IceCap
Asset Management Ltd.

TURKEY

Why we are bearish on Turkey and the Lira

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August 26, 2020

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Disclaimer

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Introduction

IceCap Asset Management Ltd. believes there is a high probability of Turkey experiencing a severe crisis within its currency, equity, and fixed income markets. Most global investors are unaware of this developing crisis, and those who are aware of this crisis may not appreciate the knock-on effects that could develop. The emerging crisis in Turkey is important for all investors as it has the potential to spread to other currencies, equities, and bond markets.

During the past few months, we have been expecting the Turkish economy and the Lira to experience significant stress due to the following:

1. Economic issues including severe current account deficits and negative real interest rates
2. Supply/demand mismatch with USD
3. Weak banking system
4. Unorthodox monetary policies
5. Geopolitics, and the unlikelihood of receiving a significant swap line from a major central bank

Turkey experienced a severe economic and currency crisis in 2018 that still has lingering effects today. The current coronavirus pandemic has caused Turkish exports to grind to a halt and tourism to all but disappear, yet Turkey still must import the vast majority of its energy resources causing deep current account deficits. Turkey has been experiencing high inflation for years now, currently at around 12%. President Erdoğan has demonstrated his reluctance to raise interest rates, holding them at around 8.25%, causing negative real rates of approximately -3.75%. This discourages foreign capital from entering the country. All these factors paint a dire economic picture for Turkey's economy.

Turkey needs USD to participate in trade and repay its substantial borrowings that are soon coming due. At the same time, it needs to sell USD in order defend the Lira. Our concerns regarding the Turkish economy and the Lira is driven by the fact that Turkey is rapidly burning through its foreign exchange reserves and is likely to run out of USD soon. It is far from certain, and perhaps even unlikely, that the United States will provide Turkey with a swap line, and even if they do this will not solve the underlying problems and will only delay the inevitable.

The Turkish banking sector has also been weakening. There is evidence that the Turkish Central Bank has been using the commercial banks as a source of foreign currency for defending the Lira. This withdraws liquidity from the system. There is also the potential for capital flight as the economic situation worsens. Meanwhile, the banks have still not fully recovered from the 2018 crisis and are holding a large amount of non-performing loans as a result. Turkey is already under significant economic stress, and the last thing that they need is a systemic banking crisis.

President Erdoğan has taken control of most facets of the Turkish government, including the central bank. He has appointed his son-in-law, Berat Albayrak, as Minister of Finance and Treasury. Both men have been criticized for their unorthodox economic views, including an intense reluctance to raise interest rates, instead preferring to pursue economic expansion and loose monetary policy at all costs. These policies are likely to exacerbate the coming crisis.

Turkey sits on a major geopolitical fault line. It is heavily involved in proxy wars in Syria and Libya, has frequent border and energy claims disputes with neighbours in the Eastern Mediterranean, and will likely have competing energy claims disputes with its neighbours in the Black Sea in the near future. Turkish geopolitics are incredibly complex, and Turkey often finds itself on the same side as one of its allies in one proxy war, but on an opposing side in another. While geopolitics is not a direct cause of the looming crisis, it does have the potential to be a trigger. Geopolitics will also have to be considered when evaluating potential solutions to the looming crisis, including swap lines and bailouts which are, of course, political in nature. Turkey's current geopolitical footing makes the risk of a geopolitical dispute triggering a crisis quite high, while also reducing the probability of Turkey receiving financial assistance from a foreign power.

Many investors are beginning to become aware of the expected crisis in Turkey, but few understand its root causes and what the crisis may mean for their portfolio. We have seen some articles state that Turkey is a one-off case and should be treated differently than other emerging markets. However, we know that emerging market crises tend to cause contagion and have the potential to spread to other emerging markets. We also know that European commercial banks remain overly exposed to the Turkish economy and are therefore vulnerable to the expected crisis. We saw a crisis with some similarities to Turkey play out in Lebanon recently, meaning that Turkey is not the first emerging market economy to experience significant stress under the current conditions, and it is unlikely to be the last. It is important that investors understand their exposure to Turkey and manage their risk accordingly.

This paper seeks to explain the causes and potential outcomes of the looming crisis in Turkey, and IceCap's views on how we expect the crisis to unfold. We also seek to inform readers and investors of the possible knock-on effects that a Turkish crisis will cause.

Overview of Turkey

Turkey is positioned on the border of Europe and Asia. This has always made it a place of geopolitical significance, and a major trade route. Turkey has a population of approximately 84 million and boasts one of the world's great cities, Istanbul. Its capital is Ankara.

Figure 1. *Map showing Turkey's location on the border of Europe and Asia. Also, it is right between the strategically important Black Sea and Eastern Mediterranean.*[1]

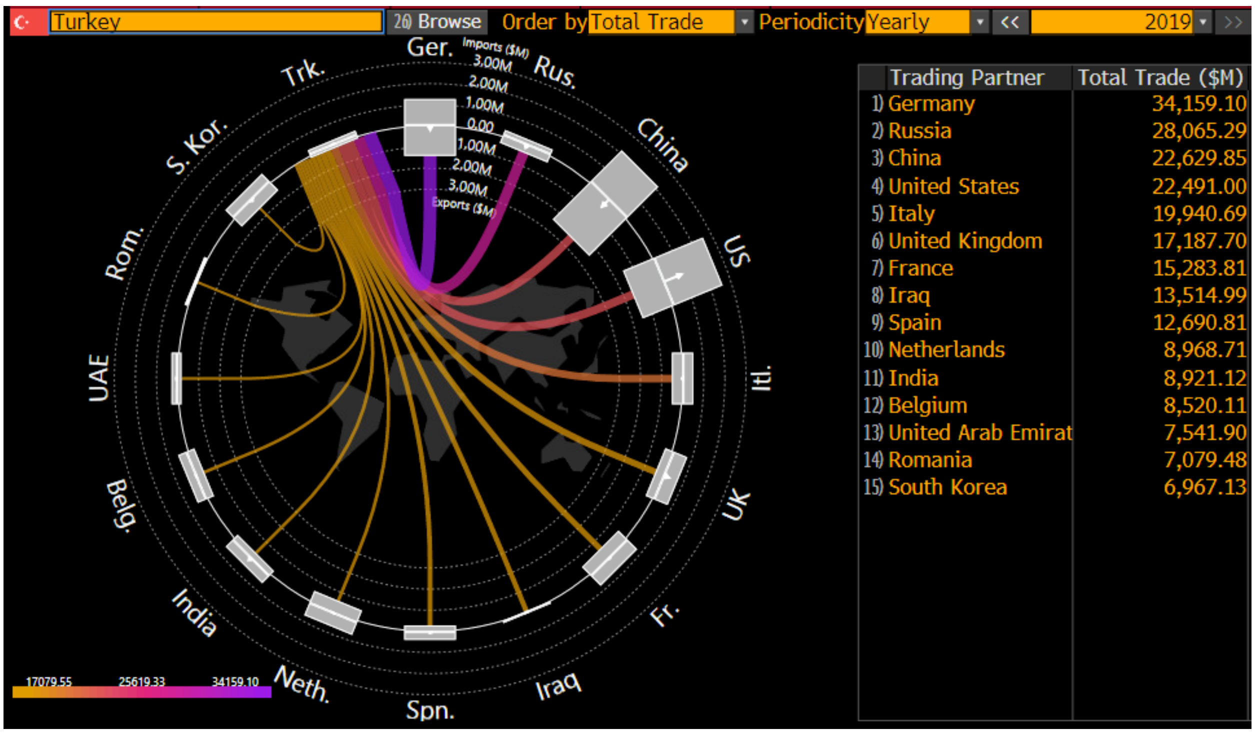
Since the end of the Ottoman Empire, Turkey has been a secular, unitary parliamentary republic. This has shifted under President Erdoğan who brought the country into a presidential system in 2018. He has also enacted more Islamist policies, recently turning the Hagia Sophia into a mosque. The former museum/church was built in 537 AD and has great significance to Christians.

Erdoğan's Justice and Development Party (AKP) has recently been losing support in major cities such as Istanbul, Ankara, and Izmir, but remains popular in more rural areas. Erdoğan has been consolidating power in Turkey since he took power in 2002, although he accelerated his authoritarian leanings after the alleged coup attempt in 2016. Erdoğan and the AKP party blame Pennsylvania based cleric Fethullah Gülen for the coup attempt.

[1] Source: Quora

Turkey is considered to be an emerging market economy. It has the second largest military in NATO and is a member of the United Nations, Organization for Economic Cooperation and Development, G20, International Monetary Fund (IMF) and World Bank. Turkey has been trying to gain European Union (EU) membership for over a decade now, although it is in a customs union with the EU. Its largest economic sectors are agriculture and textiles, although more foreign businesses are setting up manufacturing in Turkey to take advantage of a weak Lira. Tourism has been growing in Turkey over the past couple of years, but the coronavirus pandemic has devastated tourism in 2020. Turkey does produce some oil and natural gas but is far from self-sufficient. This has caused them to run large and frequent current account deficits.

