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# Turkey: Rate hike will not end vicious cycle

*The lira depreciation cycle will reoccur, but a 200bp hike would buy Turkey 12 months*

Market consensus expects a rate hike from the 14 December MPC meeting. This could temporarily bring capital flowing back to Turkey's battered markets. In this note we look at what happens next.

**Key Judgments**

- Unbalanced growth is driving a vicious cycle in which lira depreciation drives inflation, forcing a rate hike, motivating fiscal stimulus, driving up core inflation, leading to further depreciation.
- Turkey will not emerge unscathed from this latest FX-led crisis, each time this happens it increases the reliance of Turkish banks on short-term foreign debt.
- The government has no intention of fixing imbalances and this means that the underlying problems will get worse and worse.
- When the current cycle ends, other EMs are going to face a cyclical slowdown, Turkey will hit a wall.
- A rate hike from the 14 December MPC meeting will have to be big to restore confidence, 75bp would not be enough and we believe policymakers know this. More likely is a hike of up to 200bp – this would restore the CBRT's credibility for the medium-term.
- If the MPC believes that the situation is not sufficiently urgent and opts for a smaller hike, this would just be a waste of ammunition.

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# In trouble again

For the second time in 12 months Turkey has suffered precipitous lira depreciation and inflation above 11 per cent. Markets are waiting anxiously for a rate hike expected to be announced at the 14 December monetary policy meeting. Consensus seems to anticipate a hike of more than 75bp, but we believe it is likely to be higher, as much as 200bp.

Almost every analysis of Turkey currently being published stresses that the Turkish economy is deeply unbalanced and that fundamentals are driving these depreciation cycles just as much as short-term triggers such as inflation spikes and geopolitical dramas. However, almost all agree that the country is capable of bailing itself out just in time through a rate hike.

Now though is the time for investors to ask: how many times can Turkey go through these cycles before something goes seriously wrong?

## Lessons from the last crisis

On 7 December 2000, *The Economist* ran a leading article on the state of the Turkish economy entitled "The Crisis in Turkey". The piece summed up the state of the Turkish economy as follows:

*"Lax handling of the banking sector now threatens the government's whole economic strategy. If the flight from lira-denominated assets continues, [the government] will not be able to afford to defend the currency, and will have to devalue more rapidly than it had planned to do, effectively dashing hopes of taming inflation. In the meantime, crippling interest rates could halt the renewed growth that the stabilisation programme had begun to produce."*

Three months after that article was penned, Turkey entered its 2001 financial crisis, one of the worst economic disasters in the country's post-war history. It must be said that for an analyst today, these concerns about bank debt, FX volatility and unrestrainable inflation all feel a little too familiar.

### Not exactly out of the blue

By the time that the 2001 crisis finally broke, it was had been obvious for years that the Turkish economy was extremely fragile.

In 1997 the ruling Welfare Party (the predecessor to the AKP) was threatened out of office in the so-called "post-modern coup" and then banned in an intensifying crackdown on civil society. In the wake of the coup and subsequent purges, corruption and informal political interference in commercial life intensified.

Economic growth meanwhile was strong, but unbalanced, with a heavy reliance on fiscal expansion, particularly credit guarantees. As a result the country suffered from a rising current account deficit and very high inflation (see Chart 1 below). The government's fiscal position was


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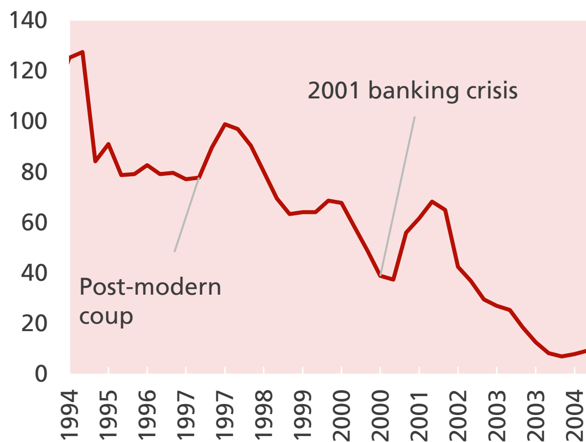
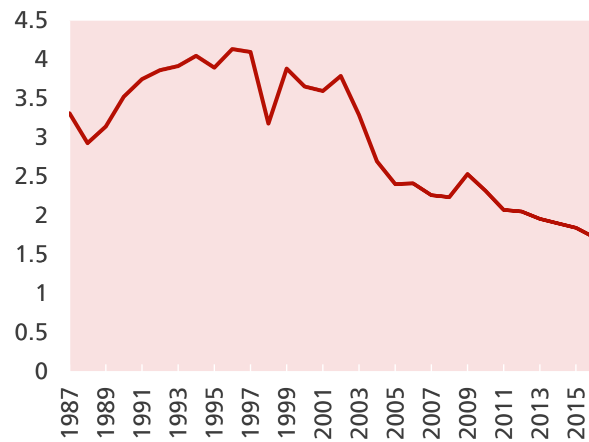
weak, with government debt at 50 per cent of GDP by 2000 due to populist giveaways (such as lowering the retirement age) and a huge defence budget (see Chart 2 below).

