KAPSAM Economic Briefing Series (2018/1)

Exchange Rate Fluctuations and Projections

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"In this economic brief, KAPSAM economy unit assess recent exchange rate fluctuations in a wider perspective, makes an analysis on the root-causes of the continuous depreciation of the Turkish Lira, and presents its projections on the exchange rates with three different scenarios (optimistic, cautious, and pessimistic)."

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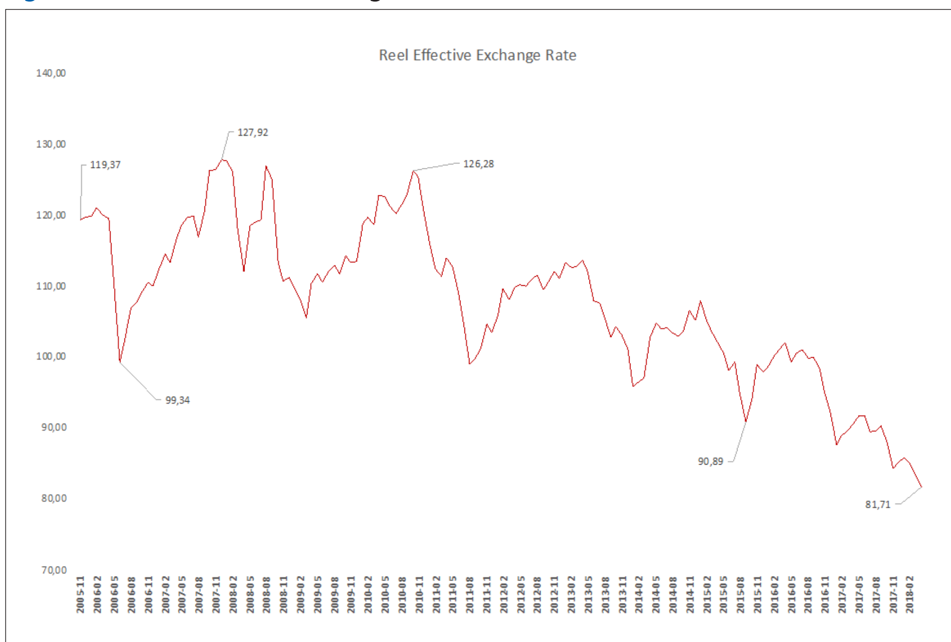
Exchange Rate Fluctuations

Dramatic depreciation of the Turkish Lira against major currencies has been the utmost important topic in the general economic agenda in the recent days. USD exchange rate's setting historic records with touching almost 5 TL, and EURO exchange rate's exceeding of 5.5 TL, alarmed economy officials on the urgency of the issue. Even though, discredited by the highest economy management, word-of-mouth rumors that the government

Figure 1.a. Nominal USD and EURO Exchange Rates Against TL

Figure 1.b. Real Effective Exchange Rates (2003=100)



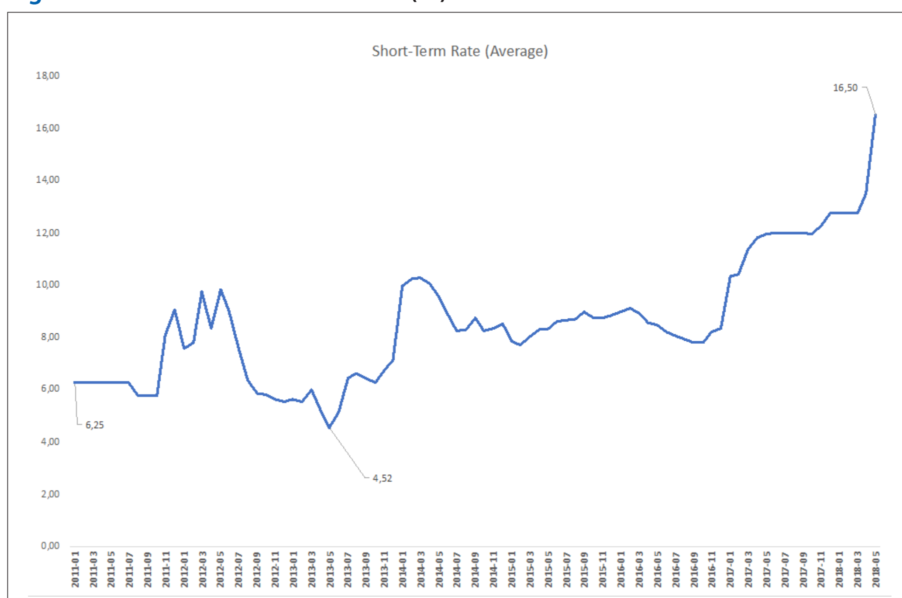
Source: *Turkish Central Bank, KAPSAM Economic Unit*