After experiencing a period of extended growth after the 2008 Great Financial Crisis (GFC), Turkey had a currency and debt crisis in 2018, the effects of which are still being felt. During the period of economic growth Turkish companies borrowed heavily in foreign currencies, much of which is coming due in 2020 and 2021. Inflation is around 12% in 2020 and the economy is expected to contract by 4.3% in 2020.[2] Turkey's largest trading partner is Germany and its complete trade flows are as follows:



Trading Partner	Total Trade ($M)
1) Germany	34,159.10
2) Russia	28,065.29
3) China	22,629.85
4) United States	22,491.00
5) Italy	19,940.69
6) United Kingdom	17,187.70
7) France	15,283.81
8) Iraq	13,514.99
9) Spain	12,690.81
10) Netherlands	8,968.71
11) India	8,921.12
12) Belgium	8,520.11
13) United Arab Emirat	7,541.90
14) Romania	7,079.48
15) South Korea	6,967.13

***Figure 2**. Turkey's Trading Partners. Germany benefits from an EU Customs Union with Turkey. Russia is significant as an oil and gas supplier.*[3]

[2] Source: Trading Economics
[3] Source: Bloomberg

The Turkish Economy

The Turkish economy has been under significant stress for a couple of months now. Most notably, it has high inflation, negative real interest rates, and severe current account deficits. Some of these problems are structural in nature while others have been brought on by the coronavirus pandemic. Regardless of the cause, the Turkish economy is in real trouble and this will have major implications for currency, debt, and equity markets, in Turkey and abroad.

Current Account Deficits

A nation's current account can be thought of as a country's income statement. A positive current account means the value of a country's revenues from exports are greater than the value of the country's expenses from its imports. A negative current account means the country is spending more money than is coming in.

Turkey, like many emerging market economies, is an export driven economy. Foreign companies, mainly from the European Union, which is in a customs union with Turkey, have been investing in manufacturing in Turkey since the 2008 Global Financial Crisis (GFC). This was done to take advantage of a credit boom, loose monetary and fiscal policy, and a weak Lira. Turkey is also a major exporter of agricultural products and textiles. Another crucial sector to the Turkish economy is tourism which has also benefited from a weak Lira over the past few years. When economic times are good, trade is flowing, and people are taking vacations to Turkey. Currently economic times are not good. The coronavirus crisis has caused a steep reduction in global Gross Domestic Product (GDP) and trade has declined dramatically. Furthermore, travel restrictions due to the virus have almost eliminated tourism dollars flowing into the Turkish economy. Therefore, there is less money flowing into Turkey's current account.

When a country imports goods from other countries, this represents an outflow from the current account. Turkey does not have a major domestic source of energy, meaning that it must import nearly all its energy needs from other countries. Turkey imports 85% of its oil and gas in its energy mix.[4] In 2019, energy imports totaled $41.48 Billion making up approximately 20% of total imports.[5] It is also worth noting that commodity prices are settled in USD, so a strengthening USD will only exacerbate this issue. While the inflows from tourism and trade that help to reduce the current account deficit have been largely eliminated by the economic fallout from the coronavirus, the demand for energy imports that increase the current deficit has mostly remained.

On August 19, 2020, Turkish officials announced that they would deliver some good news to Turks. On August 21, 2020, Turkey announced that it has found large natural gas reserves in the Black Sea. Because a key consideration of this paper is the energy driven current account deficit, the paper would be incomplete without dealing with this announcement. Considering the combined financial and economic stress, we find it difficult to accept this as fact. Turkey and the Lira are on the verge of collapse and this announcement seems to be a little too convenient. The market seems to agree, showing a quick appreciation of the Lira upon the pre-announcement followed shortly by a reversion back to a soft peg at 7.3, in a "buy the rumour sell the news" pattern. Then upon the official announcement with the discovery details, note how the Lira again sold off on the news.

[4] Source: Insight Turkey
[5] Source: Insight Turkey

Figure 3. Turkish Lira price chart on August 19th, the date that Turkey announced it would be delivering "good news" to the Turkish people. It was widely speculated that natural gas was discovered in the Black Sea. The Lira quickly appreciated, and then quickly reverted. Note that this chart is inverted, meaning that when the white line goes down the value of the Lira goes up, and vice versa.

While IceCap believes that the natural gas discovery is at best overstated, there are a couple of reasons as to why this will have little impact on the looming crisis in Turkey:

1. It will take years to develop a project of this size and complexity. The Black Sea gas will not have an impact on the current account in time to stave off a crisis. In fact, it will be many years too late.

2. Like the Eastern Mediterranean, there will be numerous claims on the gas, including from Romania and Bulgaria.

3. It is highly unlikely that Russia will allow Turkey to simply begin producing. Russia enjoys being the major supplier of natural gas to Europe. Controlling Europe's gas supply is a powerful geopolitical weapon to be used against the West, one which the Russians have used in the past. Allowing Turkey access to Black Sea energy reserves that will be transported to Europe via the already in operation Nabucco Pipeline would diminish Russia's most powerful leverage over the West.

4. It is unlikely that the amount of natural gas that is discovered is the 800 billion cubic meters (BCM) that was announced.[6] Romania's Neptun Oil field, which is near the Turkish natural gas find, has only approximately 100 BCM. The numbers make the announcement difficult to believe.

[6] Source: Reuters

Because of the above-mentioned points, we believe Turkey will continue to have to import the majority of its energy consumption needs. With the coronavirus being a concern for the foreseeable future, it is unlikely that tourism will return any time soon. The world is still grappling with the economic fallout from the coronavirus, so trade is unlikely to recover as well. As such, we expect Turkey will continue to run current account deficits for the foreseeable future which will result in deficits in their net foreign exchange accounts. Turkey's current account is illustrated in the graph below:

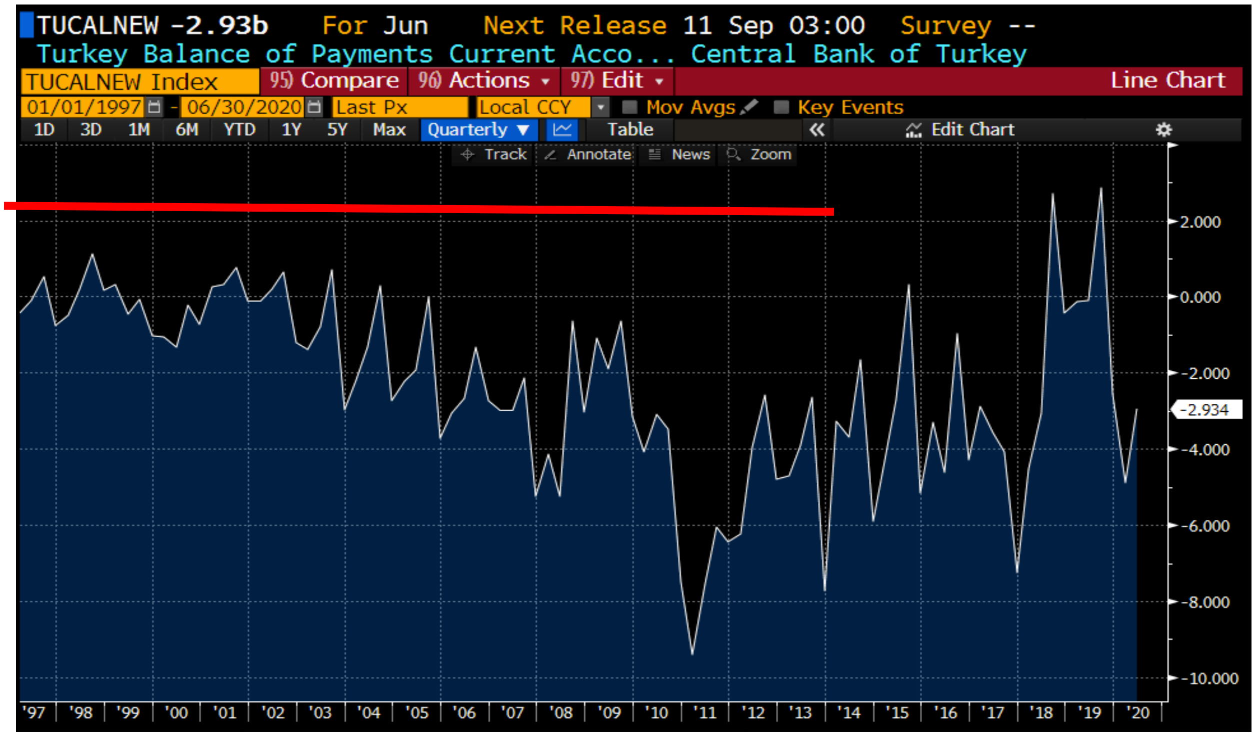


Figure 4. Turkey's Current Account. Everything below the red line is in deficit.[7]

Negative Real Rates

Most people around the world live in a country where interest rates are greater than the rate of inflation. For example, if interest rates are 3% and inflation is 2%, then investors are earning a "real" interest rate of 3% minus 2% = 1%. This means the rate of interest earned on savings is greater than the rate of inflation or increase in the cost of living. This is normal and expected by most investors around the world.

Turkey has created an interest rate environment where the stated rate of interest is less than the rate of inflation. Currently, interest rates are 8.25% while inflation is approximately 12%.[8] This causes negative real rates of -3.75% and creates a difficult environment for everyone. Because inflation erodes capital, it means investors who lend in the Turkish market are actually doing so at a loss in real terms because the return on their loans (the nominal rate) is less than their loss in purchasing power (inflation). Due to high inflation and the Turkish government's reluctance to raise nominal rates, this interest rate environment of negative real rates is currently the case in Turkey.

