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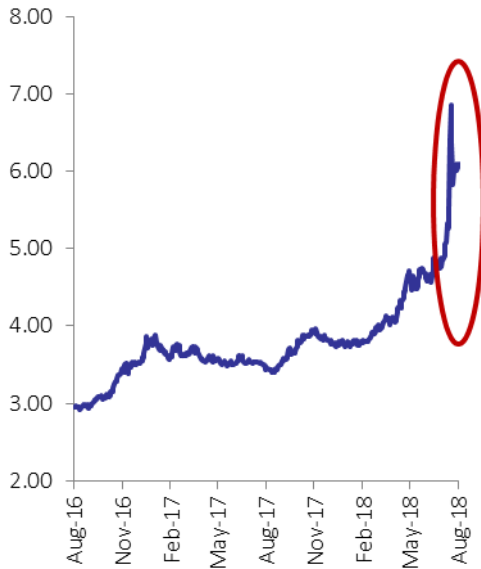
- The Turkish Lira lost 60% of its value against the dollar since year-start
- Pressure on the Turkish economy is likely to increase
- External financing needs can reach \$128 billion in the coming 2 years

The situation in Turkey can get into a larger turmoil as the US president is declaring that more sanctions or tariffs will be implemented on Turkey during the coming months. Turkey is expected to be more pressured and markets are reacting accordingly. Moreover, the Central Bank not being completely independent and pressured by the political sphere not to increase interest rates is limiting the tools the bank can use to respond to monetary and financial developments.

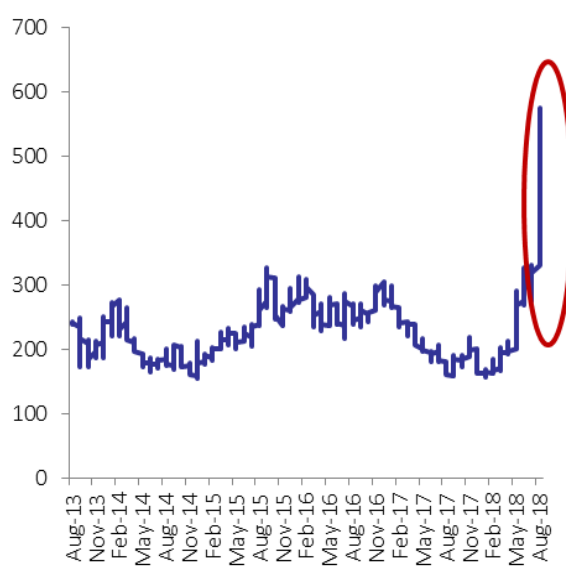
The risk of a large spillover into emerging markets is limited despite the fact that emerging markets are already feeling the pressure of the trade wars Trump is pursuing with different countries. Major currencies in emerging markets have already weakened against the dollar as investors are fleeing risky countries and moving to the US safe haven especially that the Fed has increased interest rates and is expected to increase them twice this year.

The 60% year-to-date depreciation in the value of the Turkish Lira against the dollar rattled the Turkish economy. At the end of 2017, the exchange rate of the US Dollar against the Turkish Lira stood at 3.789 and tumbled to 6.095 on August 27<sup>th</sup> 2018. Standard and poor's downgraded Turkey's sovereign credit rating to B+ from BB-with a stable outlook and forecasted a recession next year. The 5Y Credit Default Swaps for Turkey surged from mid-price of 163 basis points (bps) at the end of 2017 to 472 bps on August 24 and The Borsa Istanbul 30 Index dropped by 21% since the beginning of the year.