Note: *Real effective exchange rate is the weighted average of a Turkey's currency in relation to an index or basket of other major currencies, adjusted for the effects of CPI inflation. The weights are determined by comparing the relative trade balance of a country's currency against each country within the index.*

may change existing exchange rate regime together with a possible imposition of Tobin taxation or restrictions on capital outflows added fuel to the fire.

Upon those dramatic developments, economy management tried to give strong messages on the instrumental independence of the Turkish Central Bank and overtly announced that there is no intention for a challenge with the free (liberal) capital market dynamics. Soon after the government's opening gates for a possible intervention, Central Bank gathered the Monetary Policy Committee in an extraordinary meeting and increased short-term interest rates by 300 basis points to 16.5 percent on May 23rd. As an indication of independent and tight monetary policy stance, Turkish Central Bank raised the policy rate (one-week repo auction rate) once again by 125 basis points to ***17.75 percent.*** Both in May 3rd and June 7th press releases Monetary Policy Committee stated that: "Current elevated levels of inflation and inflation expectations continue to pose risks on the pricing behavior. Accordingly, the Committee decided to implement a strong monetary tightening to support price stability. The Central Bank will continue to use all available instruments in pursuit of the price stability objective. Tight stance in monetary policy will be maintained decisively until inflation outlook displays a significant improvement".

Figure 2. Short-Term Interest Rates (%)



Source: *Turkish Central Bank, KAPSAM Economic Unit*
Note: *Short-term interest rate represents the highest level since 2007.*

With an aim to reduce the fever, the Central Bank also decided that repayments of rediscount credits for export and foreign exchange earning services that have been extended before May 25, 2018, which will be due by 31 July 2018 (included), can be made in Turkish liras at an exchange rate of 4.2 for the USD, 4.9 for the Euro, and 5.6 for the GBP, provided that they are paid at maturity.

In the meantime, the Bank changed its operational framework of the monetary policy starting with June 1, 2018, via undergoing to an instrumental simplification process through using one-week repo rate, which would be 16.5 percent, as the key policy rate of the Central Bank. With the instrumental simplification process, the Bank aimed at increasing comprehensibility of the monetary policy implementations.

All those ***overdue*** measures, helped reduce high fever in FX markets, and prevented a "free-fall" in the value of Turkish Lira, which lost almost ***6.5 percent*** against USD in the first three weeks of May.

Yet, even though Turkey pays one of the highest real returns to attract external capital inflows to the Country, initial correction in the USD and EURO exchange rates upon the increase in the short-term rates did not continue , TL seemed to resume the devaluation trend shortly after the two moves of the Central Bank. For the time being, the value of USD and EURO against TL hovers around 4.5 and 5.3 levels, respectively with a slight upward trend.

All those developments urge us consider the issue with a wider perspective, which is not limited to the monetary policies. In this economic brief, we will analyze the issue in a longer time span, present our analysis on the root-causes of the fever in the FX market and give our projections for the USD and EURO exchange rate under three scenarios (optimistic, cautious and pessimistic) with a scenario likelihood.