The other consideration for negative real rates is that it punishes savers. Instead of the typical saver getting a little more ahead every day, negative rates mean the saver falls behind every day. Economic theory believes this lack of reward for saving will encourage savers to save less and spend more which is exactly what Turkey needs. However,

[7] Source: Bloomberg
[8] Source: Bloomberg

real life is different than theory. In fact, negative rates encourage savers to save even more than before as they try to outpace the negative rates to accumulate sufficient funds for a safety net.

The corporate sector also dislikes negative rates. While the belief is that negative rates may encourage the sector to borrow more, companies are already heavily burdened with debt. Also, these companies typically need to borrow in foreign currencies as foreign investors are reluctant to lend in Lira. In addition, considering that the global economic recovery remains weak, the near-term justification for foreigners investing in Turkey is also weak. This situation discourages foreign investors from investing in Turkey.

Similar to how the current account can be viewed as a country's income statement, the capital account can be viewed as a country's balance sheet. You might remember from your Econ 101 courses in university that in order to reach a state of equilibrium, a country's current account inflows/outflows must net out to $0 against the capital account's inflows/outflows. And herein lies the problem. Turkey is running current account deficits but is unable to attract foreign investment due to negative real rates. In other words, there is no demand for Turkey's currency coming from trade and tourism, and no demand for the currency to invest in the capital account. In order to reach equilibrium and match supply and demand, something needs to adjust. Because we know that President Erdoğan is unlikely to raise interest rates, the release valve for this imbalance has be the value of the Lira. This situation will continue to cause the Lira to decline in value dramatically. See the chart for negative interest rates below:

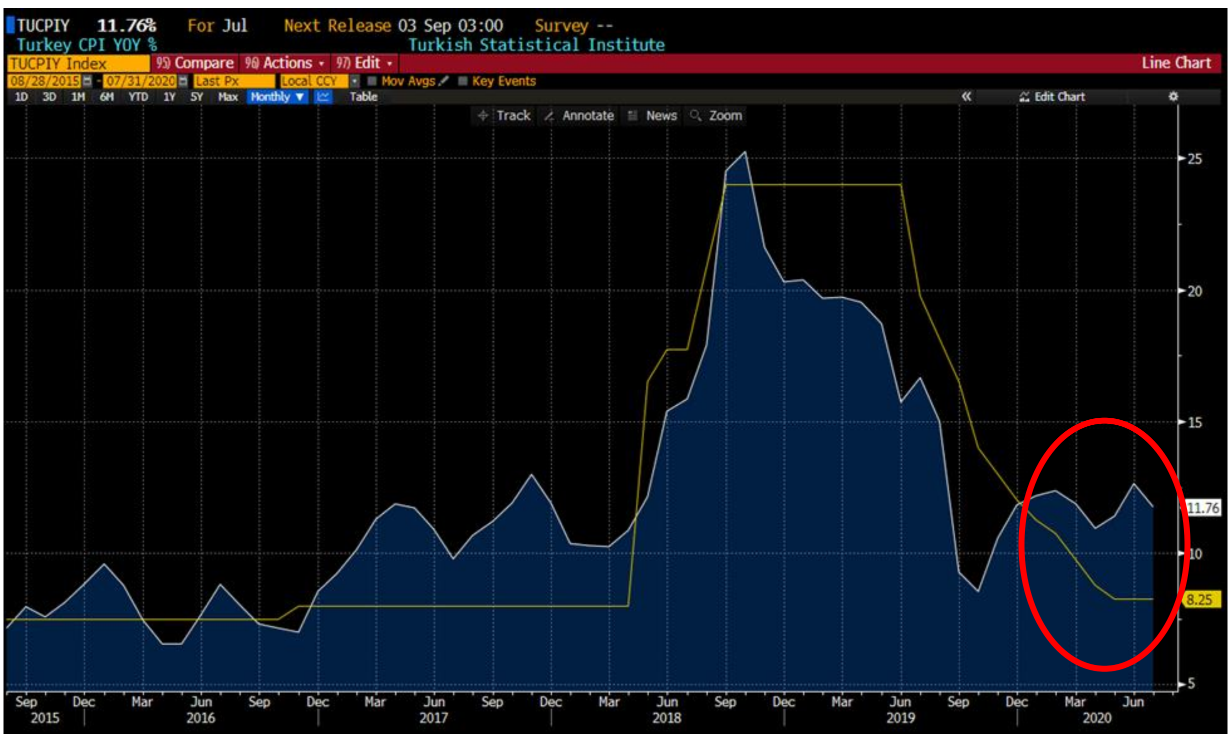


Figure 5. Chart showing inflation (white line) overlaid with nominal interest rates (yellow line). When the yellow line is below the white line there are negative real rates.[9]

USD Supply Demand Mismatch

The global economy runs on the world's reserve currency, the United States Dollar (USD). It is the most important currency in the world. Capital is raised in USD, lent in USD, and trade is conducted in USD. For emerging market economies, the USD is extremely important. A foreign investor is typically unwilling to invest in the emerging market's

[9] Source: Bloomberg

local currency largely due to that currency's volatility, and the risk of capital controls. This encourages emerging market governments and companies to borrow in a more established currency.

Turkish Demand for USD

Turkish companies are no different and have borrowed extensively in USD. Turkey, being an export-oriented economy, needs access to USD to settle trade. This includes selling textiles and buying oil. As such, access to USD is crucial. However, there is another factor which makes USD of particular importance to Turkey, and that is that they need access to USD to defend the Lira. When the Turkish Lira declines in value, the Turkish Central Bank will typically step in to support it. We have seen this over the past couple of months where the Central Bank has attempted to hold the Lira at a certain value otherwise known as a "soft peg". The Central Bank does this by selling its foreign currency reserve, mostly USD, and buying Lira. When the Central bank buys Lira it bids up its value and thereby increases the price. Therefore, if Turkey continues to try to defend the Lira, it will need USD to sell.

Turkish Supply of USD

In order to trade, pay off USD denominated debt, and defend the Lira, the Turkish Central Bank needs to have USD on hand. There are several ways Turkey can access USD:

1. Via Trade – When a country sells goods in USD, then USD flows into the country. Economic decline brought on by numerous factors including the coronavirus has caused Turkey to run current account deficits, meaning USD is actually leaving the country through trade. Tourists are not spending money in Turkey, but oil is still being bought.
2. Investment – With negative real rates and the possibility of capital controls, it is not attractive for foreign investors to send USD to Turkey through their capital account.
3. Foreign Currency Reserves – This will be spoken about later in the paper. While Turkey did have substantial foreign currency reserves, the amount is finite. They can only spend it for so long.
4. Swap lines – Also to be discussed later in the paper. Currently Turkey does not have a swap line with the United States and there is no guarantee that they will receive one in the future.

None of these potential sources of USD are reliable sources, or even viable. At the rate Turkey is spending its foreign currency reserves, it is likely to run out of USD shortly. See Turkish foreign currency reserves below:

Figure 6. Shows the decline in Turkey's foreign currency reserves. In the 2018 crisis there was an over 30% decline. Year to date there has been an over 40% decline.[10]

The Case for a Strong USD

Santiago Capital's Brent Johnson, and IceCap's Keith Dicker, have covered the rationale for a strong USD in depth. Brent's brilliant Dollar Milkshake Theory is well known by many who run in Global Macro circles, and Keith Dicker has been speaking about USD strength quite extensively in the more recent editions of the IceCap Global Outlook. We encourage everyone to read their research and watch their presentations to understand the reasons why we believe that the USD is poised to break out.

To summarize the strong dollar thesis, the USD, as the global reserve currency, enjoys many advantages that other currencies do not. Most of the world's trade occurs in USD and there has been an explosion in USD borrowing throughout emerging and developed economies. As trade declines and the velocity of money remains at an all time low, this will create a supply and demand imbalance for USD, making it poised to rapidly appreciate. As economic conditions worsen, the world's central banks will look to utilize quantitative easing as a remedy, the liquidity from which will in turn flow into the United States as it is a safe haven for capital and it controls the world's reserve currency.

Many investors will rightly point out the recent bout of Dollar weakness. The DXY Dollar index is currently hovering around 93 and is down against most currencies except, notably, the Lira. Yet, despite this weakness, the Lira and Turkey are still showing signs of significant stress. Put another way, if the Turkish Lira is in crisis during a period of USD weakness, what happens when this current period of USD weakness reverses? This is notable because a strong Dollar would be disastrous for Turkey. As demonstrated in our last paper, *The Possibility of a Revalued USD,* a strong USD is bad for trade in general and is particularly bad for emerging markets that have extensively taken on USD denominated debt. This reduction in trade will cause Turkey's current account deficit to widen thereby exacerbating the Lira's

[10] Source: Bloomberg

devaluation. It is extremely bad for countries that have borrowed in foreign currencies. As the Lira depreciates, interest payments will increase in Lira terms, sparking a liquidity and solvency crisis.

The USD has been weakening for five months now, and we do not expect this to continue for much longer. USD negative sentiment has reached extreme levels, and as investors take profits and cover their USD shorts, we believe that there will be a rapid appreciation in the Dollar. Figure 7 demonstrates that the amount of bullishness for the Euro has reached record highs. This is viewed as a contrarian indicator, and historically the Euro will weaken significantly after such a period. This suggests that we could see the USD strengthen significantly in the upcoming risk-off environment and see a sharp increase in the DXY Index.

