Credit Research Initiative
National University of Singapore
transforming big data into smart data
NUS National University of Singapore
AI·DF Asian Institute of Digital Finance
Weekly Credit Brief
Jun 06 - Jun 12 2023

Heightened FX risk set to worsen the credit quality of Turkish companies

by Wang Chenye

- **NUS-CRI Agg PD for the Turkish companies steadily increased after the earthquake in Feb-2023 as foreign reserves depleted and the Turkish lira depreciated significantly**
- **NUS-CRI Forward PD suggests the debt repayment and refinancing burden for Turkish companies may worsen despite a sign of a shift from the central bank's unorthodox policies**

Following President Erdogan's re-election on May 28, the Turkish lira (TRY) has faced mounting pressure due to macroeconomic policy uncertainty, hitting a record low of TRY 23.65 against the USD, marking a decline of more than 21% since the beginning of this year. As shown in Figure 1a, the accelerated depletion of Turkey's foreign-exchange (FX) reserves mainly due to the earthquake drove the easing of exchange-rate intervention by the Central Bank of the Republic of Turkey (CBRT). With most of their outstanding debt denominated in USD and EUR, a depreciating TRY may make the Turkish companies vulnerable to FX risks when servicing their debt obligations. In 2022, the policies of 'Liraization' and exchange rate intervention helped shield Turkish companies from FX risk. Meanwhile, the stock market boom and stimulated consumption did give a reprieve to the Turkish companies' short-term debt servicing abilities. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the Turkish companies gradually went down before the earthquake when the central bank's net foreign reserves remained high. However, as the net FX reserves declined after the earthquake, the Agg PD of Turkish companies increased, crossing over the BBB upper bound when referenced to PDiR2.0 bounds[1], indicating a worsening burden of unhedged FX debt. Looking ahead, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD) [2] indicates a further deterioration in credit health, with the Agg PD crossing the BB+ upper bound over the next 12 months as the debt repayment and refinancing burden for Turkish companies is set to worsen despite a sign of a shift from the central bank's unorthodox policies.