Root-Causes of Exchange Rate Hike

It is important to note that exchange rate hike is a derivative result came out of monetary and fiscal policy mix together with the global economic conjuncture. In this section we will make a brief analysis on the root-causes of exchange rate hike.

1. Global economic conjuncture is not supportive. *Between early 2000's and global financial crisis, abundance of the global liquidity pouring into the emerging markets and developing economies created a **"tail wind"** for emerging economies, including Turkey. In this era, many developing countries had a chance to access global liquidity with relatively low borrowing costs and consolidated domestic public finance through revenue windfalls created out of strong global growth. With the help of IMF's being an outside **"policy anchor"**, Turkey achieved a strong fiscal consolidation with a gradual decrease in the general government debt stock and deficit to GDP. After the global financial crisis, the game had changed and Central Banks of the advanced Nations (FED and ECB) had switched to a policy normalization process through increasing short-term rates as economic balances and growth prospects allow to do so. In the first few years after the global financial crisis (2009-2013), Turkey continued to be a **"safe heaven"** for the global liquidity due to the previously achieved institutional and financial reforms resulting negative real interest rates in some periods. Yet after 2013, we observed a persistent exchange rate depreciation trend in line with the new global conjuncture. The rate of change of depreciation increased during the last three years and especially in 2018 as of the date of this report. Whether the trend will continue or change back again in favor of TL depends highly on the results of upcoming election in the sense that whether the newly elected president and government will pursue expansionary or contractionary monetary and fiscal policies.*

2. Turkey did not implement a right policy-mix. *Although numerous concerns were present in the economy management, Turkey preferred expansionary policy mix to precaution after 2013. Precautionary measures were blamed as a remnant of the IMF stand-by era. Distorted*

resource allocation through ***construction bonanza*** *was pursued, and almost no preparation was made for "rainy days". In this process, monetary and fiscal policies were expansionary*

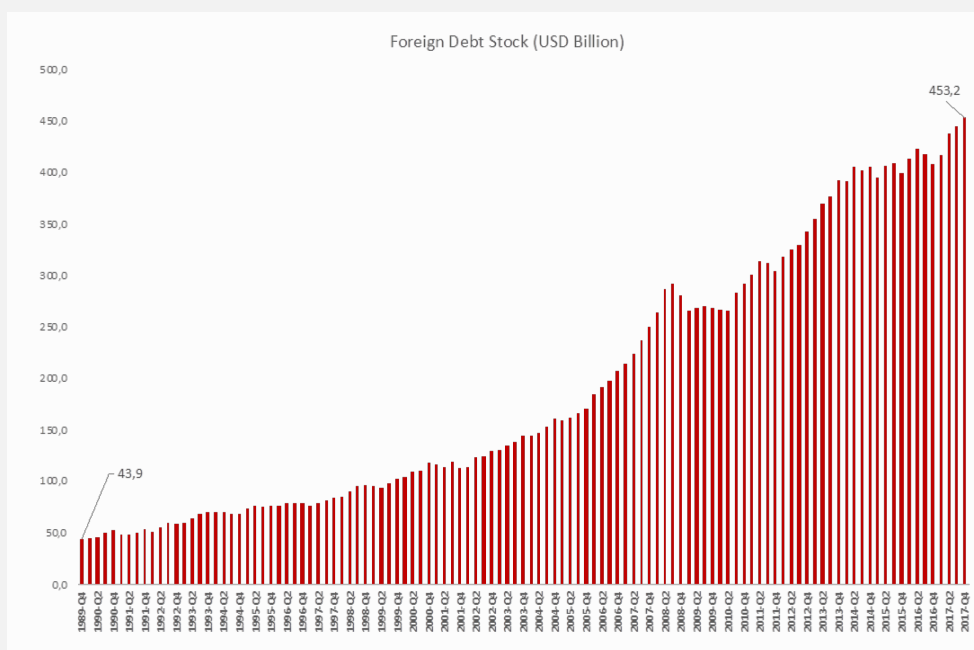
Figure 3. ***Current Account Deficit***

Source: *Turkish Central Bank, KAPSAM Economic Unit*
Note: *Blue bars represent nominal current account deficit in USD billions and showed in the right axis, while current account deficit to GDP ratio was shown in the left axis. Annual average Current Account Deficit to GDP ratio was 5.2 percent between 2009 and 2017. Current data also shows the fact that current account deficit in Turkey is around USD 16.4 billion according to the end March figures and is estimated to realize around 5 percent of the GDP in the end of 2018.*