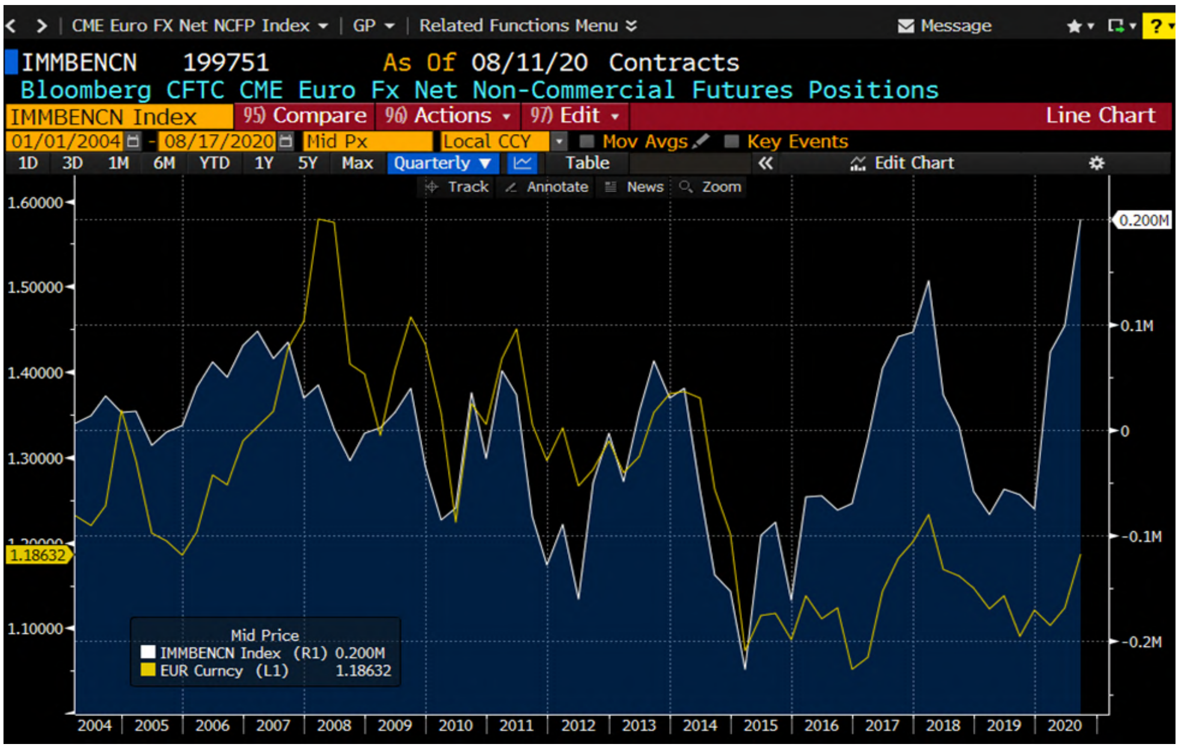


Figure 7. Chart showing Commitment of Traders publication of non-commercial futures positions in the Euro. This chart indicates that positioning is at an all time high. The yellow line on the chart shows the spot price for Euro which historically declines dramatically after periods of high positioning.[11]

A stronger Dollar will make matters much worse for Turkey as servicing its debt will become more expensive, access to USD will become scarcer, and trade will further decline.

In summation, Turkey needs USD in order to settle trade, pay debt, and defend the Lira. It does not have easy access to USD as it is running a current account deficit, it is quickly spending its foreign currency reserves, and it does not have a swap line with the United States. This is with the Dollar Index hovering around 93. If the USD strengthens, this problem will become much worse for Turkey.

Weak Banking Sector

The banking system is a vital component of any economy. Operating a bank in a financially strained economy due to the coronavirus is tough enough as it is. Operating a bank in a strained economy that is controlled by an authoritarian leader with unorthodox economic and monetary views is even tougher.

[11] Source: Bloomberg

The Turkish Central Bank is using Turkish Commercial Banks as Source of FX

Ever since the 2018 Turkish Lira crisis, Erdoğan and his close family have exerted significant control over the Turkish Central Bank. This includes changing the capital requirements for banks. When the central bank increases the reserve requirements for commercial banks, it takes capital out of the banking system. The central bank is then able to draw upon those reserves as a source of funds for itself. To defend the Lira and prevent further depreciation, the central bank is selling these US Dollars and buying Lira. The Turkish Central Bank recently did this in July by increasing the foreign reserve requirements that commercial banks need to hold with the Central Bank by 3%.[12] This provided the Central Bank with close to $9 Billion. This has been a major source of Turkey's foreign currency reserves required to defend the Lira and demonstrates that the Central Bank's foreign exchange reserves have been depleted. An adverse effect of this approach is that it weakens the commercial banks while withdrawing liquidity from the economy.

Capital Controls

President Erdoğan has begun to impose minor capital controls on the Turkish market. Notably, in early August, Turkey increased its offshore borrowing rate for Lira to 1,000+% in a bid to stop foreign investors from shorting the Lira. Additional restrictions put in place included banning local banks from lending 0.5% of their equity to offshore counterparties.[13]

Figure 8. Bloomberg chart showing interest rate spike to over 1000% in the overnight borrowing market. This action was taken to discourage foreign investors from shorting the Lira.[14]

[12] Source: Bloomberg News
[13] Source: Bloomberg News
[14] Source: Bloomberg

We have demonstrated Turkey's need for foreign exchange reserves. Because of this need, Turkey is unlikely to allow foreign currency to leave the country for much longer. There are already token penalties for USD withdrawals, and we expect these to become much more significant as the crisis develops.

If there is even the hint of significant capital controls being put into effect, we will see capital flight. Turkey has numerous wealthy, sophisticated businesspeople, as is demonstrated by the fact that Istanbul is the city with the 5th most Billionaires in the world.[15] If these people are worried about their money, they will not hesitate to extract it and are likely already doing so. The general population will be looking to do the same, buying up foreign currency wherever they can find it and even converting their Lira into gold and other physical assets. The Turkish banks will be unlikely to cope with these withdrawals, especially since they are feeling the strain from the central bank using them as a source of foreign currencies to defend the Lira.

Capital Flight

As the crisis worsens, wealthy Turks are likely to try to get their money out of the country. This will play out in a similar way to what happened in 2018. There is no shortage of wealthy Turks who are very much attuned to risks in the Turkish economy and the Lira, and the vast majority have 2018 fresh in their minds.

In the section above I have written about how Turkey has already imposed some moderate capital controls. As the crisis develops, these controls are likely to escalate as the Turkish government tries to keep a lid on the crisis. When investors begin to worry about the value of their money and their ability to move it to foreign markets, they are likely to rapidly withdraw money from their commercial banks and try to move it overseas. Turkey's current Bitcoin bull market is an indication of this, as Bitcoin allows Turkish citizens to sidestep capital controls and shelter their investments from the depreciating Lira. When this happens, capital and liquidity is withdrawn from the banks therefore further weakening them. Remember, the bank runs of today are vastly different than the ones of old. Instead of large lineups of people at the bank trying to get their money out, Turkish citizens are much more likely to simply use their smart phones. This makes the process happen much quicker which does not bode well for the Turkish banks.

Non-Performing Loans

Turkey's commercial banks' non-performing loans (NPL) in June 2020 were stated to be 4.4%.[16] By comparison, the United States' was 1.5%. Despite this, the Turkish NPLs appear to be quite low especially when considering the recency of the 2018 crisis which was primarily a debt crisis. The true NPL number is likely much higher.

We are also likely to see this number deteriorate due to the coronavirus and the global slowdown in trade and GDP. Businesses and individuals have a tendency to stop paying their debt obligations to commercial banks when the economy deteriorates. While data on the Turkish commercial bank's health is difficult to find, we believe that the health of commercial banks is much worse than what is being portrayed and will continue to deteriorate as the current economic climate continues to bite.

The lifecycle of bad loans in the banking world progresses from delinquent, to non-performing, to a charge-off. When a loan reaches the charge-off stage it acts as an immediate loss against the bank's assets and, if there are enough charge-offs, it will result in the bank having to raise new equity to remain in business. Since this is a serious event, and the timing and recognition of the event is subjective, it is common for weak banks (or in some cases weak banking systems) to have so many bad loans that the charge-off stage is delayed into perpetuity. When this happens, the banks stay alive but, in actual fact, they become zombie banks, unable to fully live and breathe in a normal functioning economy.

[15] Source: Business Insider
[16] Source: CEI Data

We believe the Turkish banking system is on the verge of having many banks experience significant amounts of bad loans that cannot be written or charged off due to the industry's inability to attract foreign capital as new investment to replace these losses.

If the loans are not written off, then it portrays a picture of bank health that is not realistic as the loans do not actually have value or produce income. While loans are not representative of their fair value, the deposits on the liability side of the bank's balance sheet are, meaning that there is less equity capital holding up the banks than we originally thought. Less equity in the banks makes them more liable to collapse.

