Turkey and Argentina: far apart and yet so close

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Highlights

- **Emerging markets recently experienced financial difficulties caused by global monetary tightening, an increase in US interest rates, the stronger US dollar, and trade disputes.**
- **Argentina and Turkey were the most affected as they share some weak economic fundamentals and a heavy reliance on external debt; their currencies have plunged, losing about 50% of their value since the beginning of the year.**
- **The two countries responded differently to the crisis, yet they both ended up with similar outcomes.**
- **A credible reform package with well-designed IMF programs and international support can still turn investor sentiment around, restore calm to the markets and reduce the chance of contagion to other emerging markets.**

Over the past few months, several emerging markets have experienced capital flight triggered mainly by global monetary tightening, the rise in US interest rates, a strengthening US dollar, and the uncertainty and tensions arising from trade disputes. The counties afflicted the most have been those with poor economic fundamentals and a heavy reliance upon external financing.

Turkey and Argentina are in this league, being battered heavily with their currencies coming under intense pressure as investor sentiment took a turn for the worse. They may also have been the culprit for spreading contagion to other emerging economies, including those with better fundamentals, including India, Indonesia, South Africa, and the Philippines among others.

Chart 1: Currency depreciation

(Currencies against $ (1st January 2018 = 100)

Source: Datastream

In the case of Turkey, downward pressure on the lira started in earnest in 2013-14 on concerns about growing budget and current account deficits as well as political uneasiness. But on August 13, it took a severe hit, losing some 20% of its value in one day. The lira has since been fluctuating depending on economic and political news but with an obvious downward trend delivering a more than 40% loss in its value since the beginning of the year.

Argentina has had a long history of economic crises and experienced over the years several episodes of very high inflation (and hyperinflation) and exchange rate pressures. After a period of relative calm following the election of President Macri in 2015, recently a confluence of adverse external and domestic factors including monetary tightening and a reduction in export revenue due to a bad harvest – all taking place in an environment of large fiscal and external current accounts deficits – affected investor sentiment. In April, investors started to unload their holdings of US dollar denominated assets putting downward pressure on the exchange rate, which has depreciated 50% since the beginning of the year.

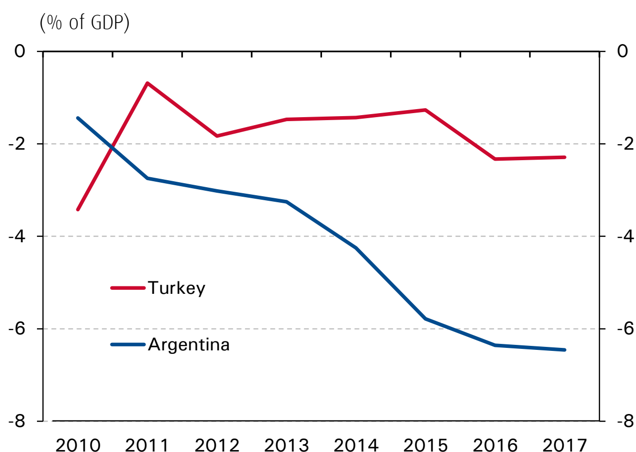
What do Argentina and Turkey have in common?

While both countries have been subjected to external shocks that are not of their doing, they do share a number of common underlying domestic economic problems that contributed to the slide of the two currencies. In brief, they both have a large dose of external debt with relatively short-term maturity, large budget deficits, large gaps in the external current accounts and poor economic management.

Twin deficits and large external debt: Both countries have large budget and current account deficits (twin deficits). The fiscal deficit in Argentina has always been at the root of the large imbalance in the external current account. While the authorities have been attempting to reduce the budget deficit over the past 2-3 years, the pace of adjustment was less than investors had expected. At the same time, there has been a sharp increase in dollar borrowing to finance the deficits, increasing the country's vulnerability to any shift in investors' perceptions.

Chart 2: Fiscal balance

(% of GDP)

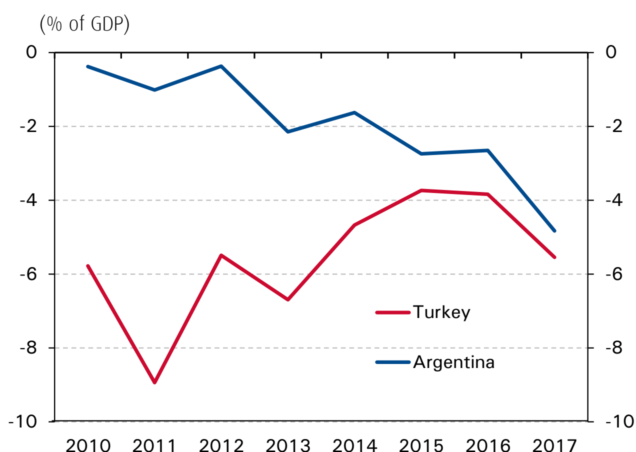


Source: IMF WEO Database

In Turkey, the current account deficits were financed by substantial external borrowing, which was easy to secure in a low (and even negative) interest rate climate in the west. At the same time, Turkey's outsized budget deficit due to a spike in spending contributed to a growth rate of more than 7% last year.

