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OPTIONS FOR TURKEY

Berenberg Macro Flash

No credit binge can last forever. After stoking demand growth artificially for years, Turkey is staring into the abyss. To pull back from the brink, the country needs a policy U-turn. The earlier Turkey changes course and the more decisive and credible its conversion to prudent policies is, the less painful the inevitable cleansing of prior excesses will be. This week's stealth monetary tightening by forcing banks to borrow at the central bank's overnight rate of 19.25% instead of its standard 17.75% rate and the crack-down on Lira short-selling exemplify the half-measures that are unlikely to restore confidence.

This note deals largely with Turkey. For an assessment of the wider impact, see [Does Turkey matter for the Eurozone?](#) (10 August 2018) and [Eurozone: beyond the rocky summer](#) (13 August 2018). We will update this assessment shortly. While the direct impact of the Turkish crisis on the big Eurozone next door should be small, the noise from Turkey could delay the rebound in Eurozone business confidence and growth for a few more months despite the easing of US-EU trade tensions. As long as frightened markets stay in risk-off mode, the euro, equities and bond yields can remain lower for a while than underlying fundamentals would otherwise suggest.

THE KEY INGREDIENT: A POLICY U-TURN

Turkey shows the classic signs of economic overheating: excessive growth in credit and money supply, surging inflation and a mounting current account deficit (see Mickey Levy's excellent [summary of key facts and issues](#)). The policies required to end such a textbook emerging market crisis are obvious: higher interest rates and fiscal prudence, including less reliance on credit-financed vanity projects such as the next mega-airport or a channel to bypass the Bosphorus. As President Recep Tayyip Erdogan had announced on 14 May that he is de facto taking control of the Central Bank of Turkey (CBT), he himself needs to authorise the change. A tall order. If he does not do so soon, Turkey could descend into a deeper economic and potentially political crisis later on.

HOW TO REGAIN CREDIBILITY?

If and when Turkey is ready to change its economic policies, it ought to send a strong signal to its own citizens as well as to global markets that it is serious about and committed to the change.

- **Independent central bank:** Making the CBT truly independent again – and thus able to pursue a policy that could inflict short-term pain for long-term gain – would make a policy change more credible.
- **Fiscal prudence:** In emerging markets, monetary excesses often reflect prior fiscal choices. A monetary policy U-turn thus needs to be complemented by a sustainable fiscal policy. Otherwise, markets would suspect that the rising debt – including the debt of institutions de jure or de facto directed by the government – would eventually be accommodated by the central bank again. In such a case, the turn in monetary policy would not be sufficiently credible for long.
- **Change in key personnel:** Appointing central bankers and a finance minister who command trust – and who are perceived as being able to withstand political pressure – could signal that Turkey is serious about a policy change. A finance minister who is the son in law of the country's autocratic president does not suit that description easily.
- **Mending relations with the US and the EU:** US sanctions are not the cause of Turkey's completely home-made economic problems. They merely triggered Turkey's most recent sell-off. However, mending relations with the US and the EU would help in two ways. First, exactly because Erdogan may find it so difficult to ditch the policies that got him into trouble with the US and the EU, a shift in his approach to the US and EU could signal that he is serious about a change in economic poli-



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cies as well. Second, US and EU concerns about Turkey partly focus on arbitrary detentions in Turkey. Anything that could be seen as strengthening the battered rule of law in Turkey may make Turkey a little more attractive for foreign direct investment again.

THE POTENTIAL ROLE OF OUTSIDE HELP

If Turkey does not change its policies, no help from abroad can make a major difference for long. Turkey is far too big to be kept afloat by small doses of foreign money for long. Support from abroad could help Turkey to buy time and/or to enhance the credibility of the required policy shift if and when it happens.

Help from Europe?

The EU has a strong interest in a stable Turkey on its doorsteps, as does NATO. But the EU does not have the institutions and funds to assume the role of the IMF for a country that is not an EU and Eurozone member. A few extra billion euros for Turkey to cope with the Syrian refugee crisis and some small amounts from other EU funds are feasible. But such sums would not make a decisive difference.

Help from the IMF?