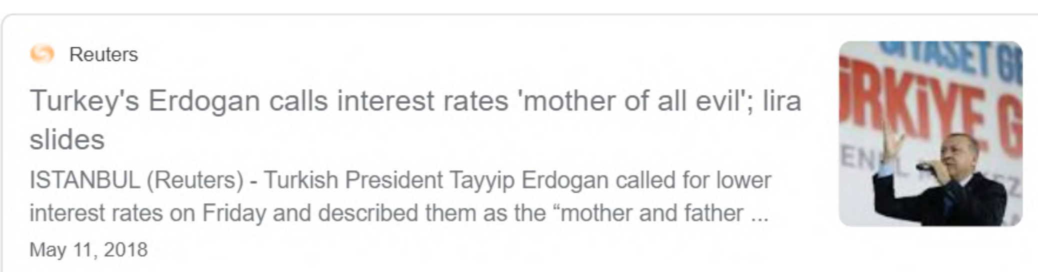
If the banking system in Turkey experiences severe stress due to Central Bank actions, capital controls, capital flight, and bad loans, then this stress will reverberate across the entire Turkish economy exacerbating the crisis. If this happens, it will essentially mean that there are holes in the banks' capital structures and the banks will therefore require capital to fill these holes. Four potential sources of capital are as follows:

1. The Turkish government/central bank - This is unlikely as the Turkish government has funding issues of its own to deal with.
2. Foreign investors – Also unlikely due to the risk of capital controls, a weak Turkish economy, and negative real interest rates.
3. The IMF – This is unlikely for reasons to be discussed later in the paper. (Spoiler alert: Erdoğan has called the IMF the "world's biggest loan shark.")
4. A Bail in – The more likely scenario involves a bail-in whereby depositors lose a portion of their money which is then contributed to the bank's capital. This will have major economic, political, and social implications beyond the scope of this paper. See Cyprus 2013 for comparison.

Unorthodox Monetary Policy

President Erdoğan has increasingly centralized his power in Turkey since the early 2000s. This includes meddling with central bank policies and even appointing his son-in-law as the Minister of Finance and the Treasury. Both men have implemented policies which have largely been rejected by economists. This does not give much confidence that they will be able to navigate the turmoil ahead.

To improve its current account deficit, Turkey needs both its domestic economy and international trade to recover substantially from the current coronavirus crisis. In addition, to roll over maturing USD denominated debt and to finance a deteriorating current account deficit, Turkey needs access to foreign capital markets but has negative rates in its own domestic market. At the same time, to defend the Lira from further declines, Turkey will need to sell USD. One option for Turkey to consider is to raise interest rates substantially. This would attract limited foreign capital while also encouraging domestic capital to remain in the country. Yet, President Erdoğan has shown a strong reluctance to raising rates. This contradictory position makes a crisis inevitable.


Reuters

Turkey's Erdogan calls interest rates 'mother of all evil'; lira slides

ISTANBUL (Reuters) - Turkish President Tayyip Erdogan called for lower interest rates on Friday and described them as the "mother and father ...

May 11, 2018

Figure 9. *Headline demonstrating Erdoğan's dislike of high interest rates.*[17]

[17] Source: Reuters

We also have the opportunity to evaluate President Erdoğan with regards to his leadership during the crisis in 2018. At the beginning of 2018, the Turkish economy was the envy of emerging markets. GDP growth was high, the Lira was strong, and interest rates were low. This encouraged Turkish companies to borrow to expand, often electing to borrow in Euro and USD. As the Lira weakened, these loans became more and more difficult to pay back in Lira terms thus sparking a liquidity and solvency crisis. Erdoğan's reluctance to raise rates did not help to resolve the issue. This led to increasing inflation and eventually to stagflation.

Figure 10. *Chart showing decline in Lira value. -25% in 2016, and -43% in 2018.*[18]

The crisis was finally diffused after Turkey received a $5 Billion USD swap line from Qatar and, much to the chagrin of Erdoğan, interest rates were increased to 24% in late September, as demonstrated in the chart below. The Turkish Lira has still never regained its previous strength that was seen in 2017.

[18] Source: Bloomberg

Figure 11. Chart showing historical Turkish interest rates. Rates were aggressively hiked in 2018 to help remedy the 2018 crisis. Rates are currently at 8.25%.[19]

While 2018 is a good case to evaluate Turkish monetary policy, there are a couple of factors that make this time different. Firstly, the effects of the coronavirus have had a major impact in international trade, and have hit one of Turkey's key sectors, tourism, particularly hard. This will further exacerbate the current account deficit issue. Secondly, the swap line from Qatar was a massive help to Turkey in solving its currency crisis. For reasons demonstrated later in this paper, including geopolitical factors impacting Qatar and the low price of oil and gas, Qatar alone will not be able to fix Turkey's issues, and Turkey is not likely to get much help from elsewhere. The other factor that helped to protect the Lira and the economy in 2018 was the interest rate hike to 24%. This happened against Erdoğan's wishes. Since then he has further consolidated his power over the central bank, thus making a rate hike only less likely. Also, if the Turkish Central Bank elects to raise rates it will cause the Turkish stock market to sharply decline. Additionally, relations between western countries and Turkey have further deteriorated since 2018. All these factors make the current economic climate more difficult for Turkish authorities to navigate.

[19] Source: Bloomberg

Figure 12. Chart showing the relationship between the Lira and the Turkish overnight interest rates. This shows how the 2018 rate hike helped to defend the Lira.[20]

Geopolitical Factors

As noted above, Turkey's position spanning Europe and Asia has always made it a place of geopolitical significance. Its position on the border of Syria has made it even more significant due to the ongoing civil war, and its tendency to engage in proxy wars make geopolitics a major factor in any analysis regarding Turkey. The current geopolitical environment surrounding Turkey is incredibly complex with numerous players, alliances and interests all competing. One needs to be an expert to even begin to understand all the complexities of Turkish foreign policy, let only make predictions as what the future holds. An example with which to demonstrate this complexity is that Turkey is allied with the United States in Libya, both supporting the Government of National Accord based in Tripoli. In Syria however, the United States has shown support for Kurdish fighters in Syria, while Turkey views them as terrorists and has launched offensives against them. Geopolitics, while not being the cause of the crisis, may be a trigger point and as the crisis in Turkey develops, it is unavoidable that Turkey will need help from foreigners. Thus, geopolitics is a major consideration when understanding potential solutions and outcomes for the coming crisis.

One possible remedy for Turkey's economic challenges that will help but likely not solve its economic concerns, would be for foreign countries to provide swap lines. Because Turkey needs to sell USD and foreign exchange reserves to defend the Lira but hold USD to conduct trade and service debt, access to USD is crucial. However, swap lines are political in nature and only friendly countries have access. See figure 13 below:

Central Banks with Access to USD Swap Lines[21]	
Bank of Canada	Banco de México

[20] Source: Bloomberg
[21] Source: Federal Reserve

Bank of England	Reserve Bank of New Zealand
European Central Bank	Sveriges Riksbank (Sweden)
Bank of Japan	Dankmarks Nationalbank (Denmark)
Swiss National Bank	Norges Bank (Norway)
Banco Central Do Brasil	Monetary Authority of Singapore
Bank of Korea	Bank Indonesia
Reserve Bank of Australia	

Figure 13. Countries that the United States Federal Reserve has approved swap lines with. All are on friendly terms with the United States.

What the countries above all have in common is that they are all friendly US allies. You may have noted the absence of China, Russia, Iran, North Korea, etc. Turkey's current geopolitical footing does not encourage the Federal Reserve extending swap lines. The following is a summary of some of the key geopolitical issues regarding Turkey that should be considered when assessing potential outcomes for the upcoming crisis:

Oil

As was mentioned earlier in the paper, Turkey does not have its own domestic supply of oil and, as such, it must import the vast majority of its energy demand. While Turkey recently announced the discovery of natural gas in the Black sea, this is unlikely to solve Turkey's problems any time soon for reasons previously mentioned in this paper. See the chart below for a breakdown of where Turkey is currently getting its oil from:

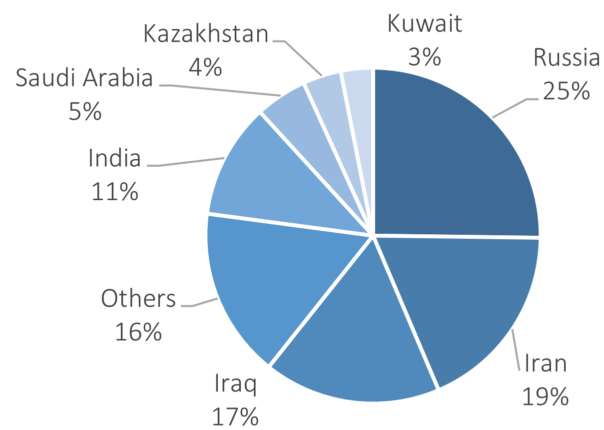


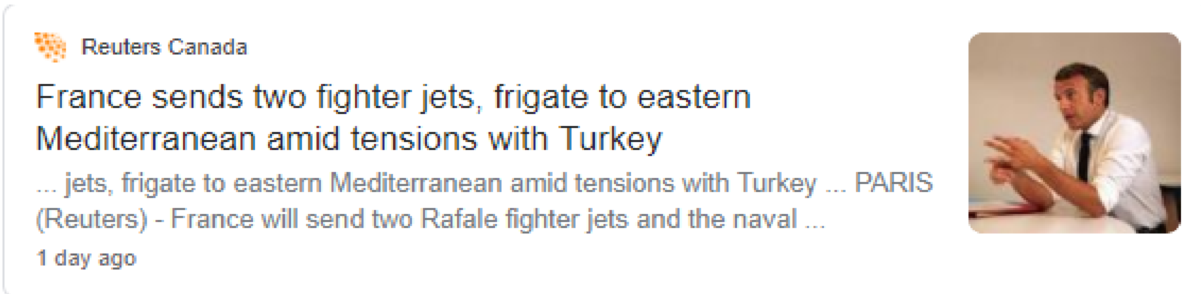
Figure 14. 2018 Turkish Energy Imports by Country. [22] *Russia is also responsible for approximately 50% of Turkey's gas imports.* [23]

Note that approximately 44% of energy sources are from Russia and Iran, countries that are not friendly to NATO and the United States. This pulls Turkey further away from the United States' sphere of influence. This demonstrates Turkey's reliance on foreign oil and gas and the lengths that it is willing to go to gain access to energy. A prime example of this desperation is Turkey circumventing U.S. sanctions against Iran by paying gold to Iran in exchange for natural gas, thereby avoiding the SWIFT payment system. This came to light in 2012-2013, and there are indications that it is still occurring. There are very few things that upset the Americans more than providing funding to Iran. Another way that geopolitics, particularly with regards to oil and gas, is playing out in Turkey is in the Mediterranean Sea. There are proven oil and gas reserves in the Mediterranean, but who has claims to them is up for debate. This mostly puts Turkey in conflict with Greece who also claims the reserves. Greece is also a member of NATO and although Turkey has the

[22] Source: Insight Turkey
[23] Source: Thompson Reuters

second largest military in NATO, Greece is much more firmly rooted in Europe and is much closer to other EU and Eurozone members of the alliance.

