MOODY'S
INVESTORS SERVICE

ISSUER IN-DEPTH
25 April 2022

Send Your Feedback

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Government of Turkey

FAQ on Turkey's vulnerability to Russia-Ukraine conflict

Soaring commodity prices, supply shocks as well as economic and financial disruption are the key channels by which Turkey (B2 negative) is exposed to Russia's invasion of Ukraine (Caa2 on review for downgrade). In this report, we review the extent to which these channels are likely to aggravate Turkey's preexisting credit challenges and whether we expect Turkey to manage the related pressures.

» **How much of an impact is the conflict likely to have on Turkey's external position and growth outlook?** Surging energy prices and much lower tourism revenues will weaken Turkey's external position this year. However, the stability of key funding sources continues to limit the risk of a balance-of-payments crisis. We have lowered our GDP growth forecast in response to the conflict, but strong credit stimulus will likely limit the extent of the slowdown.

» **With inflation already high and no indication of a change in monetary policy, is Turkey on a path to uncontrolled hyperinflation?** In our baseline scenario, we expect inflation to rise further in the near term and remain above 60% for most of the year. Lira stability, supported by the deposit-protection scheme, should cap inflation around these levels. However, a more adverse scenario in which commodity prices surge further and wages rise rapidly would present greater policy challenges.

» **Are Turkey's fiscal metrics still a source of credit strength?** Yes, but the government's recent measures to at least partially shield households from inflation will push this year's budget deficit upwards and offset any inflation-driven revenue gains. Also, government debt is now highly sensitive to currency depreciation.

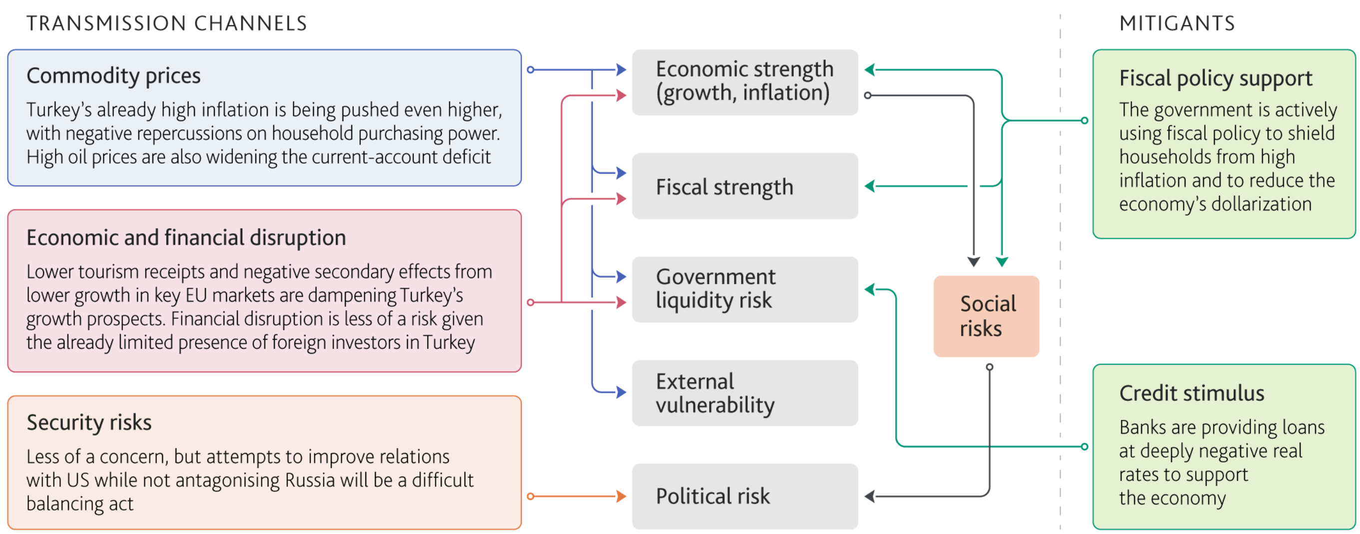
» **Can Turkey muddle through with current policy settings until elections next year?** Probably yes. Turkey has managed episodes of significant financial stress before. Historically low foreign investor participation in Turkish financial markets limits the risk of large capital outflows. Improving diplomatic ties with neighbours in the Middle East have the potential to support investment inflows and currency reserves. Moreover, tensions with the US (Aaa stable) have eased thanks to Turkey's mediator role in the Russia-Ukraine conflict.

