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Turkey: The Central Bank of Turkey designs a mechanism to mitigate FX volatility

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The Central Bank (CBRT) Deputy Governor Erkan Kilimci announced yesterday that they will start to auction foreign exchange (FX) hedging instruments to enhance tools to manage corporates' currency risk as an initial part of their long term project on the real sector's open FX position. The new tool, aimed to be in the form of non-deliverable forwards (NDF), will provide hedging with forward payments settled in Lira which will not have an impact on international reserves. The details on the framework and the start date are missing but as we understood from the news, the mechanism will be similar to the Bank of Mexico's NDF program, which was announced in February 2017 and helped to reduce Mexican peso's volatility aftermath. Hence, we elaborate the main goal of the tool as to reduce the Turkish lira volatility by both enhancing liquidity and increasing financial depth in the currency market. This could be helpful especially during turbulent market conditions with an intensified shock disassociated with economic fundamentals.

What has been announced? What do we know?

According to the announced broad framework of the NDF program; 1- Banks allowed to participate in the Turkish Lira currency market are allowed to bid for these securities; 2- Corporates can benefit from the new facility indirectly as banks may gain an interim position; 3- Dates, amounts, and characteristics of the auctions of NDFs would be announced by the CBRT in the near future.

Similar to the Mexican case, the CBRT would be able to sell USD (buy Lira) to local financial institutions as the counterparty buy USD (sell Lira). At maturity, if the FX rate is above the price agreed at inception, the CBRT would pay to the counterparty only the difference in Lira for each dollar hedged. On the contrary, the CBRT would receive a payment from the counterparty. Since, both transactions will be in Lira, the international reserves will not be affected. Probably, there could be an impact on the monetary base in terms of TL liquidity but this can be sterilized through the traditional operations. Here, the crucial point would be restoring liquidity and enhancing players within the market in both directions especially during stressed market conditions when the corporates carry concerns and speculation on further depreciation of the lira.

As we follow from the news, the CBRT has developed "Systemic Risk Data Tracking Model" in order to analyze and follow the corporates' currency risk effectively. A Law draft is also presented to the General Assembly to make the issue of corporates' data collection more efficiently. As an initial step on the CBRT's long term project on the real sector's open FX position and efforts to provide stability in the currency market, we welcome the new facility but also think that a good communication on the tool's framework is also needed to increase its effectiveness.

The Mexican case: A good example

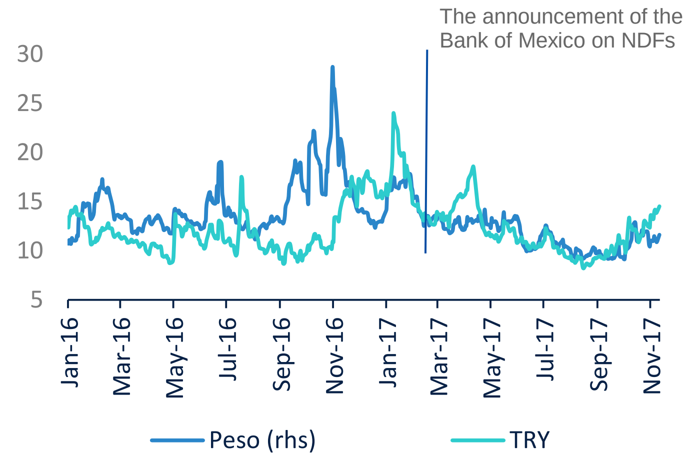
The CBRT's new tool is somehow similar to the one implemented in Mexico early this year. There, the Foreign Exchange Commission had announced an intervention programme of up to USD 20bn in FX hedging instruments in the form of NDFs in February 2017. When auctioning the instrument, the Central Bank announces that it will sell USDMXN upto a pre-determined amount and with a specified date within a 12-month horizon.

As seen below, after the announcement of NDFs in Mexico, the peso had a positive trend (Figure 1) and its volatility decreased even though this was partially supported by a change in the mood of the markets on NAFTA negotiations (Figure 2).

Figure 1 Mexican Peso and Turkish Lira (Level)

Source: Bloomberg, Garanti Research

Figure 2 Mexican Peso and Turkish Lira (1-month imp.vol.)