Another NATO "ally" that Turkey has rubbed the wrong way is France. Recently, on suspicion of transporting arms to Libya in exchange for oil, a Turkish vessel was stopped by the French Navy. The Turkish Navy promptly stepped in forcing the French to back down. This further demonstrates Turkey's need for energy, and the state of Turkish relations with NATO and Europe.



Reuters Canada

France sends two fighter jets, frigate to eastern Mediterranean amid tensions with Turkey

... jets, frigate to eastern Mediterranean amid tensions with Turkey ... PARIS (Reuters) - France will send two Rafale fighter jets and the naval ...

1 day ago

Figure 15. Headline showing France's more aggressive stance to keep Turkey in check in the Mediterranean Sea.

Syria

The 2015 EU migrant crisis is an important geopolitical factor to consider when understanding the relationship between the EU and Turkey. Collectively, the crisis splintered many EU countries and it was also a key factor affecting the 2016 BREXIT Referendum. Currently Turkey is hosting over 3.6 million refugees resulting from the Syrian civil war, many of whom desire to enter the EU.[24] To prevent a re-escalation of the 2015 migrant crisis, the EU is paying Turkey Billions of euros to ensure the migrants do not enter the EU. Whenever tensions rise between Turkey and the EU, Turkey demands additional funds or threatens to open the gates. This would put an enormous strain on European social welfare systems. This would leave southern European countries particularly hard hit as they are already reeling from the coronavirus crisis.

WORLD NEWS MARCH 6, 2020 / 9:20 AM / 5 MONTHS AGO

EU, Turkey in stand-off over funds to tackle new migrant crisis

Francesco Guarascio, Tuvan Gumrukcu

6 MIN READ

Figure 16. Headline Demonstrating Turkey-EU Tensions Regarding Syrian Refugees.

More directly, in 2019, Turkey invaded a 20-mile strip of northern Syria. The stated reason for this was to combat Kurdish forces in the region who Turkey considers to be terrorists. This move was taken after the withdrawal of US troops from Syria, a move for which President Trump received much backlash. Many viewed the Turkish intervention as a black eye for President Trump, which caused the U.S. to retaliate by imposing tariffs on key Turkish industries. None of this bodes well for Turkey receiving a swap line from the U.S.

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[24] Source: UNHCR

Figure 17. Map showing Turkish interests in Syrian. This is expressed either directly with its own military, or through proxies. The Kurds in green have a difficult relationship with Turkey.[25]

Greece

In addition to Turkish oil and gas exploration in the Eastern Mediterranean, there are numerous other flash points between Turkey and Greece. These range from concerns over EU membership to Cyprus and to border disputes. The Greek military is currently on high alert.

The most prevalent sticking point now is the oil and gas dispute that was mentioned earlier. In the previous section we demonstrated how badly Turkey needs access to energy, preferably its own supply. The eastern Mediterranean has proven oil and gas reserves not that far off Turkey's west coast. The only obstacle from Turkey's perspective is that just off that coast are islands controlled by Greece. The issue is clearly demonstrated when looking at the maps below:

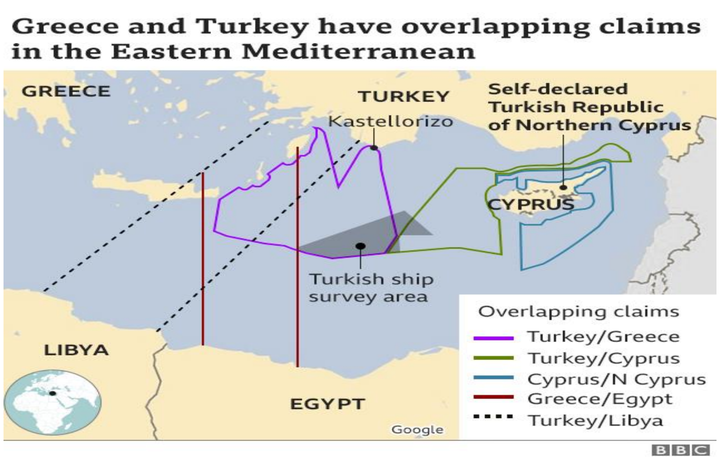


***Figure 18.** Overlapping claims in the Eastern Mediterranean. This has major implications for energy development and geopolitics.*[26]

[25] Source: The Economist
[26] Source: BBC

Figure 19. The Greek island of Kastelorizo is at the heart of Greek-Turkish conflict in the Eastern Mediterranean. This island lies just off the Turkish coast, and Turkey is beginning energy exploration activities in the area. [27]

The area where Turkey has sent vessels to explore for oil and gas lies directly off the Greek island of Kastelorizo which, in turn, lies less than two miles off the Turkish mainland. So, the essence of the issue is that Turkey needs its own domestic supply of energy, there are reserves just off the coast of Turkey, but Greek islands lying just off the Turkish mainland are preventing Turkey from claiming the oil and gas as its own. Countries' borders typically extend 12 miles out into the ocean from their shoreline. When looking at the map above, there is clearly an issue with this. Due to the mix of Greek and Turkish islands in the Aegean Sea, and the Greek islands' proximity to the Turkish mainland, the 12-mile rule does not apply thus creating a grey area. Greece will be very wary of granting Turkey exploration rights near its islands for fear of setting a precedent. Again, this is further complicated by the fact that Greece is an EU, Eurozone, Schengen, and NATO member.

Tensions have come to a head in recent weeks, as Greece and Egypt have signed an agreement regarding the exploration of oil and gas fields in the Eastern Mediterranean.[28] This prompted Turkey to send exploration vessels to search for oil and gas close to some Greek Islands. On August 12, 2020, a Greek and Turkish warship collided in the Mediterranean Sea, demonstrating how fraught tensions currently are.[29]

Greece and Turkey also share a land border, making Turkish threats to allow Syrian refugees to enter Europe particularly felt by Greece.

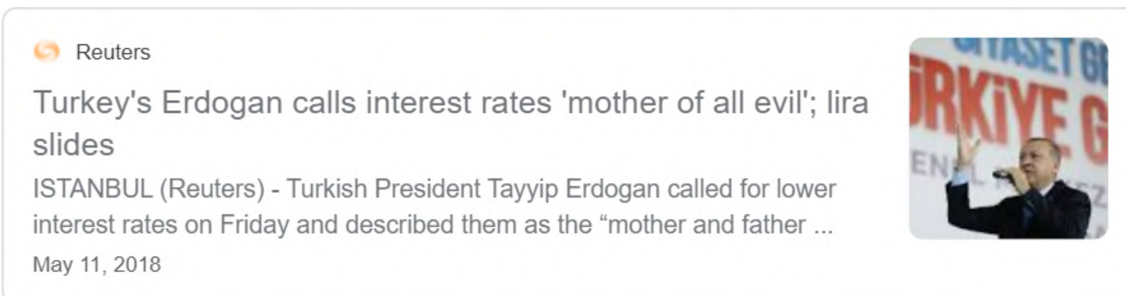
Cyprus

Speaking of predominantly Greek islands off the coast of Turkey, Cyprus has been a major sticking point between Greece and Turkey for over 50 years. Cyprus is currently split between EU member, the Republic of Cyprus in the South, and the Turkish Republic of Northern Cyprus in the North, which is only recognized and supported by Turkey. The Republic of Cyprus is its own independent state with its own government independent of Greece, while the North is entirely dependent upon Turkey, economically and for defence.

[27] Source: Global Security Review
[28] Source: Al Jazeera
[29] Source: Foreign Policy

Figure 20. Map of Cyprus, EU member, and predominantly Greek Cypriot Republic of Cyrus in Blue. The Turkish Republic of Northern Cyprus recognized only by Turkey. [30]

This puts them in conflict not only with Cyprus's Greek brethren, but also with the state itself. Cyprus is a member of the EU and the Eurozone and can be an obstacle to Turkey receiving aid from the European Central Bank (ECB). It will be difficult for Turkey to ascend to the EU or receive financial support from Europe while this is still an ongoing issue, and the competing energy claims in the eastern Mediterranean will only complicate things further.


Reuters

Turkey's Erdogan calls interest rates 'mother of all evil'; lira slides

ISTANBUL (Reuters) - Turkish President Tayyip Erdogan called for lower interest rates on Friday and described them as the "mother and father ...

May 11, 2018

Figure 21. Headline demonstrating Erdoğan's dislike of high interest rates.