**Chart 1: YoY headline inflation**




Source: Bloomberg

**Chart 2: Defence spending as % of GDP**




Source: SIPRI

As a result of these problems Turkey had already been identified by markets as being vulnerable. This meant that when the actual trigger for the 2001 crisis emerged, which was the insolvency of part of the banking sector, the value of Turkish assets fell very rapidly and turned the banking sector crisis into a wider disaster.

The 2001 crisis felt for many like a bolt out of the blue, but the conditions that enabled it were well known for years beforehand. Just as is the case today, analysts had become accustomed to seeing Turkey as vulnerable, clearly unbalanced and badly governed but did not feel that a crisis was imminent.

## Turkey has come a long way . . .

At first sight the parallels between Turkey today and in the late 1990's are alarming: high inflation, an expanding fiscal balance, reliance on external debt and an interventionist and unpredictable government. But in many critical ways turkey is a much stronger country now than it was then:

- **The banking sector is healthier:** The 2001 crisis was both triggered and defined by dysfunction in the banking sector. That dysfunction is not present now. Turkish banks today have a 4 per cent NPL ratio, in 2000 that ratio was 12 per cent. Turkish banks do not struggle to access liquidity and do not rely exclusively on monetary support.

- **The fiscal position is better:** Turkey's fiscal position today is far stronger than it was 20 years ago. Public debt is at 29 per cent of GDP, some 20 per cent lower than in the run up to the 2001 crisis. Furthermore, the Turkish government does not struggle to finance its deficit – the hunger for high yields ensures that bond sales are oversubscribed. On this front there is plenty of gas in the tank.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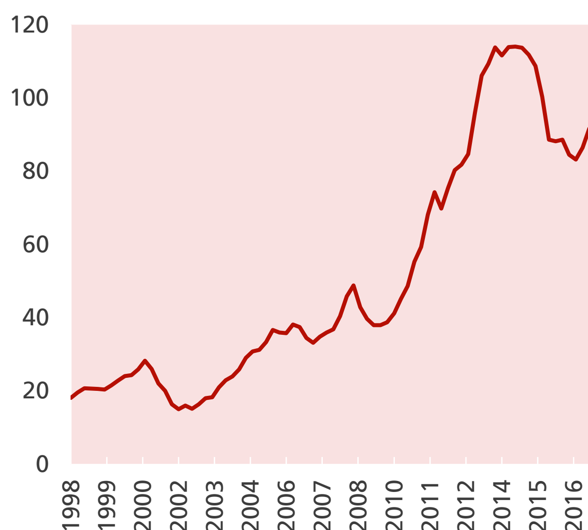
- **Monetary policy is much less mad:** the Turkish lira in the late 1990's was not just unstable, it was a basket case, on a fragile crawling peg and valued at over 1 million to the dollar. Turkish monetary policy is far from perfect today and political interference remains a huge problem, but as we've seen over the last two months, when things turn bad the lira devalues, interest rates rise and capital flows back in. In 2001 this balancing mechanism did not exist.

If Turkey really is headed into crisis it is clearly not going to be the same kind of crisis as 2001. Many of Turkey's 1990s vulnerabilities were fixed, mostly by the IMF programme of the early 2000s but also by the AKP's cautious attitude to fiscal expansion, which has been a relatively constant feature across the last 15 years.