Chart 3: Current account balance

(% of GDP)

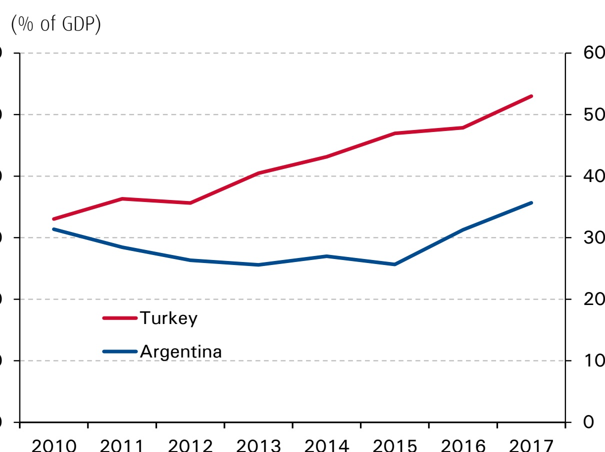


Source: IMF WEO Database

Both countries have accumulated large foreign debt, but the composition of the debt was different: more public in Argentina but more private in Turkey. Estimates put the private sector debt service in Turkey over the next 12 months at some $180 billion. With the lira taking a nosedive, servicing this debt is putting a lot of stress on banks and on many large companies laden with debt in dollars or euros. The corporate sector started to feel the pinch and many businesses are having some difficulties servicing their debt on a timely basis. On top of that, the cost of production in local currency is increasing on account of more expensive imported inputs, with a negative impact on profitability.

Chart 4: External debt

(% of GDP)

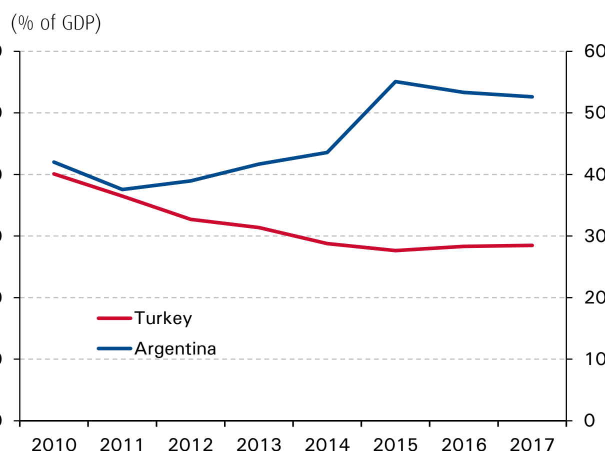


Source: IMF WEO Database

The large exposure of foreign investors to emerging markets is partly self-inflicted as they attempt to search for higher yields. At a time when interest rates in the US and EU were zero or even negative, investors started looking at emerging markets where the return was higher. They "pushed" their loans on these countries maybe without doing proper due diligence. This does not however absolve the borrowers from their responsibilities of increasing their vulnerabilities to foreign debt, exposing themselves to a possible "sudden stop" and a shift in investor's sentiment.

Chart 5: General government gross debt

(% of GDP)



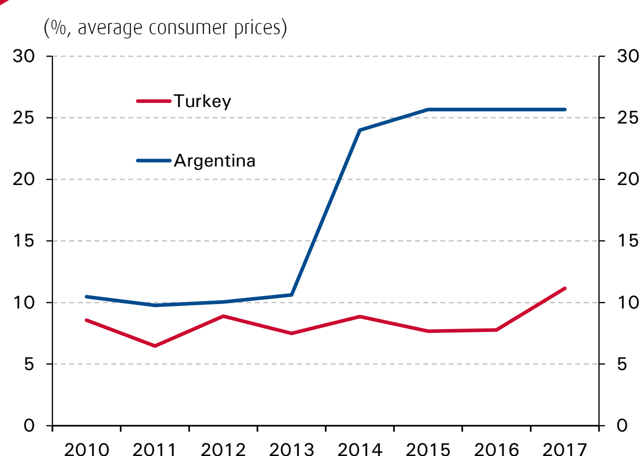
Source: IMF WEO Database

High inflation: Inflation has risen sharply in both countries and the recent currency depreciations has made the situation worse

