

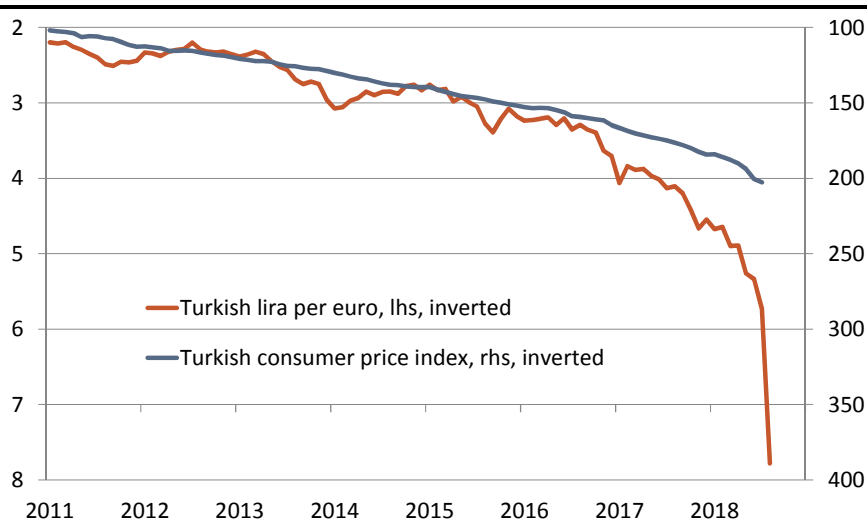


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31 August 2018

Turkey: how bad can inflation get?

Lira exchange rate to euro and domestic consumer price level



Turkish consumer price index rebased to 2010=100, last value for exchange rate 30 August 2018; inverted scaled. Sources: Haver Analytics, Bloomberg

- **The next stage:** After a temporary lull, the Turkish crisis erupted again this week. As expected, the half measures of mid-August -- to tighten monetary policy without raising the main interest rate, and to attract some support from abroad without changing policies or turning to the International Monetary Fund (IMF) – have not stopped the rot.
- **Inflation shock in the pipeline:** Turkish inflation reached 15.9% in July. The plunge in the exchange rate in August will ensure another major spike. To fully catch up with the devaluation of the exchange rate against the euro since the end of 2016, Turkey’s consumer price index would have to rise by 71% from its July 2018 level. Of course, domestic prices usually do not react fully to the exchange rate. Assuming a 75% pass-through of the exchange rate, Turkish consumer prices would still have 48% upside from July 2018 over, say, the next 18 months. For comparison, the pass-through rates into domestic prices were 100% in the wake of Turkey’s 2001-03 turmoil and 75% after Ukraine’s 2014-17 crisis.
- **Better to act fast:** How Turkey’s central bank plans to regain market confidence that it will eventually hit its 5% inflation target again remains a mystery. Only a credible U-turn in Turkish policies – raising interest rates, submitting to an IMF programme and mending relations with the US and the EU – can support the exchange rate and dampen the surge in inflation ahead. President Recep Tayyip Erdogan does not seem to be close to that yet.
- **A modest devaluation can help in the end:** For a country with a major current account deficit (c6.5% of Turkish GDP in H1 2018) and a sudden stop in capital inflows, a real devaluation is part of the solution. A decline in the exchange rate that is not fully offset by a rise in domestic prices provides the incentive to import less and export more.
- **Severe pain before the eventual gain:** Replacing imports with domestic output and shifting resources to export-oriented activities takes time, though. In the event of a dramatic rather than modest decline in the exchange rate, companies cannot afford the imports they still need. A lack of financing can delay the shift in resources. Output is likely to contract first before it recovers later on. The more dramatic the plunge in the exchange rate and the greater the lack of trust in the government and the central bank, the worse the temporary damage to output will be.
- **Contagion risks overdone:** Emerging markets are a very diverse bunch. Amid gradual Fed rate hikes in response to firm US domestic demand, emerging markets with elevated financing needs in foreign currencies face problems, while export-oriented countries without such financing needs should do fine. Even among the major vulnerable countries, hardly any other seems as determined to resist economic logic and maintain misguided policies as Erdogan’s Turkey. Argentina is in trouble but is adjusting its policies. Despite an initial risk-off reaction among investors, we do not expect a wave of emerging market crises that could seriously dent growth in the developed world.

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