### . . . but not entirely in the right direction

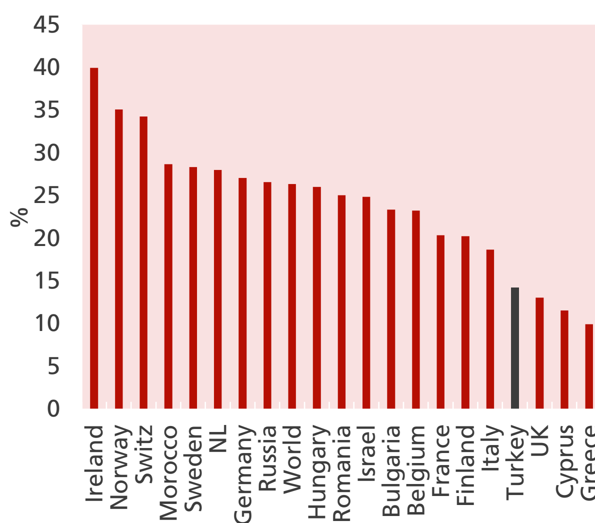
However, AKP governance of the Turkish economy can be divided into two distinct periods[1], pre-2007 and post 2007. In very broad terms, the government fixed or began to fix numerous problems between 2002 and 2007. From 2007 onwards the government has been creating entirely new problems. Many of which are summed up in the post-2008 burgeoning of short-term foreign debt (see Chart 3 below). This debt has been used to finance Turkish growth in the absence of a current account surplus and in the face of very weak local savings rates (see Chart 4 below).

**Chart 3: Short-term foreign debt outstanding**




Source: IMF

**Chart 4: Net savings as % of GNI (2015 values)**




Source: WorldBank

The foreign debt issue is a symptom of the underlying malaise: unbalanced growth. Turkish productivity growth has slowed whilst exports have been stagnant since 2012, meaning that growth has overwhelmingly been driven by domestic consumption that must be financed through external borrowing. This external vulnerability is

[1] We use here Acemoglu and Ucer's institutional understanding of Turkish growth, which, if you feel like forking out $5, can be found here: http://www.nber.org/papers/w21608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heightened by FX dynamics: "hot money" continually floods in and out of the system in search of carry from the high interest rates and as a result the whole economy suffers from resultant FX volatility.

In short: Turkey has a whole new set of vulnerabilities, only it is no longer an issue of banks relying on the government to be solvent, but of banks relying on external financing to remain solvent. The other problems are still there: the high inflation, the FX volatility, even the interventionist government. The question is: given that Turkey can always raise interest rates and bring the carry-hungry hot money flowing back in, could 2001 really happen again?

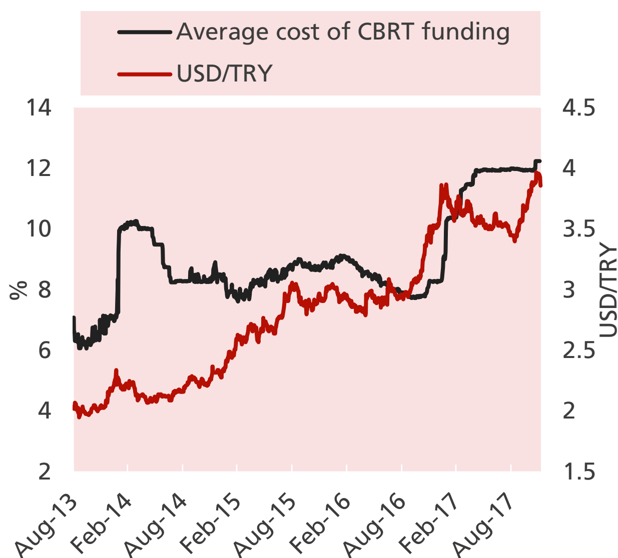
## With every TRY tumble, Turkey is weaker

The short answer is "no", Turkey is not on the brink of a crisis right now. Before the end of January either the rate of inflation will start to fall or the CBRT will raise rates, both will serve to stabilize the financial environment and hold off any serious constriction of liquidity. But the problem is that this cycle of depreciation, capital flight and inflation will happen again and again and at some point Turkey will run out of time.

First, there is the issue of hot money. The international lira carry trade has been likened to picking up pennies on the side of a volcano. The supply of pennies is bountiful and they are easy to collect, but if there is even the slightest rumble of either political instability in Turkey or a rate cut from the CBRT or even rate rises at the Fed, then the penny collectors immediately flee. The concern does not have to be particularly substantial, the money will flee all the same until a rate rise draws it back (see Chart 5 below).