to support the national economic growth. All those came at a cost, existing growth performance led to persistent current account deficit. In the meantime, recent rising oil price trend has put further pressure on the current account deficit of Turkey.

3. Total Indebtedness has been increased. *Characteristically Turkish economy grows with persistent current account deficits. Policy choice on higher growth fueled by domestic*

Figure 4. ***Turkey's Total Foreign Debt Stock (USD Billion)***



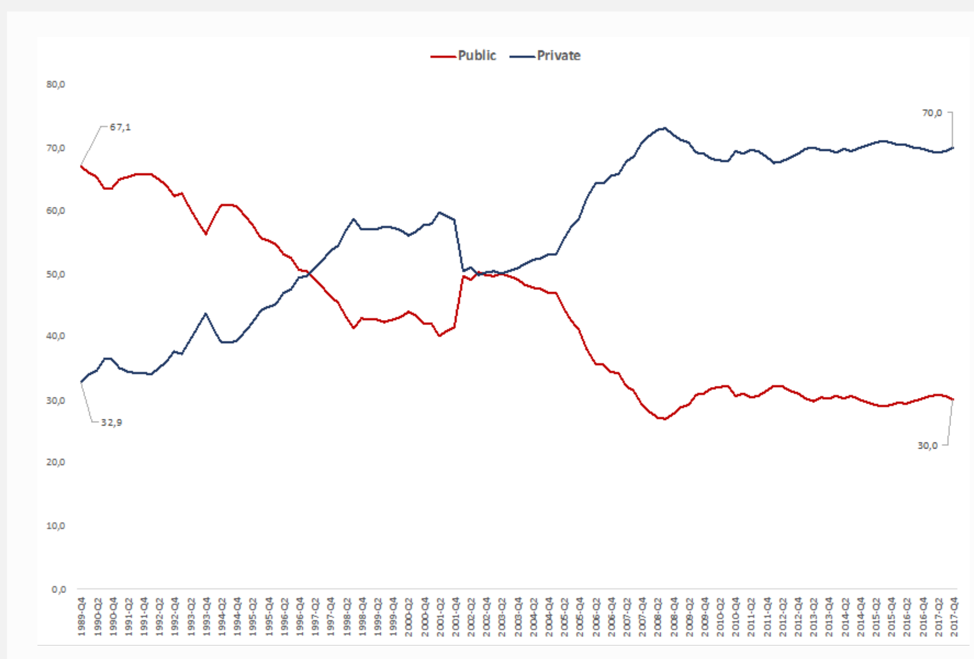
Source: *Turkish Central Bank, KAPSAM Economic Unit*

consumption and households' high leverage resulted in higher current account deficit which in turn leads to undesired consequences. Dependence of the national growth on the current account deficit expansion caused the total debt stock of Turkey to exceed 50 percent of the GDP which is very close to the pre-crisis level as observed in the beginning of 2001. High indebtedness increases risk perception (thus risk premium) in the financial market, which was emphasized recently by the leading credit rating agencies. As we can see in Figure 4, Turkey's foreign debt stock, which was USD 105 billion in 2000's, realized USD 453 billion in the last quarter of 2017. On the other hand, composition of the public and private sector foreign debt stock has changed dramatically in this period. As of the date of this report, private sector foreign indebtedness accounts for a higher share in the total foreign debt.

