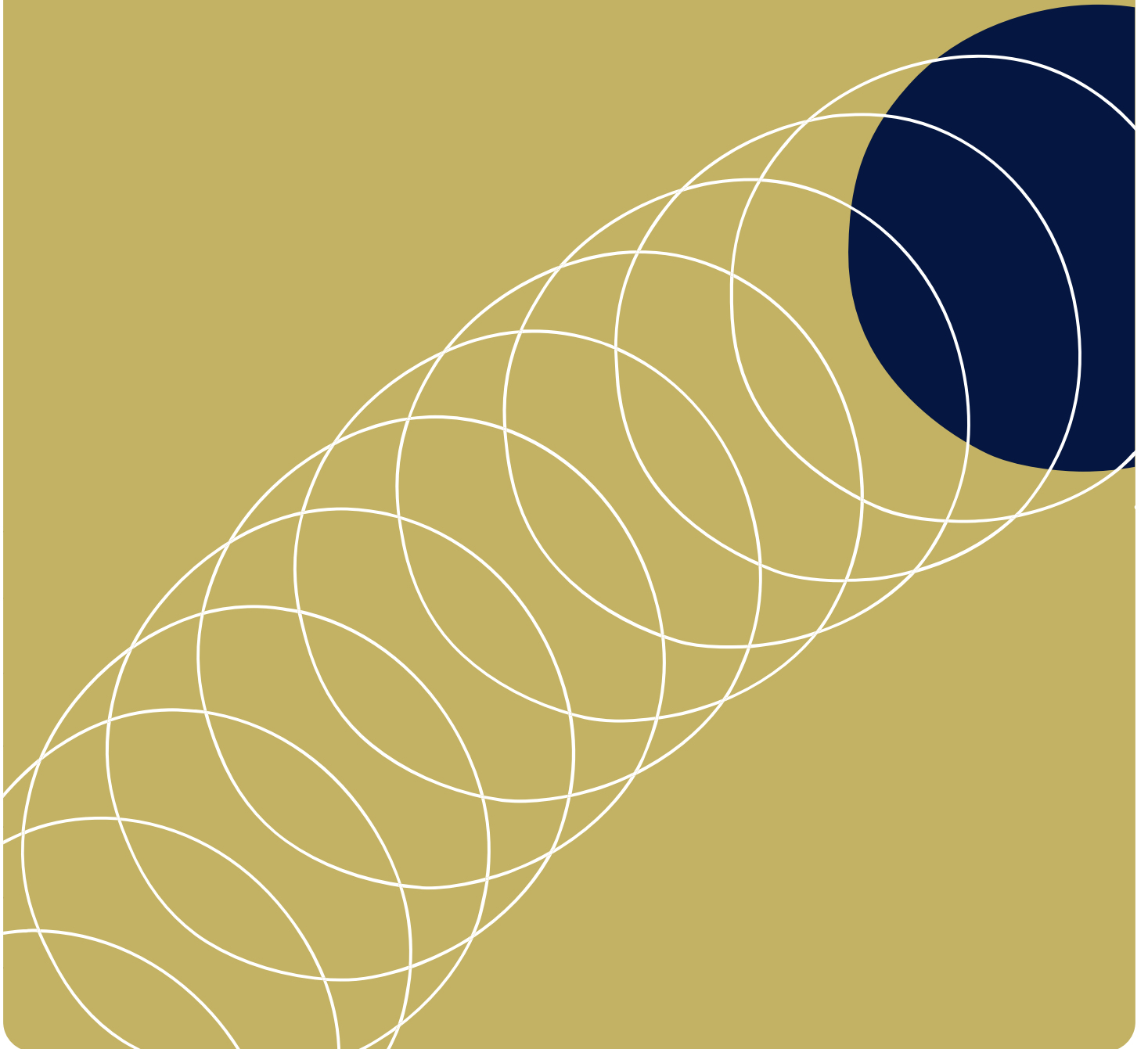


## Turkey tightens monetary policy

News from the financial markets | 26 October 2011



# Turkey tightens monetary policy

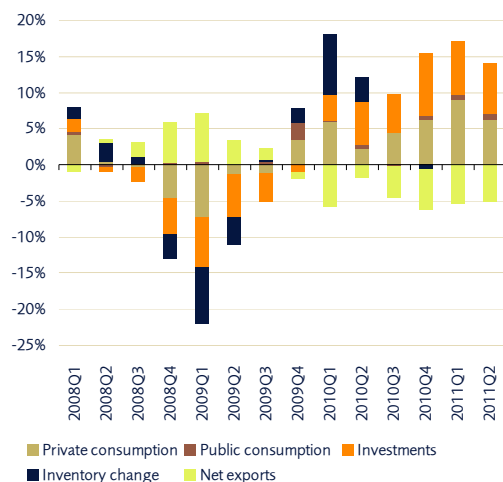
Dr. Thomas Gitzel, Senior Economist

Turkey is engineering a surprisingly sharp tug on the monetary reins. The central bank has discontinued its weekly auctions and thereby caused the effective refinancing rate to increase by almost 700 basis points. The Turkish lira (TRY) reacted positively, while TRY-denominated bonds have taken a significant hit. Apparently, concerns are increasing about how the country's lofty current account deficit can be financed. Investors with a short-term investment horizon should use this temporary lira strength as an opportunity to reduce their positions.

## Rapid pace of growth

Amongst the emerging nations, Turkey is one of the fastest growing: in Q1 2011, its GDP increased at an 11.6% annualised pace, and Q2 also recorded a not-too-shabby growth rate of 8.8%. Private consumption and capital spending are two of the main growth drivers here. In the latest reports, the latter rose by 29% compared to last year. Foreigners are financing a high level of net imports in order to satisfy the domestic demand.

Growth contributions in %



Source: VP Bank, Bloomberg

In the past, Turkey's growth was hardly on a steady course. Phases of above-average growth alternated repeatedly with periods of deep recessions, the most recent in 2009.