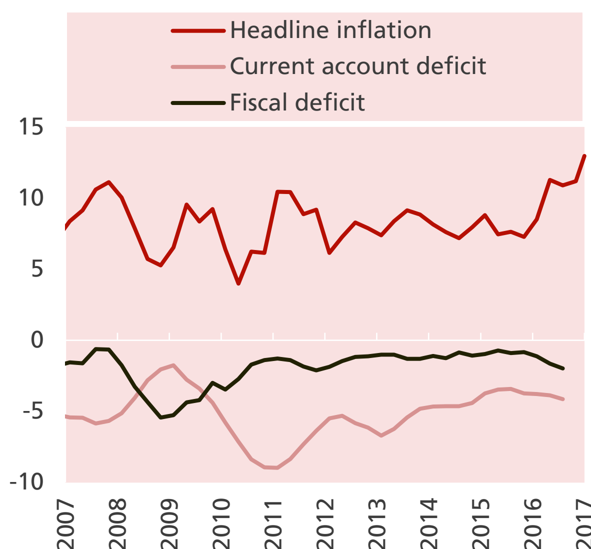
This is not just an international problem, in the last twenty years foreign exchange bureaus have proliferated across even provincial Turkish towns and internal speculative forces are almost equally

**Chart 5: Average CBRT funding rate and USD/TRY, RHS**




Source: Bloomberg, CBRT

**Chart 6: YoY change in CPI and current account and fiscal deficits as % of GDP**




Source: Bloomberg.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powerful on FX markets. Furthermore, Turkey's relations with the EU and US appear to be stuck in long-term pattern of decline. This is a bumpy process which has an almost limitless capacity to produce short-term shocks of exactly the kind that can trigger the speculative forces described above. There will be no shortage of triggers, and no shortage of participants for further runs on the lira.

Second, the underlying, fundamental, problem of unbalanced growth is worsening. The government's economic policy, which this year has turned to fiscal stimulus and credit guarantees to drive growth and boost popularity, is creating a situation in which for the first time in a decade both inflation and the current account and fiscal deficit are worsening (see Chart 6 above). This will increase the country's reliance on short-term debt to finance the twin deficit, whilst at the same increasing the cost of that debt through high inflation which drives currency weakness.

Now that lira has suffered another fall, Turkey is experiencing another intense burst of inflation, driven mostly by food prices, which are closely linked to import prices. The government's response will be to enact further stimulus measures to make up for the high interest rates that are necessary each time to bring the depreciation under control. The stimulus worsens the imbalances and drives up core inflation which weakens the currency and fuels appetite for another round of depreciation. It is a vicious cycle that is steadily increasing the system's external vulnerabilities.

### The government is not going to stop this

In 6 or 12 months' time (depending on the size of the hike), when this happens again, the Turkish government will allow yet another rate hike, but the government has no plans to tackle the fundamental imbalances. Doing so would require a return to strong productivity growth, which itself would require an easing of repression and political interference in education. That is not going to happen. It would also require an acceptance on the part of the government that consumption driven by credit is not a sustainable means of ensuring growth.

We are in a period of benign conditions for EMs, in which EM yield compression is nearly universal. This ensures a relatively healthy financing environment for Turkish banks and the government despite the problems outlined above. However, Fed rate hikes are coming and these benign conditions will not last. If this pattern continues, Turkey is going run into a wall at the end of the current cycle. Other EMs will suffer a cyclical slowdown, Turkey will fall into crisis.

## Investment conclusion

The fundamental condition of the Turkish economy, and the market dynamic of the lira, are both acting as very strong depreciation pressures. At the Monetary Policy Committee meeting next week the CBRT may opt for a hike of only 75bp. Such an action would be a waste of ammunition and merely set the scene for more FX chaos and


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subsequent hikes before mid-January. A 200bp hike on the other hand, would restore the credibility of the CBRT and settle the issue of real interest rates for at least 12 months. The lira would stabilize and inflation begin to come down by the end of Q1/18.

But in the long run, Turkey does not escape negative consequences during these depreciation/inflation cycles. Just as during the 1990s, these coping strategies build up vulnerabilities. Every time that the lira falls, and the CBRT loses control of inflation expectations, both the cost and need for foreign short-term debt increases.

When the market current cycle eventually starts to slow down, and appetite for EM assets fades, Turkey will not be able to cope. Another two years of economic governance like the last two years and the Turkish economy will be unstable and the financial sector unable to function without easy foreign credit. After the December 14 rate hike (if it is more than 100bp) there will be a buying opportunity for those seeking carry. But the next time intense lira depreciation hits, it will be time for investors to leave the casino.


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