Russia—S400 Anti Aircraft Missiles

Russia is another country that has a propensity for dabbling in proxy wars, often in the same areas that Turkey operates. However, the major issue pertaining to Turkish geopolitics is the sale of S-400 ANTI aircraft missiles from Russia to Turkey. The Turkish government bought a batch of S-400s last year prompting the United States to suspend the sale of F-35s (Stealth, multirole combat aircraft) to Turkey, and to threaten sanctions on Turkey.[31] The concern is that a NATO ally buying weaponry from a NATO adversary could compromise security, particularly for the F-35 program. The S-400s would have to be a concession from Turkey to the United States if they are to be provided a swap line.

This list of geopolitical factors is by no means exhaustive. Again, Turkish foreign policy is incredibly complex, and to go through all the geopolitical concerns would only serve to lengthen an already quite long paper. The issues above are merely a sample to demonstrate to the reader the complexities of Turkish geopolitics, and to help the reader keep these complexities in mind when evaluating potential trigger points and solutions. If Turkey runs further afoul of western allies, economics can be used as a weapon to exacerbate the predicted crisis or bring it on earlier. Alternatively, geopolitical concerns can motivate foreign governments to provide funding, thereby delaying and easing the crisis. It is important to keep these considerations in mind.

[30] Source: Max Intelligence
[31] Source: Reuters

Who Will Bail Them Out?

There are a couple of candidates for a Turkish bailout. At the top of the list is the United States, the ECB, Qatar, and the IMF. In the section below, it is explained why we believe it is unlikely Turkey will receive sufficient assistance from these entities:

The United States

The United States, while being a NATO ally, has a tenuous relationship with Turkey. During the 2018 crisis, rather than provide assistance via a USD swap line, the United States instead imposed sanctions on key Turkish economic sectors.

Current Turkish incursions in the Mediterranean, and most notably in Syria, make a swap line from the United States unlikely. The Turkish purchase of anti aircraft missiles from Russia, and oil and gas from Iran, also make a swap line unlikely. When looking at the countries to receive swap lines listed in figure 13, it is clear that swap lines are political. Turkey will be unable to obtain one from the United States, particularly while President Trump is in office, without making some major geopolitical concessions which would likely be unacceptable to Turkey. If Joe Biden wins the presidency in the November election, this is unlikely to change. Recently, it was leaked that Biden made disparaging comments about Erdoğan and the Turkish government, demonstrating an adversarial relationship between Biden and the Turkish government. Erdoğan and the Turkish Government responded with harsh rhetoric towards Biden.[32]

Turkey will not receive economic assistance from the United States without making major concessions.

Europe

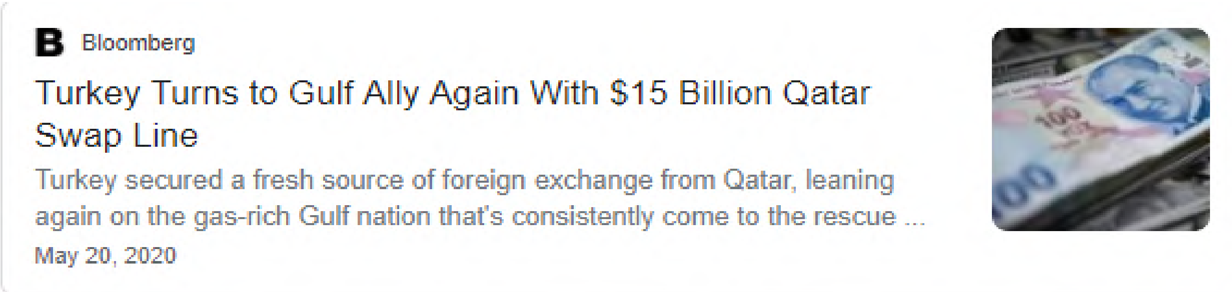
The major motivation for the Europeans to bail out Turkey would be to protect their own banking sectors. Even before the 2018 crisis in Turkey, European banks had extended massive amounts of credit to Turkish companies. Spain and Italy are particularly exposed and already have significant liquidity and solvency issues of their own to deal with. Also, Erdoğan, as he typically does, will likely threaten to open the borders to Europe thereby allowing a new migrant crisis to begin in the European Union.

Talks between the frugal four (Sweden, Denmark, Austria, and the Netherlands) and southern European countries in need of a bailout were somewhat successful. Rather than bail out Turkey directly, the Europeans will likely opt to bail out their own banking sectors and members directly. This makes more sense when considering the current geopolitical tensions between many Eurozone members and Turkey. Germany has lukewarm relations with Turkey, while Greece, Cyprus, and France are all almost certainly going to be against extending swap lines to Turkey.

Qatar

Earlier this year Qatar tripled the $5 Billion swap line it extended to Turkey in 2018 to $15 Billion.[33] To further complicate geopolitics in the region, investors should understand that Qatar is keen to build a natural gas pipeline connecting its vast reserves to the European market. Naturally, the pipeline must run straight through Turkey which ensures that Qatar will have an interest in the economic health of Turkey. Yet, despite Qatar being a very wealthy country, it is unlikely that it alone will be able to bail out Turkey, especially while Qatar is grappling with isolation from other Gulf States and low energy prices. Notably, the swap line is Turkish Lira for Qatari Riyal, not the Dollars and Euros that Turkey so desperately needs. To defend the Turkish Lira, Turkey needs to sell USD and buy Lira. A swap line in any other currency is inefficient, the Qatari Riyal particularly so. While seemingly substantial, the $15B worth of swap lines only barely replenishes the foreign FX reserves that Turkey has exhausted since January. Also, there is uncertainty as to how much and how often Turkey can continue to tap the Qatari well, especially so soon after Qatar already tripled its swap line.

[32] Source: Bloomberg News
[33] Source: Bloomberg News


Bloomberg

Turkey Turns to Gulf Ally Again With $15 Billion Qatar Swap Line

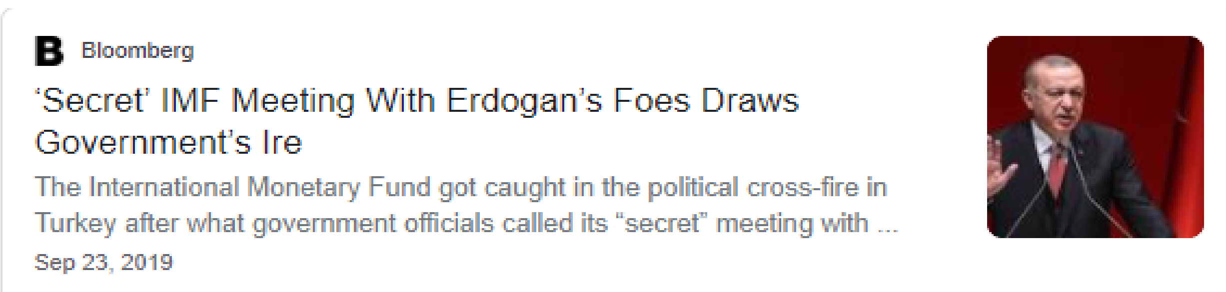
Turkey secured a fresh source of foreign exchange from Qatar, leaning again on the gas-rich Gulf nation that's consistently come to the rescue ...

May 20, 2020

Figure 22. Headline showing the increase in Qatari assistance.

International Monetary Fund (IMF)

Erdoğan has in the past stated his displeasure with the IMF, going as far as to call them loan sharks.[34] He has also lashed out against Turkish opposition parties for engaging in talks with the IMF. Remember, Turkey experienced a similar crisis in 2018 when it rejected IMF financing, and if it does accept IMF financing it will only be as a last resort. So long as Erdoğan is in power it is unlikely that he will turn to the IMF. There are other more practical reasons why Turkey will not be seeking IMF financing. When the IMF extends financing to troubled countries it requires concessions. This will include Erdoğan giving up much of his hard-earned control over the Turkish economy and monetary policy. He is therefore likely to avoid this at all costs. Also, being grouped into the same basket of countries as Argentina is a strong motivator to not accept financing until it is absolutely necessary. IMF support may be required, but only after other options have been exhausted. This is something Erdoğan would like to avoid.


Bloomberg

'Secret' IMF Meeting With Erdogan's Foes Draws Government's Ire

The International Monetary Fund got caught in the political cross-fire in Turkey after what government officials called its "secret" meeting with ...

Sep 23, 2019

Figure 23. Headline showing Erdoğan's distain for the IMF.

Other Countries

Russia and China are two other strong candidates for extending help to Turkey, and it is believed that Turkey is lobbying China to increase an existing credit facility.[35] The concern with using these facilities, apart from the obvious challenges this presents for Turkey's standing in NATO and its path to EU membership, is that the Yuan and Ruble are both emerging market currencies with their own issues. China is in a difficult position as it is running a pegged currency, it needs USD to maintain that peg, and already struggles with USD leaving its own system. This was discussed in length in our last piece, *The Possibility of Revalued USD*. Russia is also struggling with its currency's value due to low energy prices, although there has been a slight rebound in recent months.

[34] Source: Bloomberg News
[35] Source: Reuters

What are the Knock-on Effects?

