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The Effects of the Turkish Currency Plunge

By Ahmed Hassan Ali



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By Ahmed Hassan Ali*

The escalating dispute between the United States and Turkey has strained ties between the two NATO members to a point not seen since 1974, when Turkish forces invaded Northern Cyprus, which pushed relations to the verge of collapse.

The current crisis in Turkey is due to a number of factors, starting with the failed coup against President Recep Tayyip Erdogan in 2016, which severely destabilized the country's currency, and later developed due to the controversial 2017 referendum that gave Erdogan extended powers. However, the current spat between Washington and Ankara came after US President Donald Trump tweeted against Turkey's detention of American Evangelical pastor Andrew Brunson. The pastor is facing charges of terrorism, espionage, and support for the coup plotters, and was swept up as part of a large-scale crackdown following the failed 2016 military coup attempt.

However, increasing fears of Erdogan's administration of the country's economy, especially since his reelection in July with near absolute powers, played the biggest role in Turkey's currency woes. These fears are pronounced given that Turkey's problems could adversely affect the economic stability of its neighbours such as Iraq, Syria, and Iran.

Despite Turkey's economy being ranked the 17th largest in the world, its problems are only getting worse, especially with Trump's

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trade war against the country, which affects international trade as a whole, in addition to weakening international alliances and threatening economic growth across the world. Foreign investors now fear that Erdogan's populist government might adopt irresponsible economic policies that undermine the Turkish Central Bank's independence. Meanwhile, observers fear such policies might impede the implementation of the necessary steps to place the economy on a sure footing.

Before July 2018, the Turkish lira was traded at 4.7 against the dollar, however it dropped to 5.5 after the presidential elections and continued its decline until the end of August. When Trump sensed the public and political pressure he exerted against Turkey due to the detention of the pastor had begun to bear fruit, which included sanctions against the justice and interior ministers, he announced a doubling of tariffs on imported Turkish steel to 50 percent and aluminum to 20 percent. These punitive tariffs made Turkish steel the most expensive in the American market and severely declined Turkish steel exports.

The increasingly personal clash between the US and Turkish presidents raised questions about the possibility of a prolonged tit for tat campaign between the two leaders, and the chaos it could leave in its wake. Disagreements had already turned into a growing diplomatic crisis in which political affairs were being made personal. Erdogan had directly criticised the United States for refusing to extradite Fethullah Gulen, the Turkish preacher Ankara accuses of orchestrating the failed coup attempt from his self-imposed exile in the US state of Pennsylvania.

Whenever President Trump escalated his war of words, President Erdogan responded in a similar fashion and showed no sign of backing down. Erdogan lambasted the countries he accused of orchestrating the economic crisis in Turkey and pledged not to cave to western pressures. Erdogan even said: “those who think they can subject us through economic manipulations have not understood this nation at all. They cannot use the language of threats and extortion against this nation.”

Trump wanted to force Erdogan into a deal to release the American pastor by exerting political and economic pressure on Turkey. In return, the United States had agreed to repatriate an influential Turkish banker who worked for the state-controlled Halkbank. The banker had been jailed on charges of violating US sanctions on Iran, and was to complete the remainder of his sentence in Turkey. Also part of the deal was the release of a Turkish prisoner in Israel, who was freed on the request of the US President.

There seem to have been Turkish diplomatic efforts to lift American sanctions imposed on the state-controlled Halkbank, for what the US considered to be a “conspiracy” to violate its sanctions against Iran. However, the continued detention of the pastor prevented the progression of those efforts, especially since both leaders became more entrenched in their positions. The Turkish President even called upon Turks to sell their gold, dollars, and euros to shore up the lira, saying: “If there are dollars under your pillow, take these out... Immediately give these to the banks and convert them to Turkish lira and by doing this, we fight this war of independence and the future.”

The lira’s plunge caused panic in the financial markets because it cast doubt on investments in Turkish securities. Furthermore, the

yield on Turkey's 10-year government bonds jumped to over 20 percent, which means traders are demanding much higher yields due to what they believe are high risk investments. Doubts were also cast on the investments of Asian and European banks that have a significant presence in Turkey, which contributed to a stock market slump around the world.

The sharp drop in the lira's value reflected concerns about Erdogan's economic policies, which relied on investments in construction. The steepest decline in the lira since Erdogan's reelection has been fueled by fears that he has become more isolated than ever before, and follows economic policies that do not benefit investors, such as his refusal to raise interest rates to curb inflation and ease pressure on the lira. Erdogan's government went further when it announced its economic pivot towards states such as Russia and Iran despite US sanctions against them.