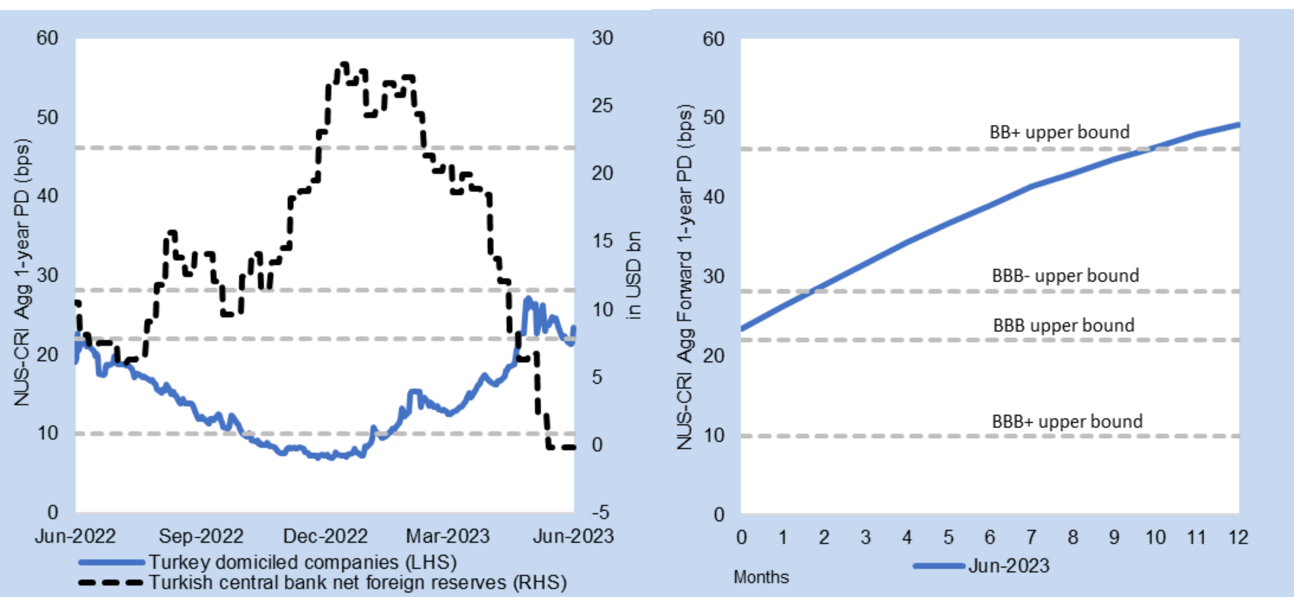

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Turkey-domiciled companies from Jun-2022 to Jun-2023, with reference to PDiR2.0 bounds, and Turkish central bank net foreign reserves; Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Turkey-domiciled companies as of Jun-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Reuters*

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

The debt-fueled growth of the Turkish economy relied on the easy mobility of international capital, and floating exchange rate in the past decades.[3] Turkish companies also benefited from international investments and enjoyed access to international credit. As a result, the companies in Turkey tend to borrow in other currencies, such as EUR and USD for lower interest costs.[4] As shown in Figure 2a, most of the Turkish corporate debt maturing in the coming years is denominated in USD and EUR, indicating that the Turkey-domiciled companies are exposed to tremendous FX risks as a significant portion of their revenue is denominated in liras.

However, since Erdogan took office, his push for aggressive interest rate cuts, and his diplomatic stance have resulted in capital outflows, causing a significant depreciation of the Turkish lira. To prevent panic selling of the lira by local businesses and residents, the authorities intervened in capital flows. Turkey's central bank introduced an FX-protected lira deposit scheme, encouraging locals to hold lira by offering compensation for any currency losses. Simultaneously, the central bank had to sell foreign reserves to buy local currency and stabilize the lira in the international FX market. However, given Turkey's typically negative current account and depleting foreign reserves, implementing the scheme became increasingly challenging. In May-2023, Turkey's central bank experienced a net reserve decrease of USD 2.48bn, leading to negative net FX reserves for the first time since 2002. With insufficient foreign reserves to stabilize the lira, holders or earners of the currency face FX risks and would bear the losses if the lira experiences a sharp decline.