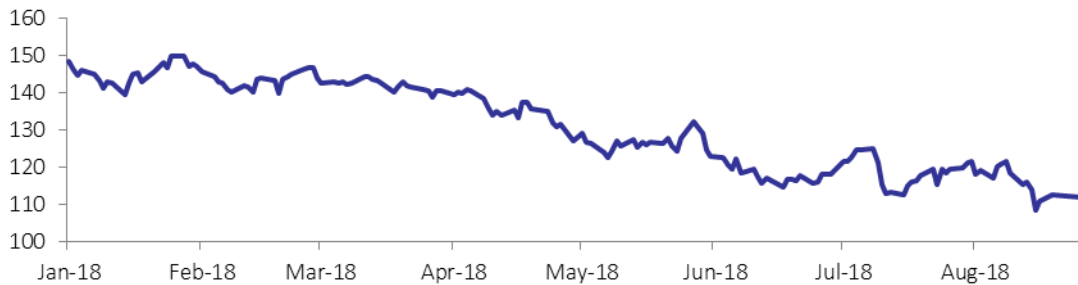
US Dollar/Turkish Lira FX Spot Rate



5Y Credit Default Swaps – Turkey



Borsa Istanbul 30 Index

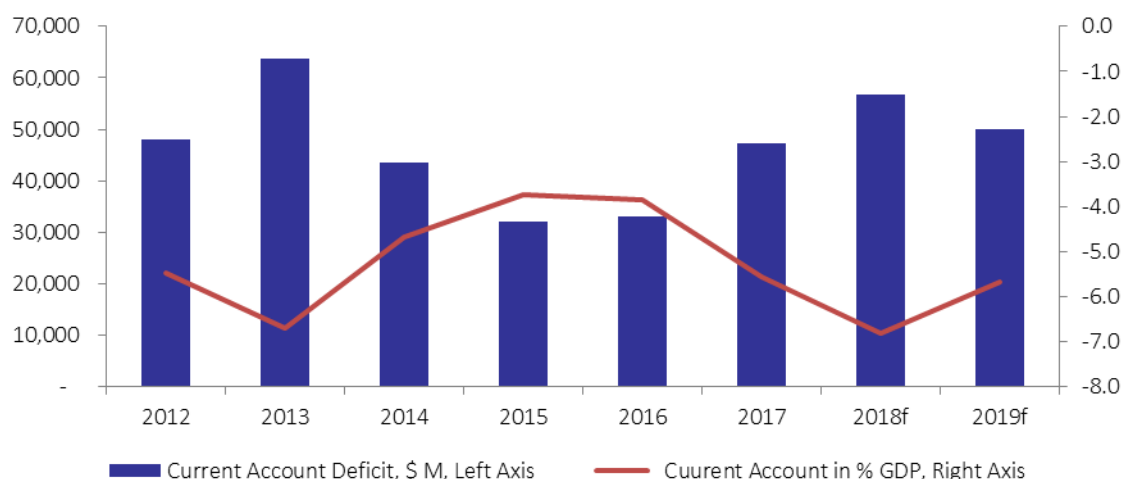


Source: Reuters

The sizeable drop in the value of the Turkish lira was sparked by tensions between Turkey and the United States. Turkey is refusing to release Andrew Brunson, a jailed American pastor held for his alleged links to political groups blamed for the 2016 failed coup d'état attempt. In rebuttal, the US slammed the Turkish ministers of Justice and Interior with sanctions and later doubled tariffs on steel and aluminum imports from Turkey to 20% and 50%, respectively.

Turkey’s economy is particularly vulnerable to currency fluctuations due to its high external financing needs that could amount to \$128 billion (two years of current account deficit and corporate debt maturing in up to 2 years). Turkey runs a large current account deficit forecasted to reach \$56.85 billion in 2018 or 6.8% of GDP. Corporate debt amounts to around \$200 billion, or 70% of GDP with half of corporate debt denominated in foreign currency. According to the Central Bank of Turkey, Corporate domestic debt issued by resident banks, other financial companies and non-financial companies maturing in up to two years amounts to around \$14 billion. Moreover, Foreign Direct Investments into Turkey dropped from \$13.3 billion in 2016 to \$10.9 billion in 2017 and is forecast to drop to \$8.3 billion in 2018, according to the IIF.

Current Account Deficit, Turkey



Source: IIF

**Turkish inflation is soaring.** The annual inflation rate reached 15.85% in July 2018 compared to an annual change of 9.79% in the same period last year. Prices of Food and non-alcoholic beverages, accounting for 23.03% of the Consumer Price Index (CPI) basket, registered a 19.40% annual surge while Transportation prices, accounting for 17.47% of the CPI basket surged by a yearly 24.21%.

