign currency, under review for downgrade on 26 July.

A key driver of the review was Turkey's deteriorating economic policy and governance frameworks in the run-up to and since the June election. "Insufficient coherence in Turkey's fiscal and monetary policies has cast doubt on the commitment to address the country's fundamental macroeconomic weaknesses and raise questions about the long-term trajectory of Turkey's creditworthiness," said Jakob Suwalski, an analyst in Scope Ratings' sovereigns team. "Capital markets will continue to test Turkey's economic management model until there's a more meaningful change of direction."

Friday's public address by Finance Minister Berat Albayrak signalled objectives of lower deficits and more sustainable growth but has been undercut by President Recep Tayyip Erdoğan's declaration of an 'economic war', indication of high interest rates as a 'tool of exploitation', launch of investigations against 'fake news' driving lira weakness, and urging of citizens to cash in gold and foreign currency to bolster the Turkish lira. On Sunday, Mr Albayrak announced a new action plan is coming, including a new 'fiscal rule' and support measures for banks and the real economy.

The second driver of Scope's July decision to review Turkey's ratings for downgrade was increasing risks to Turkey's macroeconomic stability stemming from high external vulnerabilities, with widened current account deficits and large external financing requirements of approximately 30% of GDP per annum. The fragility of Turkey's funding position presents clear challenges for the banking and corporate sectors.

Turkey's BB+ ratings balance the above vulnerabilities against relatively low government debt ratios, the country's high growth potential, a large, diversified economy, a flexible exchange rate regime, and aspects of resilience within the banking sector.

Presently, Scope sees five critical risks to Turkey's sovereign rating:

#1: The effectiveness and credibility of the nation's institutional and economic management framework have been undermined.

This impacts Turkey's credit trajectory over a longer time window. President Erdoğan's term and mandate to guide the economy now extends until 2023. The country's weakened institutional framework under the new Executive Presidency affords the President extremely broad powers, raising the likelihood of significant economic policy errors and geopolitically-driven external shocks, as reflected in reciprocal sanctions vis-à-vis the United States, including Friday's announcement of a doubling of US tariffs on Turkish aluminium and steel to 20% and 50%.

Turkey's reorientation and engagement with BRICS countries, especially China and Russia, is meaningful in its strategic statement. China has an interest in deepening trade and investment relations globally, including with Turkey. The Turkish treasury recently mandated banks to underwrite a planned renminbi-denominated (Panda) bond, while Turkey is actively developing several Belt and Road projects with Chinese backing. In Scope's view, however, while Turkey could cushion declining reserves via such bilateral channels, borrowing from China and/or Russia would not come with the structural and fiscal conditionality of an IMF programme (the latter which Erdoğan stands against), and would not repair the country's economic vulnerabilities.

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#2: The steep depreciation of the Turkish lira against the US dollar has contributed to a deterioration in the inflation outlook, with to date an incoherent monetary policy response.

This has called into question the independence of monetary policy and risks de-anchoring inflation expectations. The lira has devalued by 45% against the US dollar (to 6.9 at the time of this writing) since the beginning of 2018, losing around 17% on Friday alone. The rapid decline in the Turkish currency appears, however, to exaggerate the true scale of fundamental weakness, in Scope's view.

With the pass-through of currency declines, inflation reached 15.9% YoY in July. The central bank's recent attempts to take pressure off by lowering the upper limit of the Reserve Options Mechanism from 45% to 40%, adding restrictions on dollar-lira swaps, and, on Monday, boosting foreign exchange and lira liquidity alongside cutting reserve requirements demonstrate concern, but an ongoing reluctance to raise interest rates.

#3: A widened current account deficit alongside capital outflows endanger the country's modest international reserves.

This accentuates an ongoing balance-of-payment crisis. Turkey's current account deficit has widened, to 6.2% of GDP in the 12 months to June 2018 (from 3.3% of GDP in the 12 months to May 2016). Scope expects that higher oil prices and higher interest payments will result in a current account deficit of 6.8% of GDP in the full year 2018. Alongside meaningful capital outflows and reports of dollar shortages in Turkish banks (increasing market concerns around the imposition of capital controls), modest gross international reserves of USD 130.9bn (106% of short-term external debt) as of May 2018 are at risk of further erosion. Given Turkey's sizeable external financing needs of approximately 30% of GDP per annum, declining FX reserves exacerbates stresses.

#4: The slide in the currency at a time of more challenging global external financing conditions weighs on the Turkish private sector, which has significant foreign-currency and external-debt exposures.

This has meaningful implications on open net foreign exchange positions of the private sector. These totalled USD 223bn in Q1 2018. Next, Turkey's gross external financing needs total around USD 240bn in 2018 and next year, up from around USD 220bn in 2017.

Turkish lenders have a record of foreign borrowing. Data from Thomson Reuters LPC show that Turkish banks borrowed just shy of USD 19bn equivalent in 2017 predominantly from international banks and had raised USD 10bn in 2018 by the end of July 2018. But there is significant uncertainty as to whether the banks will be able to access sufficient levels of foreign funding to underpin economic activity, amid fears of bank runs depleting liquid assets. And borrowing costs in the syndicated loan market have risen for Turkish banks.

#5: Fiscal performance has worsened, with actions needed to demonstrate fiscal discipline. In addition, the weaker FX damages the public-sector balance sheet.

This weakens Turkey's key credit strength in its public finances. Fiscal performance has worsened owing to a series of spending measures. Scope anticipates the general government deficit to widen to (a still-moderate) 2.5% of GDP in 2018, from an average of 1.2% of GDP over 2013-2017, with an ongoing pursuit of new infrastructure and other capital-intensive projects. Moreover, expansionary fiscal policy has boosted already-high

inflation with important local government elections, scheduled for March 2019, meaning that the scale of fiscal retrenchment in the coming months may be restricted.

Next, with 42% of central government debt in foreign currency, the lira devaluation in 2018 automatically increases the public debt-to-GDP ratio by about 10pp (from the 28.3% at end-year 2017). However, the high and rising share of fixed-rate debt (75% of central government debt in June 2018) limits changes to the government's interest payments, which were low at 1.8% of GDP in 2017.

"A medium-term budget that demonstrates a strong will towards fiscal discipline, proactive, rather than reactionary, monetary policy tightening, alongside a de-escalation of sanctions would go a distance towards re-anchoring the credibility of Turkey's policy making institutions," said Dennis Shen, also an analyst in Scope's sovereigns team. "Here, Turkey's 'new economic model' needs to not only target lower, more sustainable growth, lower twin deficits and lower inflation, but significant actions need to be taken, substantiating these nominal ambitions."

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