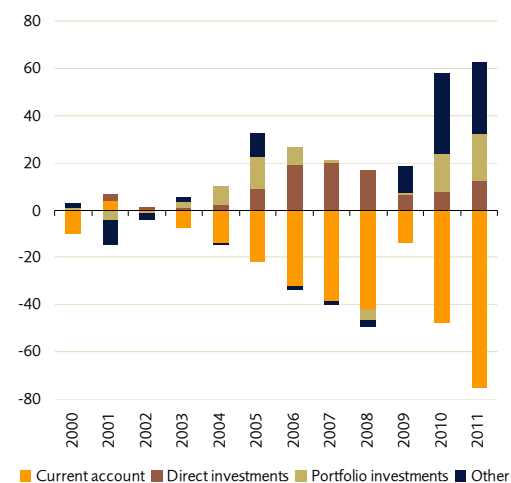
The reason for these pronounced gyrations is the Turkish private economy's tremendous dependence on foreign financing. The high level of private-sector

eternal debt necessitates continuous refinancing. So if the international capital markets are out of whack, the domestic economy suffers under a lack of capital inflows. In such phases, capital spending comes to a screeching halt, which in turn leads to a corresponding plunge in the local economy.

## Critical current account balance

A warning flag as well as evidence of Turkey's susceptibility to crises can be found in its current account balance. In June alone, the trade deficit amounted to USD 10.2 billion – never before has a single month shown such a huge shortfall. At roughly 10% of gross domestic product, the current account deficit has reached a level that clearly heightens the country's vulnerability to a crisis, according to International Monetary Fund (IMF) assessments. And precisely its type of financing increases that vulnerability to negative developments in the international financial markets. Turkey finances its current account deficit largely by means of liquid portfolio investments and other capital inflows. The latter primarily reflect obligations of the Turkish banking sector vis-à-vis foreign entities. In contrast, financing via direct investments has lost its relative significance in recent years.

