.
Print | Close

Risk.net
Financial Risk Management News and Analysis

Sovereign risk manager of the year: Turkish Undersecretariat of Treasury

/risk-magazine/feature/2233153/sovereign-risk-manager-of-the-year-turkish-undersecretariat-of-treasury

10 Jan 2013, Risk magazine staff, Risk magazine

Economists call it original sin – financing domestic spending with foreign currency borrowing, which can create a potentially crippling mismatch between the revenue a country raises and the debt it has to repay. Turkey fell into this trap during its economic crisis in 2001, when the lira halved in value against the US dollar, contributing to a situation in which the country's interest payments alone accounted for 21.8% of GDP and 103.3% of tax revenues, according to the Turkish central bank.

The country is now a paragon of virtue. Last year, for the first time, Turkey was able to say that its domestic debt was denominated entirely in its local currency, the lira – a big step towards a more resilient economy.

"No longer having to issue foreign-currency bonds to our domestic market is a final sign of credibility for us," says ibrahim Çanakcı, Turkey's Treasury undersecretary in Ankara.

But it's just one in a series of milestones that has brought the country plaudits from economists, bond underwriters, investors and fellow debt management offices (DMOs). Çanakcı and his departmental colleagues have gradually been extending the maturity of Turkey's borrowing, yields have tightened and, on November 5, the country was rewarded with investment-grade status by Fitch Ratings – the first of the big agencies to make the move, and the first time since 1994 that Turkey's bonds have been part of the upper echelons of the sovereign debt universe.

Now, instead of countries such as Turkey looking to Europe and the US for their debt management lessons, it may be the other way round, says the head of one European DMO.

"Countries like Portugal and Ireland are in the early stages of returning to the markets – and in that respect, they can learn from countries like Brazil and Turkey, which are reaping the rewards of years of hard work. The Turkish Treasury has been changing the structure of the country's debt very consistently, basically taking the opportunity to lengthen the duration without incurring too much cost. It's been a very careful process and I think it has contributed to the recent upgrade, which is quite an achievement," he says.

Some of this story can be told in numbers. When Turkey's crisis hit in 2001, the average maturity of its debt was nine months. Today, it is 61 months – up 16 months in the past year alone, and almost double the average seen as recently as late 2008.

The cost of borrowing has fallen dramatically – even over the past 12 months. Last October's auction saw Turkey effectively paying 7.5% for its two-year debt, down from 9.4% in March 2012. For a country that paid an average of 40% on its debt at the end of 2000, these are record lows and there is an obvious temptation to go on a spending spree. It's a temptation Turkey has resisted.

"It's encouraging that Turkey has used favourable market conditions to push out the maturity of its debt, rather than issuing shorter-dated debt at the lowest possible interest rate," says Ed Parker, London-based head of the Europe, Middle East and Africa team in the sovereign group at Fitch Ratings.

At the longer end of the spectrum, the country issued its first 10-year Turkish lira-denominated bond in 2010, part of the Treasury's attempts to build an issuance programme around the two-year, five-year and 10-year maturities – creating a set of benchmarks that is familiar to international bond investors. And it plans to go further.

"Investors are asking us whether we will issue longer than 10-year fixed coupon bonds – and we have announced in our 2013 financing programme that we'll consider the possibility of longer-term Turkish lira-denominated bond issuance," says Çanakcı. Turkey has had no problem issuing inflation-linked bonds out to 20 years, but doesn't want to increase that portion of the debt, the Treasury adds.

The share of foreign ownership of domestic debt is already around 23% – a historical high, up from 17% at the beginning of 2012, and 11% at the beginning of 2011. If another rating agency follows Fitch's lead, then the country will be included in global government bond indexes, stimulating demand among investors that follow the benchmarks. That should open more doors for the debt office.

"We saw an increase in foreign demand following our recent upgrade. We see growing interest from investors that currently can't buy our bonds because of their internal ratings limitations," says Çanakcı.

Page 2

But confirmation of its investment-grade status will require a change of mindset, warns one London-based market participant. "The group of peer sovereigns it will be compared with, and compete with, will be different and that brings new challenges," he says.

Turkey's bonds would then be counted among the liquid, core holdings of portfolios. In just 11 years, investors would have gone from doubting Turkey's ability to pay at all, to asking very different questions – about longer-term stability and the direction of the economy. "Turkey is very good at communicating with its investors, but will have to be prepared to do that more. Investors will be looking more to the long-term future of the economy, closely scrutinising fiscal policies and supervision of the banking sector," he adds.

One thing foreign investors can rely on is the depth of the Turkish domestic investor base. The Treasury has carefully managed this dynamic by limiting the amount of external issuance allocated to Turkish financial institutions, fostering a reliable backstop of domestic demand and helping to reassure international investors. "As an international player, that gives you an advantage – you always know there is that hard core of domestic demand. It's certainly a big factor in explaining why Turkish debt has often traded at tighter spreads than other countries with equivalent ratings," says the London-based market participant.

The Treasury further broadened its investor base in 2012 by issuing sukuk for the first time – bonds compliant with Islamic law. Turkey has had a secular tradition since the founding of the modern republic in 1923, so the launch of the programme was not an uncontroversial decision in a country with a history of tension between secular and religious factions, sparking debate about the policy in the national press. Nevertheless, the Treasury issued TL1.6 billion ($900 million) of the instruments domestically in 2012, while also selling about $1.5 billion to foreign investors.

In total, Turkey issued around TL115 billion last year, so sukuk remains a small slice of overall borrowing, but Çanakcı says the Treasury will return to the market on a regular basis. "This was just a first step. We've said in the 2013 financing programme that we'll issue sukuk domestically in February and August, and thereafter, to ensure liquidity," he says.

The sukuk programme helps support the country's Islamic finance community, which has grown from around 1% of Turkish banking deposits in 2001 to 6% now. It also taps into a new source of demand – 60% of the external debt issuance reportedly went to investors in the Gulf states.

But there are remaining risk factors. One of the main reasons the other rating agencies haven't yet joined Fitch is Turkey's stubbornly high current account deficit. It's the first risk factor listed in the Fitch Ratings upgrade decision, too.

In 2012, the deficit was around 7.5%, mainly due to poor domestic savings rates, meaning the country has to run a current account deficit to finance investment and growth. Judging the sustainability of these deficits is notoriously contentious, and it has been cut from 10% in 2011, but the agencies have some concerns on that score.

"The biggest share of the deficit financing is short term, and comes in the form of portfolio debt inflows – what many people would classify as hot money. With external debt falling due each year and a large current account deficit, Turkey is vulnerable to a drying up of capital inflows in the event of a shock to global risk appetite or a Turkey-specific shock," says Parker at Fitch Ratings.

Fitch does not expect the current account deficit to be wiped out soon, and projects it will still stand at 7.1% of GDP in 2014 – assuming a slight easing in global oil prices. However, low prevailing interest rates and abundant global liquidity should see Turkey's external financing position remain sustainable for the immediate future, the agency concludes. Turkey has undergone significant economic shocks before, but hasn't defaulted on its debt obligations since the 1980s.

"Turkey has long had a volatile economy, with a history of crises going back several decades. The Treasury can draw on this experience – and its debt management capacity is very strong," adds Parker.

Print | Close