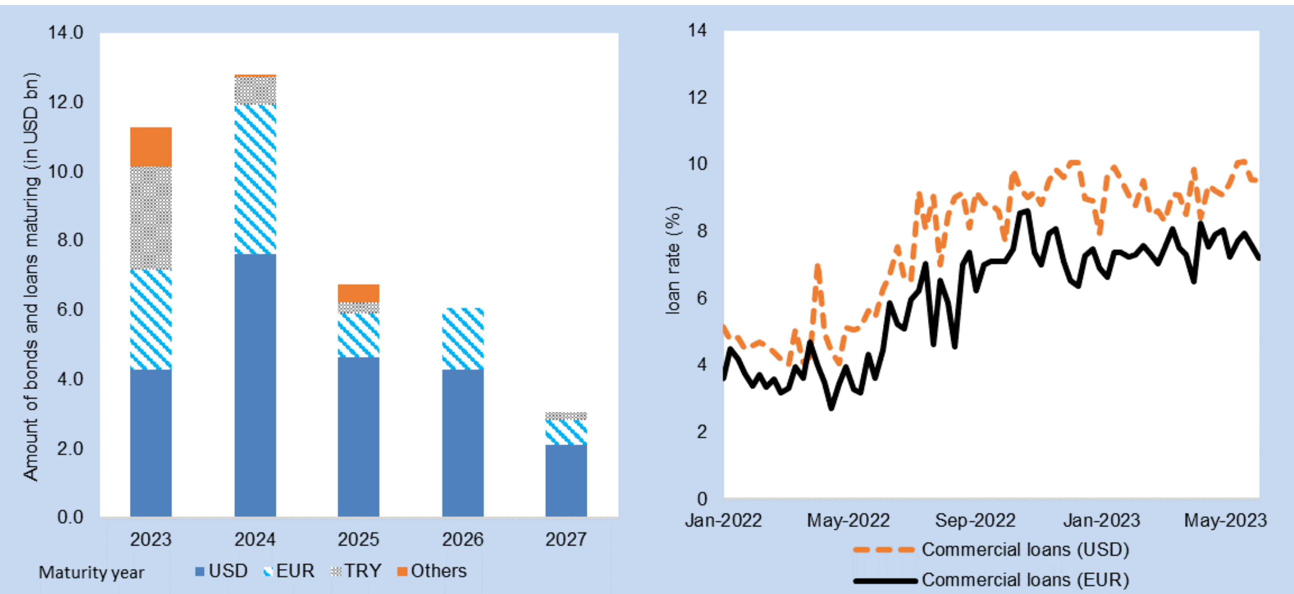

Figure 2a (LHS): Debt maturity distribution of the Turkish companies, broken down by currency. Figure 2b (RHS): The loan rates of commercial bank loans denominated in USD and EUR. *Source: Bloomberg, CBRT*

The operational environment for Turkish companies remains challenging. The economy of Turkey has been plagued by two types of inflation at the same time: demand-pull and cost-push. The decreasing interest rate and depreciating lira make consuming a much more sensible choice than saving. To add to its woes, the energy crisis pushed the energy prices up in 2022, making Turkey, a country that imports almost all its energy, pay more which increases the companies' costs and erodes their profits. Furthermore, the earthquake in Feb-2023 damaged buildings and transport lines, disrupting logistics and trade in commodities, and causing unexpected losses for the local residents and companies.

Unlike Turkey, major central banks started the rate hike cycle in the middle of last year, driving up USD and EUR denominated borrowing costs. As such, the refinancing cost for the Turkish companies also increased, eroding their debt servicing abilities (see Figure 2b). Moreover, the CBRT has implemented measures to restrict the ability of companies with significant FX assets to obtain domestic commercial loans. Also, although the boom in the lira-priced stock market might lend limited support to debt management, the boom itself may be unsustainable. Besides, Turkish banks' profitability may also worsen as the President's re-election may intensify policies of de-dollarization. As per Figure 1b, the Forward PD of the Turkish companies shows a clear upward trend over the next 12 months, suggesting their credit quality might continue to deteriorate.

[3] The economic policies in Turkey have been switching within the Mundellian Trilemma. The selection of the three targets depends on the economic status of Turkey, international situations, and political needs. The Mundellian Trilemma is a concept that states that it is impossible to have all three of the following at the same time: a fixed foreign exchange rate, free capital movement (absence of capital controls), and an independent monetary policy. According to the Mundellian Trilemma, a central bank can only pursue two of the above-mentioned three policies simultaneously.

[4] High inflation, low domestic investment, increased volume of imports, and a weak financial base left the Turkish economy with the reality of dollarization.

Since the re-election of Erdogan, there have been signs of a shift from the central bank's unorthodox policies, i.e., allowing the lira to depreciate. However, Erdogan might still stick to rate cuts as he vowed before the election. Neither the depreciating currency nor falling interest rates are good news for businesses as they seek to repay their debt denominated in foreign currencies in the near term. The collapsing lira will increase their debt cost and the low-interest rate is less attractive to the global capital. As a result, Turkish companies are likely to face a credit crunch, especially with large foreign exchange losses. Although the depreciation of the currency may boost exports and tourism in the long run, the credit quality of Turkish companies is set to deteriorate over the next 12 months as indicated by the Forward PD in Figure 1b.

Credit News

Delinquent office loans at five-year high trouble commercial mortgage bond market

Jun 09. Office building loan defaults are causing concern for mortgage bondholders due to the rise of remote work and a sluggish economy. As a result of the work-from-home trend, tenants are canceling or not renewing leases, leading landlords to fall behind on loan repayments. This has resulted in the highest level of delinquency for office loans packaged into securities since 2018, with over 4% of loans being at least 30 days overdue as of May. Investors are now avoiding commercial mortgage-backed securities (CMBS) with substantial exposure to office buildings, which has led to increased yields for some CMBS. (Bloomberg)