with inflation expected to climb further. In Argentina, inflation spiked to more than 30% this July while it stood at about 18% in Turkey. The high growth rate in Turkey last year (7.5%) fueled by expansionary fiscal policy and private sector activities financed by foreign borrowing led to an overheating economy and high inflation that was not immediately dealt with. Private sector activities focused on the real estate sector, creating an excess supply and a drop in prices, adding to an already existing vulnerability.

Chart 6: Inflation

(%, average consumer prices)



Source: IMF WEO Database

How did the two countries deal with the shocks?

Before addressing this question, although the depreciation of the two currencies is a manifestation of deeper economic problems (abstracting from political difficulties and external shocks), at this stage it will be hard to resolve these problems before restoring calm to the foreign exchange markets.

The two countries responded to the shocks differently but ended up with the same outcomes: further depreciation of the currency. At the first signs of looming troubles, the Argentine authorities took pre-emptive measures to avoid a full-blown crisis. They adopted restrictive monetary and fiscal policies and shortly after asked for the IMF assistance. Turkey on the other hand failed to make a determined effort to address the crisis head-on and to respond appropriately to inflationary pressure.

Argentina's response: The response of Argentina was a classical textbook response. While it was appropriate in terms of the policy instruments used, the measures were taken gradually, with the dose increasing after each failed attempt to relieve the pressure on the exchange rate. This did not help. More specifically, the sequence of measures taken included: (i) initially the central bank raised interest rates by 300 bps followed by another 300 bps within a couple of weeks and then by 675bps as each increase failed to relieve pressure on the peso; and (ii) the government announced a decrease in the 2018 primary budget deficit target from 3.2 to 2.7% of GDP, largely achieved through cuts in capital spending and a real cut in public sector wages.

Investors were not convinced, and the peso continued to plummet. Then in early May, President Macri announced that discussions would begin on a high access arrangement with the IMF. The IMF was very quick to respond and came up with a substantial and front-loaded support package of $50 billion, aiming to restore confidence to the markets and lessen the pressure on the balance of payments. To achieve these targets, some additional fiscal measures for 2018-19 were agreed on top of what the authorities had announced, including; (i) reducing subsidies and the wage bill; (ii) cutting spending on goods and services as well as capital spending; (iii) reducing transfers; and (iv) selling government-owned land. These measures aimed ultimately at reducing the current account deficit.

Yet even with this comprehensive package, investors' concerns were not alleviated. As a result, and following his request for accelerated disbursements under the $50bn IMF rescue package, President Macri unveiled an austerity program based on a set of measures including: (i) raising taxes on exports (a very controversial measure); (ii) cutting the number of ministries by more than half with the aim to eliminate the primary budget deficit for next year (from 1.3% agreed under the IMF program). At the same time, he dispatched his minister of finance to Washington for further talks with the IMF for a possible acceleration of disbursements under the already-agreed program and possibly an overall increase in the financial package.

Turkey's response: Investors expected the central bank of Turkey (CBT) to raise interest rates to rein in inflation. But the CBT resisted to do so, pressured by President Erdogan's opposition to high interest rates, which he considers "the father and mother of all evil". However, mounting downward pressure on the lira and record inflationary data ultimately tipped the central bank into action. On 13 September, following its policy meeting, the bank surprised markets by raising the policy rate (one week repo) by 625 bps to 24%. The lira gained 4% against the dollar on the news.

Nonetheless, observers were stunned by the initial inaction of the CBT even as the lira lost about a quarter of its value against the dollar in August. This sent negative signals to foreign investors as it put into question the CBT's independence (and credibility), a cornerstone of price stability.