The most obvious and direct knock on effect of a crisis in Turkey would be the effect on European commercial banks. In 2018, the ECB expressed its concern about its commercial banks' exposure to Turkey. We have spoken about the excessive debt that fueled the economic growth in Turkey in the years after the Global Financial Crisis, and which then caused the crisis in 2018. The main providers of this credit were banks like Spain's Banco Bilbao Vizcaya Argentaria (BBVA), Italy's UniCredit, and France's BNP Paribas.[36] While many of these banks have done some de-risking since 2018, exposure remains high as illustrated by the chart below:

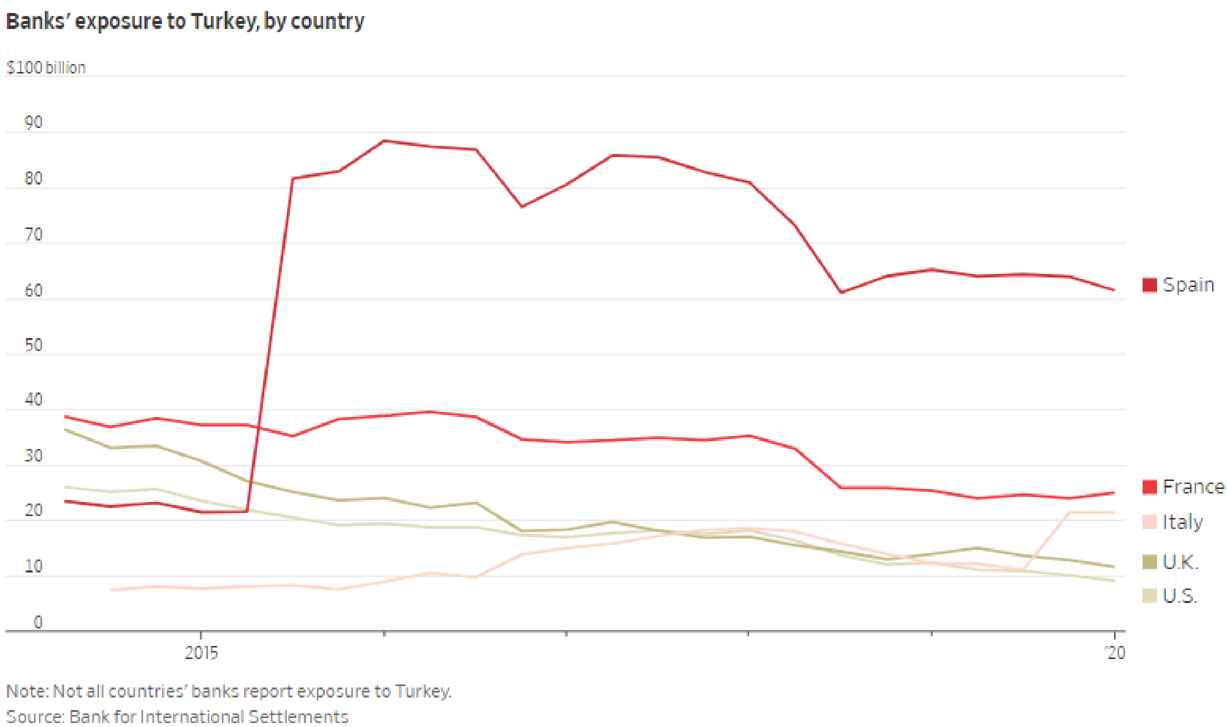


Figure 24. *Chart showing continued exposure of southern European banks to Turkey.* [37]

While it might appear that this will encourage an ECB bailout of Turkey, the geopolitical section of this paper demonstrated how this will be a major challenge, especially considering the conflict with Greece, Cyprus, and France. While it is often preferable to nip the problem in the bud and provide assistance directly at the source of the problem, that is unlikely in the case of Turkey. Europe and the ECB have already exhibited a willingness to bail out southern European banks, and this is a trend that we at IceCap expect to continue in the near future.

Also consider that European bank stock prices are extremely weak, with many back to the same prices first reached in the 1990s. As an example, on the next page is the price chart for France's largest bank, BNP Paribas, which shows that it is back to 1998 levels while also being down 60% from its 2007 all-time high.[38] We know that the European banking system is very weak and the last thing it needs is another crisis, especially one originating from outside of the European system.

[36] Source: Financial Times
[37] Source: Wallstreet Journal
[38] Source: Bloomberg

Figure 25. Chart showing that the price of Frances's largest bank, BNP Paribas is back to 1995 levels.[39]

It is also important for investors to remember that the events that are beginning to unfold in Turkey are not unique. In IceCap's previous paper we demonstrated China and other emerging market countries' exposure to the USD, how they are adversely affected in periods of USD strength, and how access to USD is crucial for them. Most recently, Lebanon found itself in a crisis similar to the current situation in Turkey. This is the result of emerging markets' exposure to trade that is largely settled in USD, and their need to access financing in USD. If the Dollar strengthens or trade declines, they will find themselves extremely vulnerable. Turkey is not the first emerging market to be caught in this trap, and it will certainly not be the last.

We would like to take this opportunity to remind readers that the crisis in Turkey is unfolding with the USD DXY Index around 93. It was only a few of months ago when it was above 100, and we expect the dollar to rebound strongly in the near to medium term. This will make the upcoming crisis in Turkey much worse and will also cause other emerging markets to experience periods of significant stress.

[39] Source: Bloomberg

Conclusion

Turkey is in a damned if it does, damned if it doesn't situation. It has $118.7 Billion in short term debt coming due that will have to be paid using foreign currency.[40] Turkey currently has inflation of approximately 12%, and the Lira is quickly depreciating.[41] Turkey needs foreign currency, most notably USD and Euro to service debt, needs to participate in trade, and needs to defend the Lira. The structural reasons for the Lira's decline are not going away any time soon. Turkey still does not have a current, significant source of oil and gas and will continue to be dependent on imports in the near term. As global trade tightens and tourism grinds to a halt, Turkey will continue to run severe current account deficits. As foreign investors lose confidence, especially if significant capital controls are hinted at, foreign investment will not flow into the capital account, thus causing the Lira to devalue dramatically. Turkey has been defending and will likely continue to try to defend the Lira by selling its foreign reserves, of which it has a finite supply. There has already been a significant decline in reserves, and Turkey will quickly run out of foreign currency unless it receives a swap line or bailout. Because Turkey's geopolitical stances in Syria and the Eastern Mediterranean have upset western countries, it is unlikely to receive a swap line from a central bank that controls a major currency. As it burns through its foreign currency reserves, the Lira will experience significant stress.

The possible outcomes and probabilities are outlined in the table below:

Event	Result	Likelihood
Receive swap line	Does not solve underlying issues but buys time. Kicks the can down the road and provides the Turkish government with time to solve economic problems.	The likelihood of this is low. Due to geopolitical factors, Turkey is unlikely to receive a swap line without making big concessions.
Allow the Lira to be devalued (external devaluation)	Inflation increases, cost of borrowing increases, equity markets decline, defaults. IMF intervention may be required.	The likelihood of this is quite high.
Raise interest rates	This will result in Turkish equities declining significantly but will help to protect the Lira and fend off inflation.	The likelihood of this is quite high. Although Erdoğan is opposed to high interest rates calling them "evil" and "unIslamic", rates are likely to be hiked late in the crisis as Turkey runs out of options, similar to 2018.

Figure 26. *Table showing possible resolutions to the Turkish crisis, including probabilities.*

All options have negative outcomes for Turkey. Raising rates will cause the equity market to decline significantly. Allowing the Lira to devalue and inflation to increase will also have negative outcomes for the Turkish economy with knock on effects across many asset classes. The stress entering the Turkish market will also cause capital flight out of the country. This will bring stress to the commercial banking system which is already vulnerable. An obvious knock on effect of the looming crisis in Turkey is in southern European banks which, even after 2018, remain exposed to Turkey. Because Turkey is lacking the resource that is used to extinguish its debt (foreign currency), a liquidity/ solvency crisis will be sparked that will have implications for debt markets. This will extend to other markets including currencies and equities.

[40] Source: CEIC Data
[41] Source: Trading Economics

The risk of contagion spreading to other emerging markets and the European banking system has a high probability, posing a risk that is not being appreciated by most investors. Events in Turkey have the potential to trigger a sell-off in broader equity markets around the world.

IceCap remains positioned to protect investor capital by limiting our exposure to emerging markets including Turkey, while anticipating and taking advantage of the knock-on effects that are in line with our investment views. In our long-only portfolios, we have zero exposure to emerging market equities and credit, while taking positions that appreciate along with the USD.

For accredited investors, fiduciaries, and qualified eligible persons, we have other opportunities. If you are one of the previously mentioned people and would like to know more about how IceCap is positioned to benefit from our investment thesis, please reach out to us directly.

About the Author

Keith Oland joined the IceCap team as a Global Strategist in 2020. He has experience in Global Banking and Markets with Scotiabank and is currently pursuing a CFA designation as well as a CPA designation. Keith graduated Summa Cum Laude from Saint Mary's University in 2014 with a double major in Finance and Accounting, and a Certificate in Financial Instrument Analysis. Keith also spent two years at Carleton University in Ottawa studying Political Science, Law, Economics, and Geopolitics. While at Saint Mary's he acted as a Research Analyst and Energy Sector Portfolio Manager with the IMPACT Fund. Always passionate about education, he has worked as a tutor for the Athletics Departments of Dalhousie and Saint Mary's Universities, been a Student Ambassador for the TMX Group's Montréal Exchange promoting financial literacy with a focus on derivatives, and spent a year teaching English in Korea.

Keith is an avid adventurer who has travelled to 73 countries and is always on the lookout for experiences outdoors, ranging from skiing in the Rockies to trekking in the Himalayas. While in Nova Scotia, his home province, Keith loves playing hockey, hiking, golfing, and sailing.

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