Turkey Joins the Russian Axis

In recent years, Turkey has become closer to Russia and Iran, both of whom are under US sanctions. This represents a shift in American-Turkish relations, which were quite strong under Barack Obama, who described Turkey as "a great Islamic democracy, and a model of great importance to other Muslim countries in the region." The relationship between Turkey, Russia, and Iran developed as an understanding in resolving the Syrian conflict, which has entered its eighth year. As a result of this understanding, most of Syria returned under the control of President Bashar al-Assad, who the United States continues to seek to overthrow. The disagreements between the Americans and Turks seem to have begun with how to deal with Syria's Kurds. The United States views the Kurds as allies in the war

against the Islamic State group, while the Turks complained that US authorities have not upheld their commitment to limit Kurdish presence to the east of the Euphrates River.

Turkey responded to the lack of US commitment to the issue of the Kurds by carrying out military operations in Syria and launching an offensive against Kurdish factions loyal to the United States. At the same time, Ankara has sought to negotiate with Russia to purchase an advanced S-400 air defence system, which the Americans view as a step that affects the strategic defence interests of the United States and its allies, bearing in mind that Turkey is an active member of NATO. Foreign Policy magazine quoted an American expert as saying that if Turkey uses US F-35s while also relying on the Russian S-400 defence systems, Moscow will be able to collect valuable information about the plane, which is the latest high-tech aircraft in the US arsenal. Therefore, the US military announced a delay in the delivery of the aircraft to Turkey.

The Turkish Government's Monetary Policy

Keeping interest rates low has helped finance Turkey's fiscal stimulus program for construction industries to generate high growth, but low interest rates are also driving inflation. The weakness of the Turkish currency will exacerbate Turkey's persistent inflation problem, making life more difficult for the population of 80 million. With inflation already rising for several months, Turkish consumers face rising food, fuel, and medicine prices, and imported products have also become more expensive. For example, while the lira continues to lose value against the euro, the gap between amounts paid by pharmaceutical companies to European suppliers, and the amounts they receive from Turkish pharmacies, continues to widen.

The lira has lost more than 40% of its value against the US dollar since the beginning of this year, and Turkey's economy already displays signs of fatigue, as it manages its current account deficit, coupled with high levels of private sector debt and large foreign financing in the banking system. Annual inflation was 15.9% in July, more than five times the average for rich countries, and the government's foreign currency borrowing has also increased sharply. There is also concern among foreign investors about a collapse in the construction sector after years of growth, leaving Turkish banks with increasing debts. Turkish companies have sought to reduce borrowing costs in recent years by obtaining loans in foreign currencies. However, observers now worry that companies may default on loans, because Turks pay them in lira, while the gap between the lira and other currencies such as the dollar and the euro grows.

Economists fear that Turkey will experience a recession and a debt crisis that requires a bailout by the International Monetary Fund if confidence in the lira is not restored soon. Meanwhile, the IMF believes that Turkey has the lowest level of adequate reserves for the economies of major emerging markets, making it especially vulnerable to speculative attacks.

Turkey has limited options in its quest for external financing. In contrast to Greece, which went through its own financial crisis, Turkey is not a member of the European Union and does not use the euro. This means that the European Central Bank and rich Northern European countries might not offer Ankara the help it needs. Therefore, Turkey may turn to Russia, which is facing its own problems, or China, which is trying to ease trade tensions with the United States. Turkey might even turn to Qatar, the world's richest country in terms of GDP per capita, especially given Turkey's support

for Qatar in overcoming the Saudi-led blockade that has entered its second year. Observers believe that Erdogan will try everything to avoid resorting to IMF.

Potential Impacts on Global Markets

Experts are drawing a bleak picture of the continued decline of the Turkish lira, warning that global markets will face huge repercussions. Investors are trying to assess the impact of the crisis on the European banks that lent money to Turkey because of the country's current account deficit, alongside high levels of private sector debt and foreign financing for the banking system.

As mentioned earlier, the inflation rate reached an annual rate of 15.9% in July, and government borrowing of foreign currency increased significantly. Investors were concerned that Turkish companies that had borrowed heavily to profit in the construction boom, might struggle to repay loans in dollars and euros, because a weak lira means that there is more to repay, which in turn only exacerbates the problem.

Despite the fact that Turkey represents only 1% of the world economy, experts warn that Turkey's crisis may have global implications, particularly on countries in the region with close ties to Ankara. The crisis has already caused a sharp decline in European markets, especially in countries where banks deal in Turkish lira.

According to Reuters reports, emerging market currencies fell as investors worried about infection. For example, the South African rand, the Russian ruble, and the Mexican peso, all plunged amid fears that the failure of Erdogan's government in dealing with the financial crisis will have a domino effect on other weak countries. The Turkish

President's insistence that his country will be able to overcome the economic blockade was not enough to reassure financial markets and has put the strategically important emerging market countries in a very precarious situation. Instead of dealing with his country's financial troubles amid pressure from the markets to deal with the weak lira and high inflation, Erdogan has attacked the US president for imposing sanctions and doubling tariffs on Turkish steel and aluminum imports, by saying: "We are together in NATO, and then you seek to stab your strategic partner in the back".