4. Debt composition has changed. *Easy access to credit with almost no precautionary measures led to higher private sector foreign currency indebtedness. Public sector debt was the core reason behind crisis that Turkey had faced in its economic history. Currently, Turkey's private sector owes more foreign debt than does the government.*

For the time being, private sector accounts 70 percent of the total foreign debt stock, while the public sector's share is 30 percent. Exactly the opposite was observed in 1990's, as can be seen in the Figure 5. Change in the debt composition from public to private sector adds further risk premium for the sustainability of the economy. Since governments would not allow its private sector to collapse, existing private sector debt has a potential to partially convert into government debt in the forthcoming period. We observe initial signs of the potential conversion in the expansion of Credit Guarantee Fund (CGF) coverage and amount and increase in investment guarantees classified under the quasi-fiscal liabilities.

Figure 5. ***Foreign Debt Stock Shares (Public-Private, %)***

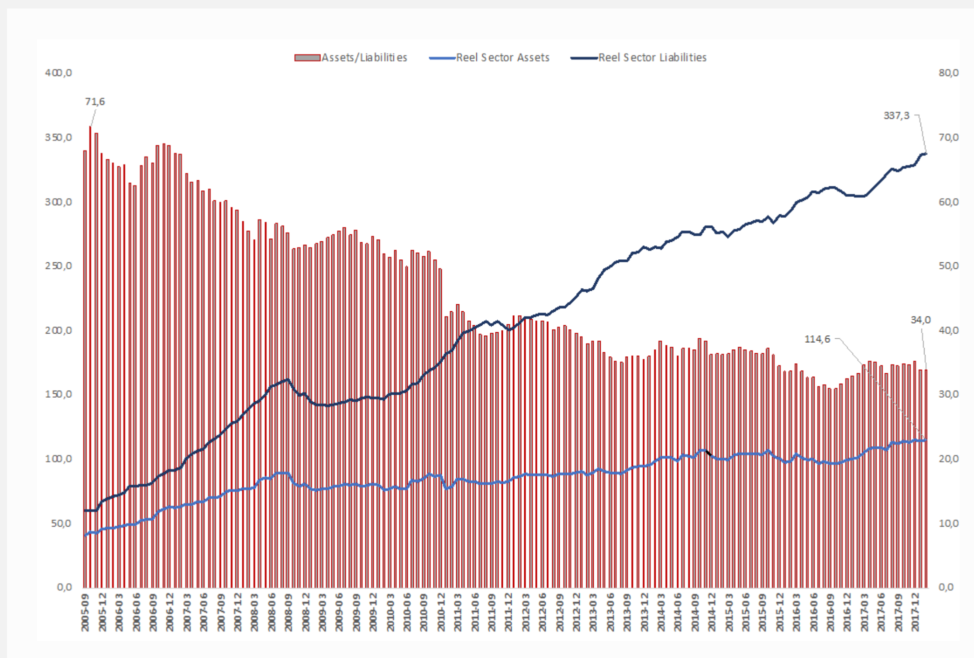


Source: *KAPSAM Economic Unit*

***5. Risk management in the private sector of Turkey is low.** We observe the fact that foreign currency denominated liabilities of the private sector have been increasing while the assets have been relatively stable. This means a dramatic increase in private sector leverage and thus poses FX roll-over risks and adds fuel to the risk perceptions.*

*Real sector liabilities recorded at **USD 337.3 billion** while assets were **USD 114.6 billion** in the end of 2017. Assets to liability ratio, which is a very important indicator for the real sector's financial sustainability, has decreased from above **70 percent in 2006 to 34 percent in the end of 2017.***

Figure 6.** **Private Sector Assets Versus Liabilities (USD Billion, %)



***Source:** Turkish Central Bank, KAPSAM Economic Unit*
***Note:** Red bars represent assets to liability ratio (as percentage) and showed in the right axis, while nominal level of assets and liabilities are shown with black and blue lines in the left axis (as USD billion).*