Source: Bloomberg, Garanti Research

How will the NDFs work in the case of corporates?

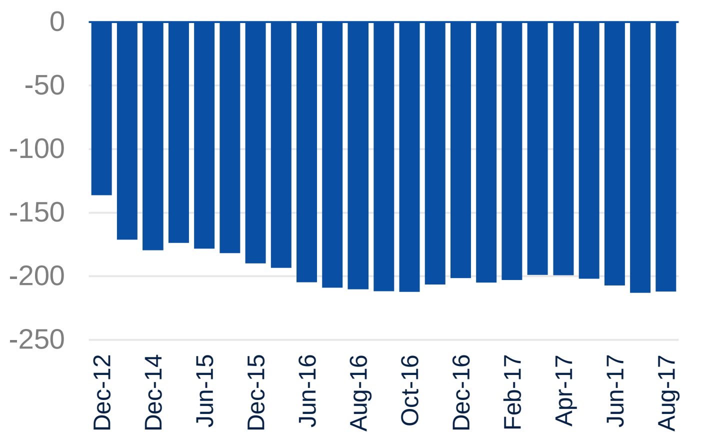
Although the direct counterparty for this tool will be the eligible banks, it would also have positive impact on corporates indirectly. As of August 2017, the real sector has an open FX position of around 210 bn USD (25% of GDP), which makes them vulnerable against currency shocks (Figure 3). In times of rapid depreciation of the lira, these dollar indebted corporates could apply to both spot and futures markets to cover their short positions in dollars. However, the demand for dollars is considered to exceed their actual amount of debt repayments in these times of distress for two reasons:

- Some corporates would try to cover not only the interest payment but also the principal amount of their FX debt assuming further depreciation.
- Apart from hedging, they would also get into speculative trading to benefit from the high volatility in the market.

These two effects put further pressure on the lira and amplify the first round shock. As the lira depreciates sharply with market participants in the short position in dollars, the hedging costs for FX indebted corporates also rise rapidly. Thus, the new NDF tool would help correct this self-fulfilling cycle.

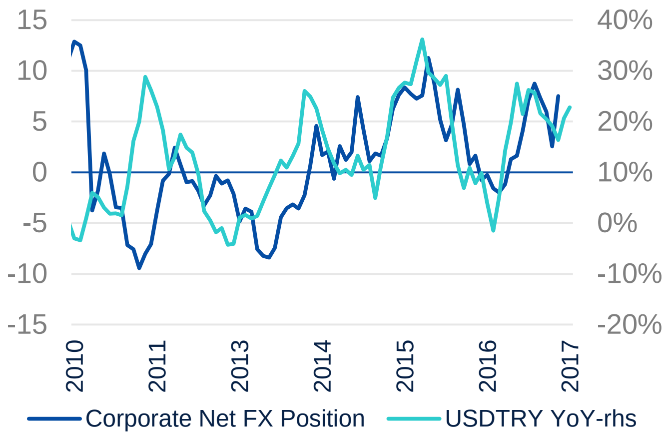
As domestic banks are not allowed to carry open FX position, after bidding for NDFs, they will eventually close their positions by taking opposite position in the market or reselling these agreements to their corporate customers. By enhancing players within the market in both directions and strengthening the forward market deepness, the CBRT will break the chain of rising hedging costs during stressed market conditions, making it affordable and preferable for firms with FX debt problems.

Figure 3 Corporates' Overall FX Position (USD Bn)



Source: CBRT, Garanti Research

Figure 4 Corporates' Net Short Term FX Position (%, USD)



Source: Bloomberg, CBRT, Garanti Research

In sum: a positive measure to enhance liquidity during stress times

In Turkey, corporates tend to buy dollars as a natural hedging instrument when the lira carries depreciation pressures and increases the potential of selffulfilling movements (these sharp movements in currency create a vicious cycle that brings further inflationary pressure through sizable exchange rate pass-through and affects expectations by altering pricing behavior). In this respect, the new tool may serve to increase the depth and liquidity of the currency market and help the economy management cope with corporates' currency risk effectively without excessively relying on international reserves.

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