Having manoeuvred itself into a textbook emerging market crisis, Turkey could be a classic case for IMF support with stern conditionality. As the IMF would insist on the policy changes needed to put the country on the right track again, an IMF bail-out with close supervision would enhance the credibility of a Turkish policy change. Erdogan would just have to go back to his roots. Upon first coming to power as prime minister in 2003, he initially built a reputation for economic confidence by building on an IMF programme that extricated Turkey from its 2001 crisis. The political hurdles are very high, though. Erdogan now rails against the IMF. More importantly, the US is the biggest shareholder in the IMF. As it stands, US President Donald Trump would almost certainly want to prevent a IMF bailout for Turkey, possibly threatening to pull US funding from the IMF in such a case. Put differently, Erdogan will first have to strike a deal with Trump, which very likely would have to be very much on terms set by the US.

An IMF bailout could only become a realistic option if Erdogan has mended political relations with the US and the EU. If Turkey meets both conditions, making a U-turn on monetary and fiscal policies and repairing relations with the US and the EU, an IMF stamp of approval for the new policies may still be helpful. But instead of an actual programme, a comment by IMF leaders that, on the new set of policies, Turkey is getting it right again, might already help to ease tensions and enable Turkey to stem capital flight in such a case.

Help from Russia, China or Qatar?

Instead of mending relations with the West and asking for IMF support, Erdogan may be inclined to seek financial help from autocratic rulers abroad, hoping that they would not impose pesky conditionality on him in return. For three reasons, that attempt is likely to fail in the end:

- First, if Turkey secures funds from new lenders but does not change its policies much, the money will merely buy a little time until it has seeped out of the country again, leaving Turkey in the same calamity as it is today but with more foreign debt.
- Second, help from Russia, China or Qatar would do very little to enhance the credibility of any potential policy change in Turkey. It would likely be interpreted as a signal that Turkey is trying to shirk the required monetary and fiscal adjustment.
- Third, none of these potential lenders seems willing to offer the sums that would be required to keep a Turkey that continues to pursue misguided policies afloat for any significant length of time, say a year or two. Remember that earlier Greek and Cypriot attempts to get help from their Orthodox brethren in Moscow had ended in tears during the euro crisis.



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OUTLOOK FOR TURKEY

With a swift and deft policy adjustment, Turkey may still get away with a period of below-trend growth instead of a recession. So far, Turkey does not seem to be changing its policies fast enough, though. As a result, the risk is mounting that the Turkish economy may contract for a while in the absence of a credible policy change fast.

As it is tough for Erdogan to change course visibly, he will likely try to get by for a few more weeks with a series of half measures and half-hearted attempts to improve relations with the US and EU. That seems unlikely to turn things around decisively. On balance, we see a better than even chance that a very reluctant Turkey will eventually yield to market pressures and adjust its monetary policy in a number of steps in the next three months. It may also seek more energetically to defuse tensions with the US and the EU. But Turkey will probably shy away from many of the steps that could make the policy change very credible fast (such as iron-clad central bank independence and an IMF stamp of approval). If so, it will have to re-establish credibility the hard way instead. The interest rate hikes required to stop the rot and the resulting economic pain will thus be more pronounced than would be necessary with a more credible adjustment.

If and when Turkey changes course, two factors could help to mitigate the crisis somewhat. First, whereas Turkey's previous crises (2001 and 2008/2009) happened during global economic downturns, the world economy is now expanding at a satisfactory pace. As long as the exchange rate falls by more than domestic costs have risen, that should help to stimulate exports. Second, once the Lira is perceived to have undershot sufficiently, purchases of Turkish real estate financed by the foreign exchange holdings of Turks and foreign investors could ease the financial strains somewhat.

If Turkey does not change course on its own, markets will eventually force a wrenching adjustment on the country until a fall in real GDP has turned the current account deficit into a surplus sufficient to finance some on-going capital flight. In this context, "markets" would be largely a shorthand for Turkey's own citizens trying to protect the value of their liquid assets by shifting them into a foreign currency.

Alternatively, Turkey may theoretically choose to take an even higher dose of the drug that got it into trouble, credit-financed spending accommodated by an overly loose monetary policy. That may delay the pain for a while. But it would exacerbate the underlying problem. The correction afterwards could then feel even more like a "cold Turkey" shock.

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