***6. Quasi fiscal risks are also high in the government sector.** Quasi fiscal liabilities in the government sector currently have various forms in Turkey. Various guarantees (investment and demand guarantee or revenue commitments) arising from PPP-type contracts, use of credit guarantee mechanism to ease financial bottlenecks for the private sector, and other various contractual and non-contractual commitments are all contingent liabilities and the source of potential government spending increase. Government fiscal obligations contingent on the occurrence of any particular event is considered as a contingent liability. Generally, those kinds of obligations are neither budgeted nor accounted for. If a country's banking sector fails, or its subnational (local) units such as municipalities or state-owned institutions find themselves unable to meet their obligations, or a large state-guaranteed infrastructure project runs into difficulties, the central government comes to the rescue. Whether a government is obligated by law or simply forced by circumstances to provide public financing to cover such contingencies, its contingent liabilities can lead to large increases in public debt (IMF Finance and Development, Vol. 36/1).*

Categorization of contingent liabilities could be classified under explicit and implicit liabilities. Explicit contingent liabilities are government liabilities recognized by a law or contract while implicit contingent liabilities are moral obligations of government, which arise from public and interest group pressures. The very well known "Too big to fail" motto in the global financial meltdown and accompanying big state bailouts are good examples of implicit contingent liabilities.

All these commitments pose risks for increased government deficit in the future. According to our calculations, general government deficit has a potential to go above 4 percent of the GDP in the medium-term if no measures are taken to tighten current fiscal policy stance in Turkey. Note that government budget deficit to GDP was around 1.5 percent in 2017.

***Table 1.* Contingent Liabilities and Long-Term Commitments**

Explicit Contingent Liabilities **(Government liability recognized by a law or contract)**	Guarantees in BOT-type PPP schemes Service fees under BRT-types PPP schemes Guarantees in TOR Schemes (if any demand guarantee is granted in the contract) Potential payments from Credit Guarantee Fund up to maximum threshold
Implicit Contingent Liabilities **(Moral obligations of government, which arise from public and interest group pressures)**	Guarantees in BOT-type PPP schemes Service fees under BRT-types PPP schemes Duty losses of the Sovereign Welfare Fund Potential payments from the Credit Guarantee Fund above the maximum threshold
Long-term Commitments	Public hirings Social security schemes BO-type PPP schemes Rent amount under BRT-types PPP schemes New Incentive Scheme

Source: KAPSAM Economic Unit

Scenario Analysis

Key Scenario Assumptions*

OPTIMISTIC SCENARIO

- Global growth with higher pace than the IMF estimates (0.5 percentage point higher than the WEO estimates in the projection period).
- Fiscal tightening with limiting general government deficit to 1.5 percent of the GDP.
- Continuation of the monetary tightening and increase in the short-term rates when it becomes necessary.
- Precautionary measures that aimed to curb domestic demand thus increase national savings.

CAUTIOUS SCENARIO

- Global growth at the same pace with the IMF estimates.
- Moderate fiscal policy management with a general government deficit around 2 percent of the GDP.
- Moderate monetary policy management, which is also prioritizing growth rate at around 5 percent.
- Moderate precautionary demand controls or saving increasing measures.

PESSIMISTIC SCENARIO

- Global growth at the lower pace than the IMF estimates (0.5 percentage point lower than the WEO estimates in the projection period).
- Continuation of the current expansionary fiscal policy path.
- Expansionary monetary policies prioritizing a growth rate above 5 percent.
- No precautionary demand controls or saving increasing measures.