How does the conflict impact Turkey's external position and growth outlook?

Because Turkey imports most of its oil and gas needs, rising commodity prices are likely to be the dominant channel by which Turkey will be affected by Russia's invasion of Ukraine (see Exhibit 1). Turkey's energy balance was already starting to deteriorate before Russia's invasion on 24 February, standing at a deficit of nearly $53 billion in the 12 months to February 2022, more than double the level of a year earlier and the highest shortfall since records began (see Exhibit 2). Turkey imported 33% of its gas and 23% of its oil from Russia on average between 2017 and 2020.

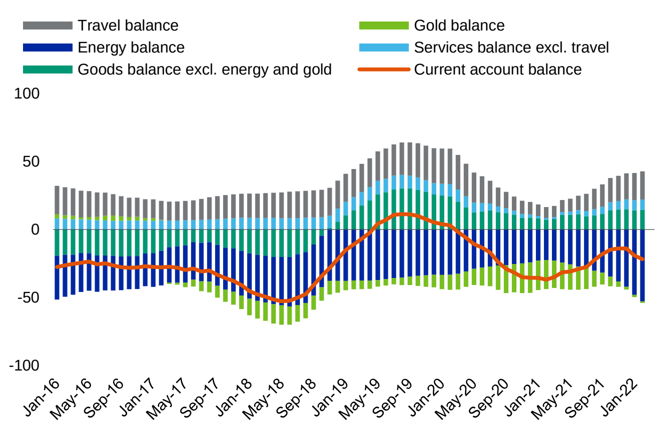
Tourism is likely to be another key channel because Russia and Ukraine accounted for 19% and 8.3% of total arrivals in 2021 (see Exhibit 3). Turkey's competitive currency could entice tourists from other countries, but we still expect overall revenues from tourism to be close to last year's (pandemic impacted) $18.8 billion, and materially lower than the $28.7 billion recorded in 2019.

Exhibit 1
High commodity prices are the main transmission channel of the conflict to Turkey



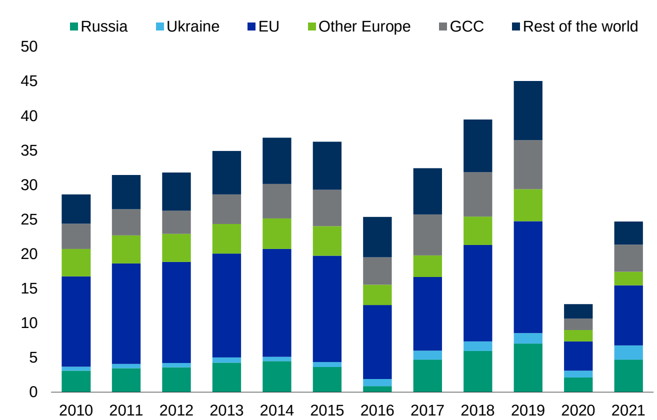
Source: Moody's Investors Service

Exhibit 2
Energy imports will be a drag on the current-account balance
12-month rolling (US$ billion)



Source: CBRT and Moody's Investors Service

Exhibit 3
Russia and Ukraine account for a significant share of tourists
Foreign tourist arrivals by nationality (million)



Source: Ministry of Culture and Tourism and Moody's Investors Service

Turkey's external metrics are likely to be the most visibly affected by these channels. We now forecast a current-account deficit of more than 5% of GDP this year, compared with the 1.7% we forecast pre-invasion and the 1.9% last year. As a result, Turkey's foreign-currency (FX) reserves will not be rebuilt as we had expected preinvasion, but instead remain close to the currently moderate levels of around $66 billion (hard currencies only, see Exhibit 4).

Although the Central Bank of Turkey (CBRT) has been using some of its reserves in an effort to limit pressure on the lira, its requirement that corporates convert 40% (up from 25% recently) of their foreign earnings into lira is supporting reserve levels. The CBRT is also reportedly seeking to extend the rediscount export credit mechanism[1], which was the key driver of rising central bank FX reserves last year. In the first three months of the year, goods exports amounted to around $60 billion.

