Credibility Crisis in Turkey

March 24, 2021

Following a commitment to more policy orthodoxy in late 2020, Turkey appears to have once again suddenly changed direction with the sacking of Central Bank of Turkey Governor Naci Agbal and the appointment of Şahap Kavcıoğlu as his replacement over the weekend. Investors will now be focused more closely on the outlook for asset prices in this market. Here we discuss what brought about the change and what the implications are for our portfolios.

Background

In 2020, geopolitical tensions and economic mismanagement had undermined investor confidence in Turkish emerging markets (EM) debt, impacting badly needed foreign direct investment and portfolio flows into the Turkish lira.

Turkey had a large current account deficit that relied heavily on portfolio flow financing, high inflation, opaque fiscal management, short-term foreign-currency debt in the corporate sector, depletion of central bank reserves, and a weak lira. There was a potential balance-of-payments crisis.

Between January and November 2020, the Turkish lira lost more than 40% against the U.S. dollar. As investor confidence disappeared, in November 2020 Turkish President Recep Tayyip Erdoğan appointed Naci Agbal as governor of the Central Bank of Turkey with a seemingly clear mandate to tackle Turkey's inflation problem.

The hiring of Agbal was instrumental to restore confidence among international investors amid increased hopes for policy orthodoxy, and his successive, aggressive interest-rate increases (including a 200-basis-point hike last week) brought stability to the Turkish lira.

The appointment of Agbal (as well as a new finance minister) brought credible and competent autocrats to key finance roles in Turkey, communicating a more orthodox market-friendly approach that would reduce both macro imbalances and market risk premia. The situation was promising: Under Agbal, the lira went from one of the worst-performing EM currencies in the third quarter of 2020 to one of the best in first quarter of 2021.

The Sacking of Agbal

With the country’s benchmark interest rate now standing at 19%, four months of Agbal’s aggressive interest rate hikes appear to have been enough for Erdoğan.

Erdoğan frequently communicates his belief that high interest rates cause inflation (an unorthodox view; more commonplace is the belief that high interest rates quash inflation) and he moved swiftly to replace Agbal with Sahap Kavcıoğlu on March 20, raising questions around potential policy reversal.

The appointment of Kavcıoğlu is of particular concern to the markets as he has been very critical of Agbal’s interest-rate hikes.

Erdoğan is now on his fourth central banker in less than two years, and Turkey still has a serious external debt position given extremely low international reserve levels and high levels of short-term debt denominated in foreign currency.

Investment Implications

Portfolio outflows are likely to exacerbate the problem and lead to further currency weakness. At the same time, inflationary pressures are likely to intensify given this pronounced currency depreciation and a strong pass-through into inflation, creating a vicious cycle that will also have a detrimental impact on potential growth

It is difficult to see how investors can remain comfortable investing in Turkey in this context. This is a major credibility crisis.

However, confirmation of policy direction is crucial in the near term. The Central Bank of Turkey has reiterated its commitment to price stability and we hope the capital controls that were used last year to try to stem foreign-exchange weakness do not reappear. Investors will be watching closely for any personnel and policy changes in the finance ministry and key government positions, and any signs of stress in the banking sector, which has historically enjoyed high rollover ratios.

Asset prices moved aggressively on the first day of trading since the announcement. Dollar bond spreads are significantly wider, the currency has weakened over 10%, and local bond yields have surged higher.

Liquidity is tough to source, particularly in the local forward market, which appears to be broken for now. This has left assets inexpensive and positioning much cleaner; however, they are vulnerable to further volatility as we await further news.

With implied yields on forwards trading at astronomical levels and valuations attractive, we are comfortable adopting a wait-and-see approach on our existing forward contracts, offset by a short duration position in rates that remain very sensitive to currency moves.

In our external debt portfolios, we continue to hold a small overweight exposure to low-cash-price dollar bonds, because we believe—given Turkey's current access to dollar liquidity—that a restructuring has a low near-term probability, and some bonds already reflect relatively low recovery values in case of such an event.

Before decisively adjusting the portfolios more optimistically or cautiously, we will wait for clarification about the near-term implications of the decision to sack Agbal, the policy choices Turkey will make, and the implications of these events for markets.

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