FINANCIAL MARKETS

WHY DID THE TURKISH LIRA FALL?

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TURKISH CURRENCY WOES

FOREWORD

The markets have bee shaken by a dramatic fall in the Turkish lira. Concerns about Turkey falling into an economic crisis have rippled across the global markets.

The goal of this eBook is simple. We want you to understand why the lira has fallen - and what steps the Turkish government could take to stabilise the situation.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

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LIRA: A SHARP FALL

WHAT'S HAPPENED?

Since the start of 2018, the Turkish lira has significantly fallen in value. In fact, it's fallen (at the time of writing) 35% against the US dollar.

The fall has been record-breaking. Lira recently dropped to a record low against the US dollar at 7.14.

So why has this happened to one of the world's fastest-growing emerging economies?

Well, the answer is quite simple. The financial markets are anxious that Turkey is heading for an economic crisis.

Now, the reasons for a potential economic crisis are complex (we'll explore the key themes later in this eBook). But what you need to know is that many foreign businesses and financial institutions are exposed should Turkey become unable to repay its debts.

This is why we've seen volatility in the financial markets. Let's explore the state of the Turkish economy is a little more detail.

CENTRAL BANK INDEPENDENCE?

Usually, it's the responsibility of a nation's central bank to control inflation.

Typically, this is done through monetary policy tools. To curb high inflation, the orthodox course of action is to increase interest rates.

Interest rates act as a 'brake' on economies that are overheating. Essentially, higher interest rates make it more expensive to borrow money - and provides an incentive to save.

This acts to reduce the money supply within an economy, reducing inflationary pressure in the process.

The Central Bank of the Republic Of Turkey hasn't taken this action so far. It's led to questions about the independence of the central bank - and the influence of Turkey's President Erdogan. The Turkish head of state has publicly expressed his dislike for interest rates.

At the time of writing, the Turkish interest rate stands at 17.75%. Even though this is comparatively high compared to other major economies, many economists think interest rates need to be hiked further to curb inflation.

OTHER EXTERNAL INFLUENCES

While questions remain about the actions of the Turkish central bank, there are other factors which have dragged on the price of the lira.

FOREIGN DEBT

One of these factors is foreign debt. As we've mentioned, Turkey is an emerging market. This is reflected in its rate of economic growth. Because of this, the Turkish government and many Turkish businesses have secured foreign finance.

This means the Turkish government and many Turkish businesses hold debt in foreign currencies. Clearly, this is problematic considering the dramatic fall in the value of the lira.

As lira continues to depreciate against other currencies, Turkish entities will be at risk of not being able to repay their foreign debts. Some Spanish and Italian banks are exposed to this possibility.

This dynamic has also panicked global stock markets, as investors dwell on the fact that Turkish entities could default on foreign debt. This was reflected in stock market volatility in August 2018.

Of course, this anxiety has applied further pressure on the Turkish lira, creating a vicious cycle.

US TRADE TARIFFS

Another reason why the Turkish lira has fallen concerns new US import tariffs on Turkish steel and aluminium.

In response to diplomatic tensions over the detention of a US citizen in Turkey, the US government has doubled its existing tariffs. Turkish aluminium now faces a 20% US import tariff, while Turkish steel faces a 50% US import tariff.

In response, Turkey has announced its own retaliatory tariffs on US products (120% tariff for cars and 140% on alcoholic drinks). It's an unprecedented state of affairs between two NATO members.

This sudden increase in trade tensions with the US has only added to the market's anxiety about Turkey's economic prospects. Again, this has been reflected in a volatile stock market and the plunging price of lira.

SOLUTIONS FOR THE LIRA?

So how can Turkey stabilise the lira and avoid slipping into an economic crisis? The most obvious answer is for the Turkish central bank to increase interest rates.

However, it's unlikely that we'll see this happen. The approach adopted by the Turkish government and central bank is to 'wait the crisis out'. It's not a strategy many economists have confidence in.

Strict monetary and fiscal management is required in this situation. A good example of this comes from Argentina. Its central bank has regularly adjusted its interest rate to stabilise the peso.

At this moment in time, it seems likely that the lira will continue to face severe downward pressure for the foreseeable future.


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