To date, President Erdogan has made no indication that the American pastor will be released, and has so far made no request to the IMF for emergency financial assistance, and has said the lira would soon stabilize at the most reasonable level. Economists and experts fear that Erdogan's rhetoric is only adding fuel to the fire. As the lira gets weaker, Turkey may face a downward spiral, where default is only outcome, and with companies that have \$300bn of dollar-denominated debt being especially vulnerable. Currency speculators have begun assessing the potential harm to Europe, and identifying emerging market countries that have benefited from lower global interest rates for debt accumulation in foreign currencies during the period after the financial crisis.

Some EU leaders fear Turkey's financial problems could spill over into the EU, either through losses to Spanish and Italian banks that provided large loans, or through politically unacceptable increases in immigration. German Chancellor Angela Merkel has called on President Erdogan to abandon his opposition to raising interest rates, allowing the Central bank in Ankara to raise official borrowing costs from its current level. With its economy facing great difficulties, Turkey will need credible and fiscally disciplined economic policies,

alongside an independent Central Bank, if it is to reverse its current economic course.

A rapprochement with the United States could reduce the amount of effort it takes the Turkish Central Bank to take control of the economic situation, but this is unlikely to happen at present. Given Turkey's political and economic conditions, it is not clear if the necessary steps will be taken to contain the implications of the current crisis on the market. Furthermore, Erdogan's anger at Trump has raised speculation that he might withdraw Turkey from NATO and seek financial support from Russia and China rather than the IMF. Additionally, the Turkish president's rhetoric about "the economic terrorists on social media" and his desire to prosecute them as a "network of traitors" has only increased fear and anxiety among investors.

Summary

An unstable Turkey is not in the best interest of the EU, yet there is no political will to help the Turks, perhaps due to Erdogan's positions towards Europe in recent years, especially Germany, which have been marred by acrimony. While some in Europe fear that the Turkish crisis could threaten the refugee deal with Ankara, others view Turkey as needing more hard currency than ever before, thus making any threat from Turkey manageable.

Economists predict that if Turkey remains on its current course, it will ask the EU for some sort of financial bailout. However, European rescue mechanisms are reserved for members only, and even if the EU agrees to help Turkey, Erdogan is likely to reject the conditions associated with this help, such as raising interest rates.

Turkey's crisis is the result of years of lax financial and monetary policies, which were put in place almost entirely by President Erdogan. What makes the situation even more dangerous is that Erdogan is the only person able to fix his country's economic problems, however he is unlikely to do so in the near future.

Foreign investors – mostly from European countries – say President Erdogan has called on Turks to boycott the iPhone and other American electronics, and launched a scathing attack on local critics in Turkey, describing them as traitors and economic terrorists, instead of attempting to find a compromise in his confrontation with the Trump administration on the US pastor's imprisonment. What matters most, according to foreign investors, is that Erdogan has not shown any willingness to make hard policy decisions, such as raising interest rates to control inflation and stop the depreciation of the lira. Instead, he has taken personal control over the Ministry of Finance, and stripped the Central Bank of its independence, thereby putting Turkey's credibility in doubt among many investors.

Will the Currency Crisis Turn into a Larger Monetary, Economic, and Political Crisis?

Economists believe that Turkey's leadership did not deal with the underlying causes of the lira's depreciation, and as long as the causes are not addressed, the crisis will continue. As inflation rises to 15%, many wonder how far Erdogan can go if the Turkish middle class, who voted for him in large numbers, start losing much of their savings. If Turks have yet to feel the effects of the currency crisis, they are sure to do so soon. Meanwhile, companies that have benefited from loans in dollars and euros will find it severely difficult to repay those loans, an issue that has played a prominent role in destabilizing the Turkish

economy in recent years. In addition, refinancing loans or seeking new credit will be increasingly difficult, not to mention the concerns presented by oil, as Turkey is a dollar-based oil importer.

Those who study Turkey's history over the past 100 years will find that the country have gone through three stages of economic recovery. First, between 1950–1953, when Turkey benefited from American financial aid as part of the Marshall Plan to combat the Communist tide. The second, between 1983–1990, when Turkey utilised the Iraq–Iran war to gain an economic advantage. The third stage was between 2003–2013, when the country opened its doors to foreign investments, making Turkey a huge emerging market economy.

However, Turkey has lost the reputation that attracted such huge investments, which is why Turkish corporations are urging the government to take the necessary steps to resolve the crisis, including ending the conflict with Washington and raising interest rates. Given the pressures and the catastrophic projections, some observers believe it is only a matter of time before Erdogan reverses his collision course, and ultimately seeks the IMF's help, where the US president will no doubt be waiting.

Notes

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