

18 June 2020

Article

Euroclear: A possible turning point for Turkey

International investors could soon get increased access to Turkey's debt market after a deal between Brussel's based Euroclear Bank and the Finance Ministry. It's an important move after years of concern that Turkey was moving away from international markets



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It's taken eight years to get here

After eight years of talks, Euroclear Bank, an International Central Securities Depository (ICSD) and the Ministry of Treasury and Finance have reached a deal, with the imminent launch of a Euroclearable link to enable international investors to access to the domestic debt market. The deal should provide foreign investors full access to the local market in a more secure and standardised way. The Treasury will have enhanced access to wider liquidity pools. There's also the potential for a reduction in the overall volatility of borrowing costs, as we've seen in other cases. Most importantly, after years of concerns that Turkey might disengage from international markets, this deal could mark a turning point and prove to be quite the opposite.

Background to the agreement

Admittedly, back in May, we weren't expecting this deal because of policies aimed at avoiding or curbing additional pressure on the Turkish lira (TRY).

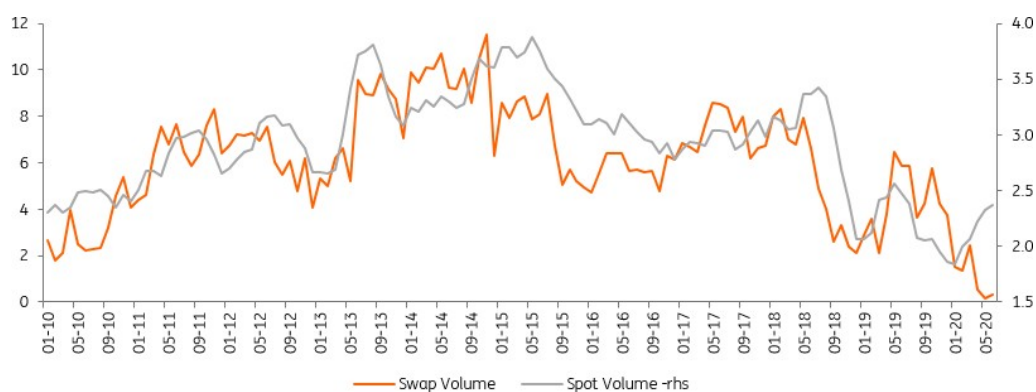
- In mid-April, the BRSA (Banking Regulation and Supervision Agency) decided that derivative transactions with foreign counterparties, where at the initial date local banks pay TRY and receive FX, should not exceed 1% of the bank capital, down from 10% limit, set earlier.
- In early May, BRSA also lowered the limit to 0.5% of banks' equity for TRY depo, repo transactions, and credits with foreign financial institutions.

These policy moves have effectively pulled the volume of swap transactions between local banks and foreign counterparts significantly downwards, appreciably shallowing the market.

As a response, Clearstream Banking said that transactions in TRY over its Bridge settlement platform can no longer be settled under satisfactory conditions due to liquidity restrictions on the currency.

Consequently, the BRSA exempted Euroclear Bank and Clearstream Banking from these limits on banks' TRY transactions with foreign financial institutions, citing objectives of protecting the clearing of TRY-denominated bonds and Sukuk, and ensuring Turkish lira securities are traded efficiently. Finally, Turkey reached a deal with Euroclear in the past few days.

Volume of FX transactions with customers abroad (monthly avg, US\$ bn)



Source: CBT, ING

The Government's motives for the deal

With significant improvement in financial infrastructure and adjustments in the legal framework, Russia, Peru, Chile, Malaysia and Poland have achieved Euroclearability status in recent years, though there are a number of countries in emerging markets, including Brazil, Indonesia, India, and Philippines etc., that do not sufficiently meet all the requirements to be Euroclearable. Strong client interest with reform-driven EM stories has been one of the major drivers for them to join Clearstream.

In the Turkish case, key drivers according to the Treasury and Finance Minister, Berat Albayrak, are:

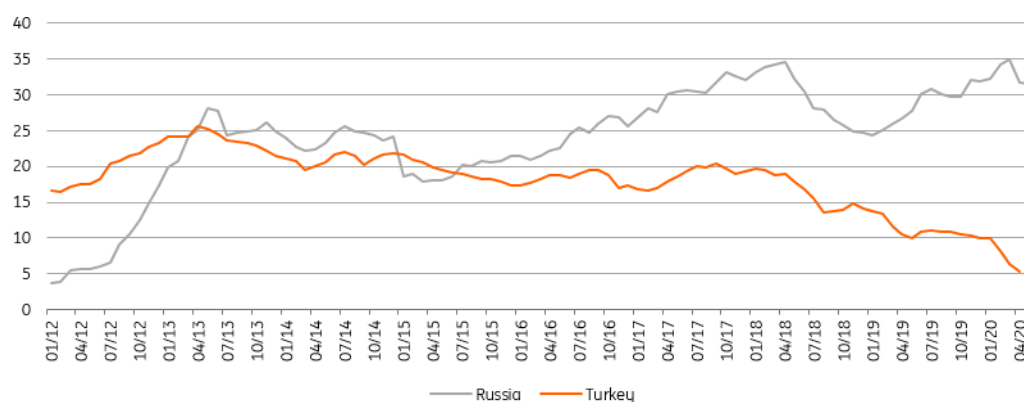
- 1) To further align the capital market framework with globally recognised standards: The government has always had an objective of deepening capital markets via diversification of financial instruments and raising more funds through alternative and less costly methods. In this regard, we have seen some efforts to improve capital markets including a new capital markets law, new products such as the issuance of Islamic bonds, the establishment of ETFs etc. So, the agreement is seen as another step in this direction.
- 2) Support to the Istanbul Financial Center objective: It is widely acknowledged that an international financial centre should offer deep liquid and sophisticated capital markets and competitive regulator regimes with foreign investment and offshore business flow. So, Minister Albayrak expects contribution from the deal here.
- 3) Wider foreign access to the local market: For the government, being able to tap into the liquidity provided by international investors through Euroclear is important for the continued development of our local debt markets. The move should also contribute to the local market outlook, as a safe place for bond investments in times of risk aversion.

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Turkey can potentially benefit in a number of ways

It can attract more foreign investors to invest in domestic markets. Turkey has been under pressure with greater volatility in core economic measures (i.e. inflation, interest rates etc.), while downgrades by rating agencies in the last few years have contributed to those stability concerns. Accordingly, we have seen a significant decline in foreigners' market share in domestic bonds from almost more than one-fourth of the stock in early 2013 to slightly above 5%, the lowest of the current series which began in 2005. Early experience from other countries shows that Euroclearability can be a booster to foreign portfolio flows. As an example, Russia signed an agreement on October 2012, and OFZ became fully Euroclearable in February 2013. Since late 2012, the share of non-resident investors has more than doubled with strong flows. This is also the case for other countries including Chile, Poland and so on.

Nonresidents' share in domestic debt stock (%)

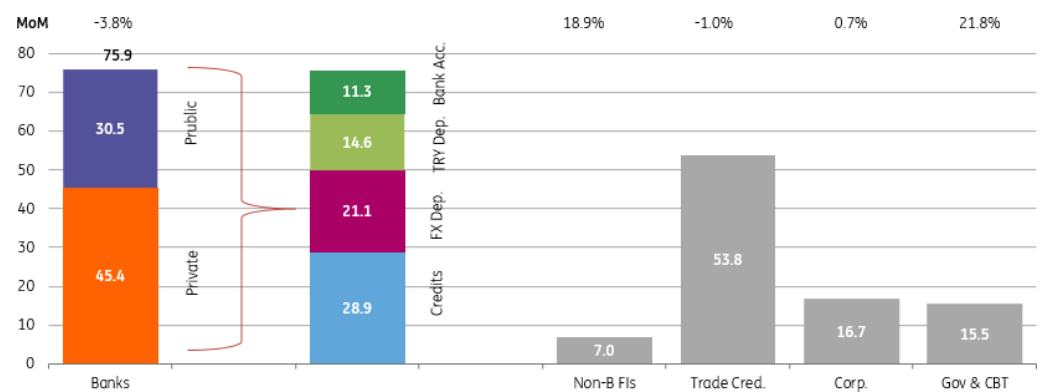


Source: ING

It should be noted that the deal is unlikely to create a direct imminent impact given risk anticipation from high external financing requirements compared with other EM peers, a recent decline in reserves and continuing geopolitical fragilities. This has already been reflected on overall capital flows to Turkey, barely positive on a 12M rolling basis in recent months.