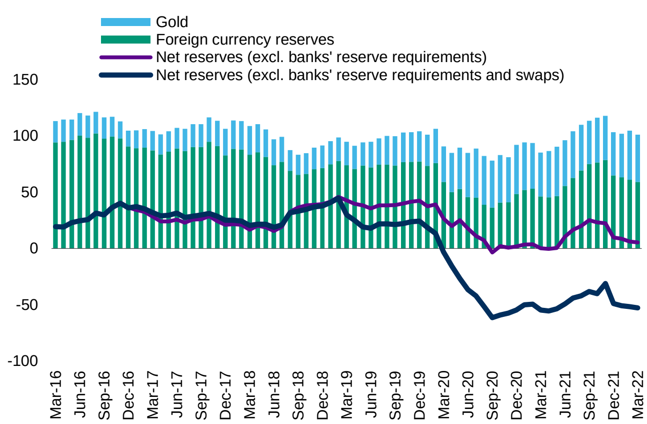
The stability of Turkey's main external financing sources will mitigate the risks arising from the economy's higher financing needs, which we now estimate at around $220 billion on a gross basis. This includes short-term debt of around $120-130 billion, a large part of which consists of trade finance ($43.8 billion), nonresident deposits in the Turkish banking system ($43.4 billion) and the CBRT's swap lines with other central banks ($30 billion), which have all proven to be stable or even increased despite repeated financial stress in Turkey. Market-reliant funding is at much more manageable levels of below $100 billion or around 15% of GDP. The government has already raised nearly half of its external funding needs for the year, including a $2 billion bond issued in mid-March, in the midst of the conflict. Banks have also been able to roll over maturing syndicated loans, even at times of currency volatility and stress.

Like for other countries, we have reduced our growth forecasts for Turkey this year. We now expect real GDP growth of around 3%, compared to 4% earlier. The main reason for the comparatively modest downward revision is our expectation that the banks will again be encouraged to lend at deeply negative real interest rates, particularly to corporates. Credit growth has already been on an accelerating trend over the past five months (see Exhibit 5).

Exhibit 4

Interventions and wider current-account deficit have halted reserve accumulation

US$ billion

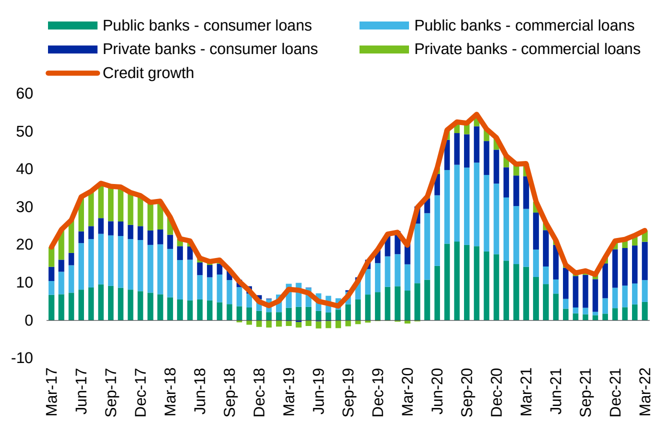


Source: CBRT and Moody's Investors Service

Exhibit 5

Accelerating credit growth will support the economy this year

Credit growth (year-on-year % change) and contributions (pp)



Source: CBRT and Moody's Investors Service

With inflation already high and no indication of a change in monetary policy, is Turkey on a path to uncontrolled hyperinflation?

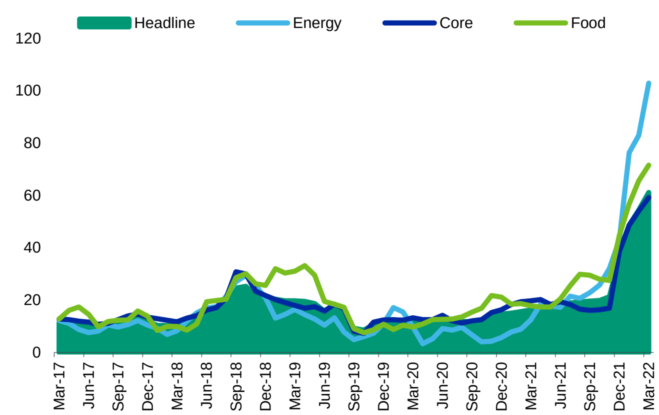
Turkey's inflation is among the highest in emerging markets, with consumer price inflation standing at 61.1% in March according to official data. We expect inflation to rise further in the near term and to remain above 60% until December, when strong base effects should reduce consumer price inflation to around 40%. Energy and food prices were the key drivers of inflation in recent months, but inflationary pressures are widespread (see Exhibit 6).