China local state borrowers undergo consolidation at record pace

Jun 09. China's local government financing vehicles (LGFVs) are rapidly merging and reshuffling assets among themselves to ease debt pressure and improve fundraising. From January to May, LGFVs, which primarily finance infrastructure projects, engaged in 240 deals including mergers and asset transfers, more than double compared to the previous year. This marks the highest number of deals since 2010. The focus on LGFVs' USD 9tn debt market has increased, despite no defaults on public bonds. Concerns remain about their debt-servicing capabilities, highlighted by a recent last-minute bond payment. The consolidation of LGFVs is seen as an inevitable trend to enhance quality, reduce risks, and enable better regulatory control. (Bloomberg)

Bonds everywhere suffer as rate-hike fears swamp traders

Jun 08. The global bond market is experiencing a decline as two surprise interest rate hikes this week by central banks highlight that the fight against inflation is far from over. Shorter-maturity treasury yields are reaching their highest levels since March, while Australian yields have surged to levels not seen in over a decade. The Bank of Canada's unexpected rate hike, following the Reserve Bank of Australia's move, has led investors to reconsider their expectations of future rate cuts by the Federal Reserve. This raises concerns about a prolonged rate hike cycle and the potential for increased volatility in global risk assets. (Bloomberg)

Treasury's USD 1tn debt deluge threatens market calm

Jun 07. Financial markets are preparing for a potential influx of over USD 1tn in treasury bills following the resolution of the debt-ceiling issue, which could lead to increased volatility. Approximately USD 850 bn in bond issuance, which had been delayed until a debt-ceiling deal was reached, is expected to be sold between now and September, overwhelming buyers and potentially raising short-term borrowing costs. While major disruptions are not anticipated, concerns remain about potential unforeseen problems in the financial system that could impact market stability. (WSJ)

Europe's commercial property slide is catching up to UK rout

Jun 12. The correction in Europe's commercial property market is intensifying, as higher borrowing costs are impacting valuations. According to an index compiled by MSCI Inc., the value of commercial real estate in Europe declined by 10.8% in the year ending in Mar 2023. In contrast, the UK experienced a 16% fall during the same period, with some landlords now observing signs that the worst of the repricing may be behind them. This decline in asset values, including office buildings, retail shops, and warehouses, has been faster than in previous crises, and landlords are beginning to see buyers attracted by rising rents and limited supply. (Bloomberg)

Aussie big four banks hike home loan rates to match central-bank move (Reuters)

Worst-performing emerging-markets bond could be heading for more pain (Bloomberg)

India's top lender SBI to raise up to 500bn rupees via debt in FY24 (Reuters)

Regulatory Updates

Bank of Canada lifts rates to 22-year high, ending four-month pause

Jun 07. The Bank of Canada decided to resume its interest-rate increases after keeping interest rates steady for a period of four months. The central bank raised rates by a quarter-point to 4.75% from 4.50%, reaching a 22-year high. This decision was driven by stronger-than-expected consumer spending and concerns that inflation may remain elevated. Earlier in January, the Bank of Canada had halted rate increases to assess the impact of previous hikes on the economy, following an aggressive campaign that raised borrowing costs by 4.25 percentage points over a 10-month period. At the time, central bank officials believed that economic activity and inflation would slow down throughout 2023. (WSJ)

China central bank governor reiterates stable policy stance

Jun 09. Governor Yi Gang of China's central bank stated that the monetary policy will remain targeted and credit growth will be kept stable, indicating a largely unchanged policy stance despite calls for additional stimulus. The governor expressed confidence in achieving the official growth target of around 5% for this year and projected a gradual rebound in inflation during the second half of the year. Yi downplayed deflation risks, attributing the recent inflation slowdown to a weaker demand recovery and a high base effect from last year's energy and food prices. He highlighted the growth in consumption, expecting it to translate into increased income for companies, more hiring, and further spending. (Bloomberg)

Bank of Korea governor emphasises sophisticated response to growth, financial risk (Reuters)

Russian central bank gives most hawkish signal this year as it holds rates (BT)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Amrita Parab, Raghav Mathur, Claudio Bonvino