Indeed, following the 13 August plunge in the lira, the Turkish authorities took a few ultimately unsuccessful measures before raising rates a month later. These efforts included:

- Lowering the amount commercial lenders must keep with the regulator and easing the rules that govern how they manage their lira and foreign-currency liquidity. This was intended to assure the markets that there is enough liquidity in the system to satisfy any demand for the liras and to avoid panic in the hope that this would reduce pressure on the currency. But this did not work.
- Shortly after, the central bank raised the overnight borrowing rate by 150bps as a backdoor way to raise the main policy rate. This was not enough for investors.
- This was followed by a decision by the Banking Regulation and Supervision Agency (BDDK) to cut the limit on lenders' swaps to 25% of shareholder equity, from 50%, in a bid to prevent foreign funds from short-selling the struggling Turkish lira. This measure too failed to convince investors of the seriousness of the authorities, as they interpreted it (coming from BDDK) as an inadequate replacement for higher interest rates.
- The central bank then changed overnight borrowing limits, ending the unrestricted funding it had implemented earlier, effectively tightening liquidity. But this only led to the weakening of the lira.
- At the end of August, the government raised taxes on dollar deposits of up to a year and scrapped a 10% tax on lira accounts with maturities longer than a year. This too was not convincing and the lira continued to fall, losing around 9% that week.

Two different approaches yet both unsuccessful

At the outset, Argentina attempted to deal with the crisis using conventional and appropriate responses such as raising the rate of interest and clamping down on the budget deficit and shortly after calling on the IMF for support. One could debate whether these measures were sufficient to stop the crisis in its tracks, but in principle they should have helped. They did not.

Argentina's response at the beginning was somewhat hesitant. In fact, there was some missteps and miscommunication that confused investors instead of calming them down. In its initial announcement on the 2018 budget, the Argentine government did not account for the impact of higher interest rates, the depreciation of the peso and the interest bill, undermining the government's communication strategy. Also, when the President announced that he was talking to the IMF for a possible program and even later when he asked for more front-loading of disbursements, investors and the pubic were confused and took these announcements to mean that things were not going well. These factors also affected investors' perception of sovereign risk and some rating agencies downgraded Argentina's outlook.

The substantial IMF package should have assured market participants, but this was not the case. The strict and harsh measures on the fiscal front were not well taken by investors. The imposition of taxes on exports, which are a source of foreign exchange that the country desperately needed, was considered counterproductive. The other fiscal measures were not growth friendly and could lead to a severe recession, casting doubts about the success of the program.

While the situation is different from the Asian crisis in 1997-98, some of the measures recommended by the IMF are the same. A more appropriate response would have been to inject substantial foreign exchange into the country and convince investors that the IMF is willing to "do whatever it takes" to salvage the situation and regain their confidence. Providing assurances to investors and flushing the country with excess liquidity should have preceded the anti-growth fiscal measures. Once the situation calms down, then appropriate fiscal measures will be introduced in parallel with the stabilization of the financial markets. One has to put out the fire first before putting the house in order.

The response of the Turkish authorities to the tumbling lira has been piecemeal and appears uncoordinated and reactive to daily developments. The classical traditional response to inflation and exchange rate depreciation was not adopted. To the contrary, there was the unorthodox stand that higher interest rates will cause inflation rather than reduce it. Besides, the authorities did not come up with a comprehensive economic package dealing with fiscal, monetary and some structural measures. Leaving the political factors aside, the response was unconvincing and it is not surprising to see that the situation has worsened.

Looking at what Argentina went through, Turkey could feel "vindicated". The authorities could say that the classical economic response and the IMF support did not help Argentina, and therefore "why should we bother?" They are adamantly refusing to call on IMF support. Indeed, such support could be less relevant for Turkey since the IMF typically targets a buildup in the central bank official reserves and deals only intangibly with private sector debt, which is the main concern in Turkey at this time.

While the classical approach to an emerging market financial crisis may not work in one country, it does not mean that it should not be considered. An appropriate economic policy response is a necessary condition (but it may not be sufficient if adverse political and other factors are dominant) to deal with financial crises like the current one. The outside world cannot be fully responsible for what is going on in Turkey although it could be a factor. The intermittent and shy response to the spike in inflation and the fall in the lira threatened credibility and undermined investor confidence. The timing and sequencing of measures is of essence but neither was appropriate.

At this time, some tinkering on the edges would not be useful. A comprehensive and credible set of measures including

monetary tightening, fiscal consolidation, improved relation with the outside world, and better communication with the international investor community is a must. An IMF support program that is comprehensive and well-sequenced with the involvement of private creditors will help the authorities in getting out of the situation they are in right now. The authorities should come out and say that they would be willing to take all the necessary measures to stabilize the situation and provide some assurances to investors. This entails acknowledging that mistakes have been made and that the central bank will regain its complete independence. This will not be difficult to do with an executive presidency at the beginning of its mandate.

In summary, Argentina and Turkey can get out of the crisis if they adopt credible reform programs with IMF support that could be a catalyst for other creditors, including the private sector. International support for the countries that were the hardest hit is a must to avoid contagion to other emerging markets and possibly to other countries.

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