Financing side of the current account balance in USD billion

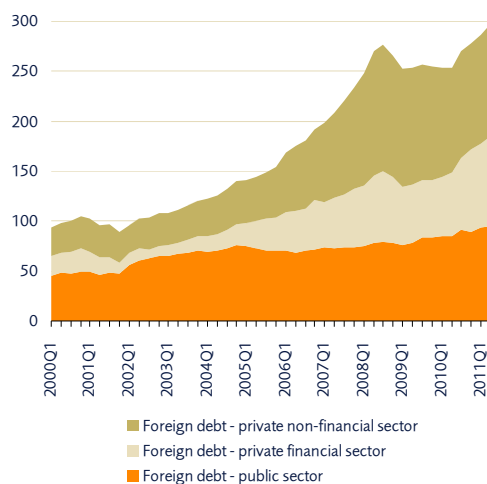


Source: VP Bank, Central Bank of the Republic of Turkey

### Growing level of private short-term foreign indebtedness

Turkey's large current account deficits of recent years have also led to a successive increase in its external debt. While the portion attributable to the state rose only marginally, it is mainly the foreign obligations of the private sector – especially the financial sector – that have recorded a significant increase.

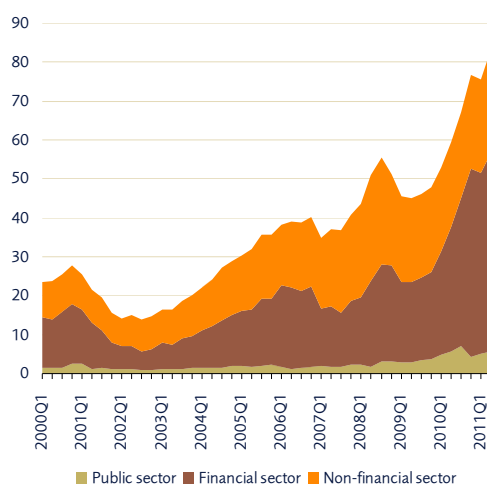
Turkey's external debt in USD billion



Source: VP Bank, Central Bank of the Republic of Turkey

Conspicuous is also the country's bloated short-term foreign indebtedness. Over the past two years, that proportion of external debt has risen by 10 percentage points to 27% of the total. Here, too, the financial sector is accountable for a major chunk.

Short-term foreign indebtedness by sector in USD billion



Source: VP Bank, Central Bank of the Republic of Turkey

### Current situation is not sustainable

The Turkish current account balance is too high and the country will probably not be able to rollover its foreign obligations fully in the months ahead:

- The debt problem in the euro zone threatens to place a heavy burden on the banking sector. There will quite likely be a further reduction of country-specific limits within the European banking sector. Apart from the other Eastern European countries, this will also affect Turkey.
- The financing difficulties caused by this can be expected to hit the Turkish economy hard, in which case domestic demand will be severely curbed. A painfully sharp slowdown in growth has to be reckoned with, and stimulus on the part of the central bank cannot be expected. To the contrary, the CBRT will counter the outflow of capital by tightening its monetary policy.

### TRY under pressure

In the forex markets, the Turkish lira has been under downside pressure ever since the outbreak of the 2008 financial market crisis. This is due to the country's high current account deficit. Versus EUR, the Turkish unit has lost 27% in the past three years, almost 33% versus USD, and at present 48% versus the Swiss franc. In effort to halt the plunge in TRY, the Turkish central bank has already intervened in the foreign exchange market. In addition, it has also boosted overnight borrowing rates from 9% to 12.5%. Since today, that represents the determining price for bank refinancing activities because the weekly auctions for supplying liquidity to the system at a significantly lower rate have been halted until further notice. That has provided short-term help to the lira, but we reckon that TRY will experience another round of weakness in response to efforts aimed at reducing the current account deficit.

### The bottom line

Turkey's catch-up process will continue. But currently the country on the Bosphorus is battling a lofty current account deficit. Given the difficult situation today in the capital markets, the financing of that shortfall is a tall task indeed. We are reckoning with further adjustments. We recommend that risk-conscious investors who do not have the requisite time horizon take advantage of temporary phases of strength in TRY – for example in response to interest rate hikes such as the one seen today – as an opportunity to adjust their positions. The yields on TRY-denominated bonds are also likely to increase; but equally spoken, at their currently high levels, they do offer a certain degree of protection against a falling lira.



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