Our baseline forecasts are based on broad stability of the lira exchange rate, which is now the key policy objective of the central bank. It has had some success with the introduction of its deposit-protection scheme at the beginning of the year (see Exhibit 7). The scheme is offered to households, corporates and nonresidents and makes up for any loss incurred should the lira's depreciation over the term of the deposit exceed the lira interest rate. The Treasury compensates for lira deposits while the CBRT compensates for foreign-currency deposits that are converted into lira. Interest has been gradually increasing, with over 20% of term deposits having been placed into FX-protected lira accounts as of 8 April.

Since the start of the year, the TRY/USD rate has fluctuated in a relatively small range between 13-15. We expect the authorities to extend and potentially broaden the scheme further in case of significant depreciation pressure. Reportedly, the government is considering introducing a new savings deposit that provides some inflation protection. These schemes may halt the trend towards ever-increasing dollarisation but they are unlikely to bring about a fundamental reversal given continued high inflation and lack of central bank credibility.

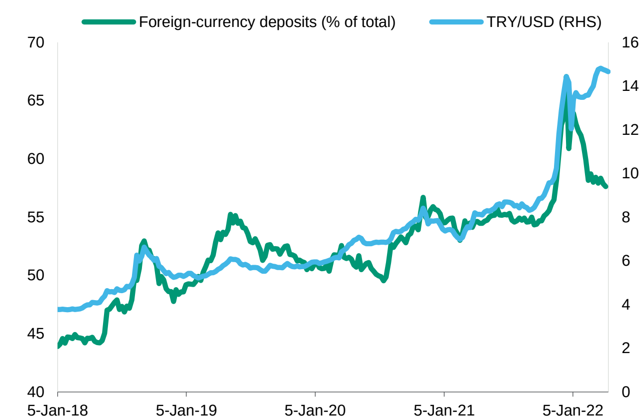
The risk of a more adverse scenario is not immaterial, possibly as result of a renewed increase in commodity prices or worsening supply constraints. A Turkey-specific risk is rising wage pressures: in December, the minimum wage was raised by 50.5%, but this has already been eroded by inflation. Pressure to raise the minimum wage again, which is earned by around 6 million people or 18% of the labour force, may rise. One public-sector trade union has already called for a further increase recently.

Exhibit 6
Inflation will likely remain around 60% for most of 2022
Consumer price inflation (year-on-year % change)



Source: CBRT and Moody's Investors Service

Exhibit 7
Deposit dollarisation remains high despite some success of deposit scheme



Source: CBRT and Moody's Investors Service

Are Turkey's fiscal metrics still a source of credit strength?

Yes, but we expect Turkey's public finances to weaken this year and next, as a result of slower growth but also due to the various measures implemented by the government to shield poorer households from the full impact of high inflation. These include VAT tax cuts on a range of basic items, the elimination of personal income tax on the lowest wage earners as well as a hike in public-sector wages and higher state contribution to the pension system. In addition, the corporate tax rate for exporting companies has been reduced, with potential further tax incentives for corporations in the pipeline.

The deposit-protection scheme has also intensified fiscal risks for the government. The government paid around TL11 billion (0.1% of GDP) in March and we estimate that a 5% depreciation of the lira against the dollar costs the government around TRY20 billion (0.2% of GDP) based on the current amounts deposited (and assuming accounts are not rolled over when they mature). Foregone revenue adds to the overall cost of the scheme because households and corporates are exempt from paying taxes on interest income until June.

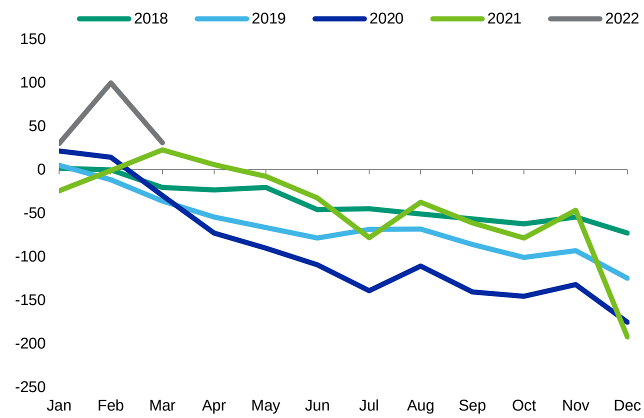
However, tax revenues will benefit from the wage and pension increases at the start of the year, and last year's deficit came in lower than expected, at only 2.7% of GDP at the central government level and 3.7% of GDP for the general government. We forecast a budget deficit for the central and general government of around 3.5% and 4.5% of GDP respectively for this year. In the first three months of 2022, the central government recorded a surplus of TL30 billion or 0.4% of GDP, providing the government with some fiscal space for the remainder of the year (see Exhibit 8).

