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Emerging Markets

Turkey: Dangerous Economic Gambles Continue

Executive Summary: Turkey's policy reversals are set to exacerbate the country's longstanding economic vulnerabilities, which include weak external finances and limited confidence of the population in the Lira as a store of value.



Issue

The dismissal of a central bank governor appointed just 5 months ago again highlights the severe policy risk affecting Turkish assets and investments.



Impact

The country's longstanding economic vulnerabilities, weak external finances and the limited confidence of the population in the Lira as a store of value will be exacerbated in coming months.



Next Steps

With government finances also precarious and low levels of hard currency reserves, the developments again raise the possibility that the country will need external assistance within a year.

More Information, Below

This weekend, President Erdogan dismissed Governor Agbal of the Central Bank of the Republic of Turkey (CBRT) after a tenure of only 5 months. In recent months the central bank had increased rates, restored some measure of market credibility, and was starting to anchor inflation expectation. Since Governor Agbal took over in November, the CBRT has hiked interest rates from 10.25% to 19% with the latest raise just this past week. Along with a strong monetary tightening, the central bank delivered strong statement guidance regarding a “*permanent price stability*.” Since this shift from the CBRT, the Turkish Lira has rallied over 15% against the US dollar, which has helped alleviate some pressing near-term balance of payments issues. Agbal’s dismissal is now the 3rd dismissal of a central bank governor in 2 years.

While incidence of the pandemic is below the global average for Turkey and a vaccination campaign is underway, the economic impact has been because of reduced tourism. An oil importer, the country’s finances will now also be affected by the rising global oil price. The economic and debt challenges of the country have been exacerbated over the past year by erratic economic policy.

Turkey’s traditionally low savings rate and resulting dependence on foreign currency to finance economic growth have long been an proverbial Achilles’ heel to its economy. The practice of issuing proportionally large amounts of short-term and variable rate debt is an additional risk in this regard. Strong FX buffers at the CBRT and a strong fiscal position can mitigate the risk of balance of payments pressures but the dismissal of Agbal again raises the risk of unusual rate-setting and costly yet ineffective interventions to support the Lira. In terms of avoiding the most acute risks, the CBRT benefits from a swap agreement with the Qatar Central Bank equivalent to \$15 billion (close to 2% of GDP).

With net FX reserves at lows not seen since the early 2000s (\$18.45 billion v \$13 billion in 2003 as of December), the risk of severe balance of payment pressures will return given the shock the dismissal is likely to have to the Lira. Whether external markets will continue to be there to meet the significant financing needs of the Turkish public and private sectors remains to be seen in that scenario. Lack of confidence in rate-setting and economic policy will be visible in coming months in increased holdings of the Turkish population of euros, dollars, and gold.

Were Turkey to need additional external financial assistance, for example in the form of a program from the IMF, its global diplomatic position would need to be shored up first. The government seeks involvement in almost every feasible geo-political conflict, and its behavior regularly rises to the level of nuisance, occasionally even a priority for the EU, US and others. Aside from an active role in nearby wars (Nagorno-Karabakh, Syria, Libya), it is involved in confrontations against NATO partners and E.U. countries over gas in the Eastern Mediterranean, fights against Russia in Syria, disagreements with NATO over the purchase of the Russian S-400 missiles, disagreements with the U.A.E. over

relationships with Israel and Middle East politics broadly, longstanding tensions with Saudi Arabia, and with China over the latter's treatment of the (Turkic) Uighur population.

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