Year on Year % Change in Consumer Price Index, Turkey

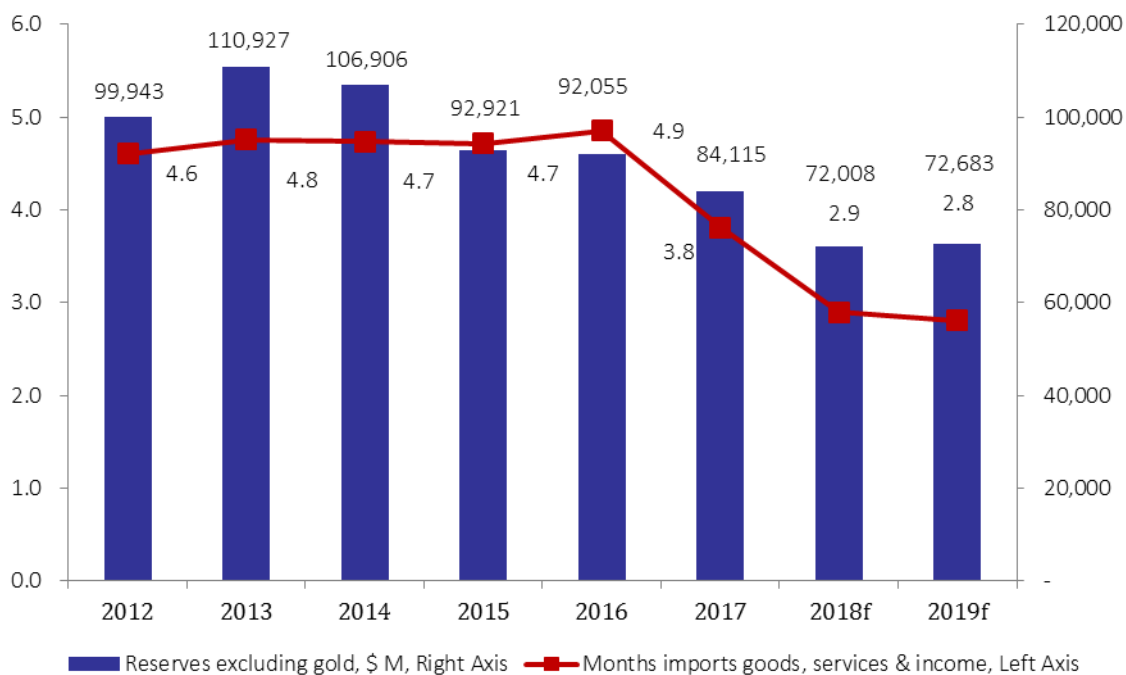


Source: Reuters

**Despite high inflation and a depreciating currency, the Central Bank of Turkey has not yet increased interest rates.** The case of Turkey is a particular one as the country’s President Erdogan publicly opposes increasing interest rates. The last time interest rates were upped by the Turkish Central Bank was in June, bringing the repo rate up by 125 bps to 17.75% ahead of parliamentary elections. However, the benchmark repo rate remained unchanged at the Central Bank’s latest policy meeting in July.

**The Central Bank of Turkey is however attempting to control the slide in the lira without raising its benchmark interest rate.** The Central Bank did put a halt on operations to short the lira in order to contain speculation moves and forced banks to borrow overnight at the rate 19.25% instead of at the rate of 17.75% for the one-week window. Moreover, the value of swap contracts banks can undertake with foreign counterparties was reduced from 50% to 25% of the regulatory capital; if the value of the swaps exceeding the new limit is not eliminated, the banks are not allowed to engage in any new transactions or renew the maturity of existing swap contracts.

Reserves at the Central Bank of Turkey



Source: IIF

**The depreciation of the Turkish Lira sparked contagion talks.** Spanish, French, Italian, German and UK banks have a combined exposure of more than \$160 billion to Turkish debt. However, markets are still figuring out the extent of the crisis’s spillovers across other emerging m

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