Similarly, Turkey's public debt remains significantly lower than in other emerging markets (see Exhibit 9), despite the more than 50% increase in the central government's debt burden last year, around two thirds of it was driven by the large depreciation in December. Greater exchange rate stability should limit the rise in the debt burden this year. In our baseline scenario, we forecast the general government debt ratio at around 42% of GDP this year, broadly unchanged from last year. With around 60% of the debt now denominated or linked to foreign currencies, the vulnerability to a weaker exchange rate is very high though and a key risk.

Exhibit 8

Budget performance has been strong in the first three months of 2022

Cumulative central government deficit (TRY billion)

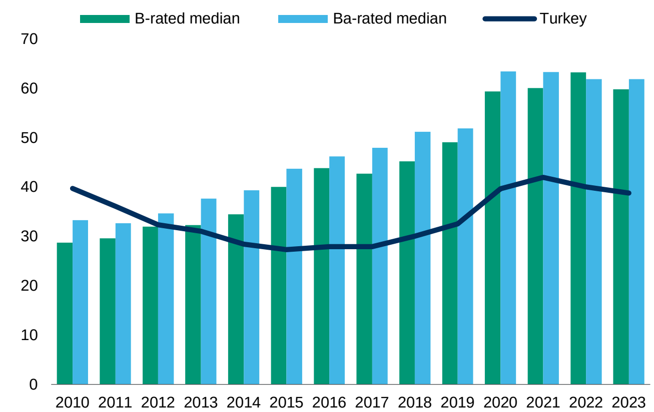


Source: Ministry of Finance and Moody's Investors Service

Exhibit 9

Turkey's debt burden will remain lower than rating peers

Debt (% of GDP)



Source: National authorities and Moody's Investors Service

Can Turkey muddle through with current policy settings until elections next year?

Turkey can probably continue to muddle through, using unorthodox policy measures like the deposit-protection scheme to stabilise the currency. Historically low foreign investor participation in Turkish financial markets limits the risk of large capital outflows. As a result, the behaviour of domestic savers and investors will be crucial for maintaining some degree of stability. However, there are no signs of domestic savers losing their confidence in the solidity of the Turkish banks. Banks are generally well hedged and experienced at dealing with high currency volatility.

At the same time, Turkish President Tayyip Erdogan has aimed to improve previously strained diplomatic ties with several of Turkey's neighbours in the Middle East, including Saudi Arabia (A1 stable) and Israel (A1 positive). The diplomatic offensive may well succeed in raising investment inflows and supporting the central bank's foreign-currency reserves. The current military conflict between Russia and Ukraine also offers Turkey the opportunity to improve its relations with the US and the EU (Aaa stable) again given its mediator role in the conflict. But it is a delicate balancing act, given Turkey's close relations with Russia (Turkey imports around a quarter of its energy needs from Russia) and the government's reluctance to follow the Western sanctions.

Moody's related publications

- **Credit Opinion**: Government of Turkey - B2 negative: Update following forecast change, 1 April 2022
- **Credit Opinion**: Government of Turkey - B2 negative: Update following forecast change, 23 February 2022
- **Issuer In-Depth:** Government of Turkey: FAQ on latest round of currency pressure, 8 December 2021
- **Credit Opinion**: Government of Turkey - B2 negative: Update following rating affirmation; outlook unchanged, 3 December 2021
- **Issuer In-Depth**: Government of Turkey – B2 negative: Annual credit analysis, 22 July 2021
- **Issuer In-Depth**: Government of Turkey: External refinancing progress mitigates risks from low foreign-currency reserves, 2 July 2021
- **Issuer Comment:** Government of Turkey : Surprise firing of central bank governor reverses recent positive developments, likely to increase credit pressures, 22 March 2021
- **Rating Methodology**: Sovereign Ratings Methodology, 25 November 2019

Endnotes

1 Rediscount credits are short-term loans extended to exporting corporates in lira and repaid in foreign currency, contributing to reserves.

REPORT NUMBER 1325691

MOODY'S INVESTORS SERVICE