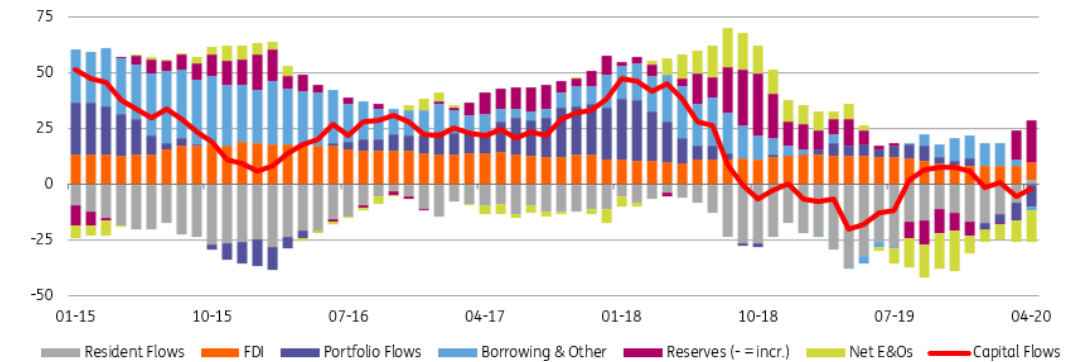
Any support from the deal to portfolio flows would be a plus for Turkey. However, for the benefits to materialise, foreign investors will also be looking for signs of stabilisation in the external financing (e.g. successful rollovers of syndicated loans, FX reserves), funding market and the TRY as Euroclearability by itself can be considered as a necessary but not sufficient step to broaden the investor base or to see a reversal in the decrease in foreign investor involvement.

Short term external liabilities (US\$bn, as of March 2020)



Source: CBT, ING

Breakdown of C/A Financing (12M Rolling, US\$bn)



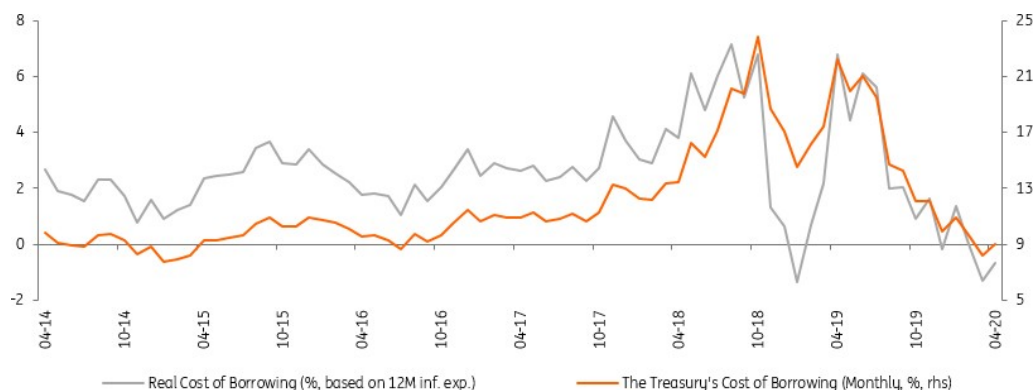
Source: CBT, ING

2 Supportive impact on borrowing costs

Additionally, Turkey can benefit from the supportive impact on borrowing costs: Assuming a more diverse and stable foreign investor base following the Euroclearability that also allows local issuers to deal with a wide range of international investors, borrowing costs' volatility should come down and reduce vulnerability to fluctuations in capital flows. Turkey still enjoys a low public debt-to- GDP ratio relative to its peers, providing room to resort to more fiscal stimulus in times of strains, just look at the currency shock on 18 August and, of course, the Covid-19 pandemic. However, in the short-term, liquidity could be an issue due to increasing fiscal funding needs. The deficit is expected to exceed 5% of GDP in 2020 and public debt-to GDP is around 35% as of April 2020.

Given this backdrop, any support from the deal for more flexible and effective debt and fiscal management should be a plus for policymakers. In this regard, the Treasury can also have the flexibility to reduce reliance on foreign debt capital markets (USD/EUR external issuances) on the back of a broader investor base in local currency credit. Moreover, this could also help extend the maturity profile of the TURKGB curve. All of this would ease financing pressure and, over time, reduce concerns on FX external debt.

Borrowing cost of the Treasury



Source: Ministry of Treasury and Finance, TurkStat, ING

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The country's international profile

A third benefit would be to positively contribute to Turkey's international profile: Increasing government activity with frequent changes to rules and regulations, reflecting greater volatility in the business environment has also affected foreign investors, increasing concerns about the possibility of capital controls, among others. The deal, likely supportive for the liquidity of domestic markets and financial stability, should be a signal of the government's interest to attract portfolio flows and commitment to free movements of capital.

Overall, the Euroclear link will be in place by mid-July meaning that it will apparently be a more cost-effective, efficient and simple alternative to the Delivery versus Payment (DvP) through local custody accounts. This will facilitate access to the domestic TURKGB market within a more secure and standardised way for non-resident investors as well as allowing the Treasury enhanced access to wider liquidity pools. But the crucial impact can be on Turkey's international profile, indicative of Turkish policymakers' interest to accelerate capital flows.

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