** All scenarios assumed that no political and geopolitical turmoil would be occurred.*

Table 2. Exchange Rate Projections

	Optimistic Scenario		Cautious Scenario		Pessimistic Scenario	
	USD/TL	EUR/TL	USD/TL	EUR/TL	USD/TL	EUR/TL
Jun 18	4.51	5.30	4.62	5.31	4.71	5.42
Jul 18	4.61	5.41	4.65	5.49	5.15	6.08
Aug 18	4.58	5.40	4.68	5.52	5.17	6.10
Sep 18	4.58	5.40	4.69	5.53	5.20	6.14
Oct 18	4.54	5.36	4.71	5.56	5.25	6.20
Nov 18	4.52	5.33	4.74	5.59	5.28	6.23
Dec 18	4.51	5.32	4.75	5.61	5.31	6.27
Jan 19	4.49	5.30	4.77	5.63	5.35	6.31
Feb 19	4.48	5.29	4.79	5.65	5.38	6.35
Mar 19	4.47	5.28	4.85	5.72	5.41	6.38
Apr 19	4.46	5.27	4.89	5.77	5.45	6.43
May 19	4.44	5.24	4.91	5.79	5.49	6.48
Jun 19	4.44	5.23	4.96	5.85	5.51	6.50
Jul 19	4.42	5.21	4.99	5.89	5.56	6.56
Aug 19	4.41	5.20	5.04	5.95	5.63	6.64
Sep 19	4.40	5.20	5.10	6.02	5.66	6.68
Oct 19	4.40	5.19	5.15	6.08	5.70	6.73
Nov 19	4.39	5.18	5.19	6.12	5.79	6.83
Dec 19	4.38	5.17	5.25	6.20	5.87	6.93
Jan 20	4.37	5.16	5.31	6.27	5.96	7.03
Feb 20	4.36	5.15	5.36	6.32	6.06	7.15
Mar 20	4.35	5.14	5.39	6.36	6.12	7.22
Apr 20	4.34	5.13	5.41	6.38	6.19	7.30
May 20	4.33	5.11	5.44	6.42	6.25	7.38
Jun 20	4.33	5.10	5.48	6.47	6.39	7.54
Jul 20	4.32	5.09	5.51	6.50	6.44	7.60
Aug 20	4.33	5.11	5.55	6.55	6.53	7.71
Sep 20	4.32	5.10	5.58	6.58	6.67	7.87
Oct 20	4.31	5.09	5.63	6.64	6.76	7.98
Nov 20	4.30	5.08	5.67	6.69	6.82	8.05
Dec 20	4.30	5.10	5.75	6.80	6.90	8.15

Scenario Likelihood and Conclusion

Dramatic exchange rate hike in the recent days occupies an important place in the economic agenda. Due to the transmission mechanism between exchange rate and inflation, and risks posed to the Turkey's real sector over FX roll-over risks increases the importance of the issue. Yet mainstream discussions in the public take the issue as a sole monetary phenomenon, put the blame only on the Central Bank, and neglect other dimensions (and root-causes) of the fever in the FX markets. Central Bank might be late in monetary policy interventions. Yet exchange rate depreciation could not be explained solely on the ground of Central Bank's inertia. In this economic brief, we tried to depict the picture of the current situation in a wider perspective, tried to analyze root-causes of the continuous loss in the value of TL and presented our exchange rate projections under three different scenarios (optimistic, cautious, and pessimistic). It is also important to note that, none of those scenarios encompass any political and geopolitical turmoil and/or a sudden stop of capital inflows to Turkey.

To sum up, our analysis on the core reasons behind the exchange rate hike boils down to the wrong public policy mix (expansionary fiscal and monetary policy stance in the wake of global liquidity shortage), boosting of high economic growth in exchange of rising current account deficit and rising foreign debt stock. Exchange rate hike seems to show ups as a derivative result of the rising risk perceptions in the economy.

Considering continuation of the monetary tightening (policy normalization) of the FED and ECB, Turkey will experience rainy days for some years to come. Global liquidity would be scarce and borrowing cost would be high. Even though our analysis does not focus on the political dimensions of the issue, election cycle, which would continue until the local elections are completed in March 2019. We have serious concerns as to whether a precautionary policy path could be implemented in Turkey. Considering generous election promises of almost all the political parties, necessary fiscal tightening is becoming harder to materialize.

*Considering all those facts, we believe that **the most likely outcome would be somewhere between cautious and pessimistic scenario.***

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