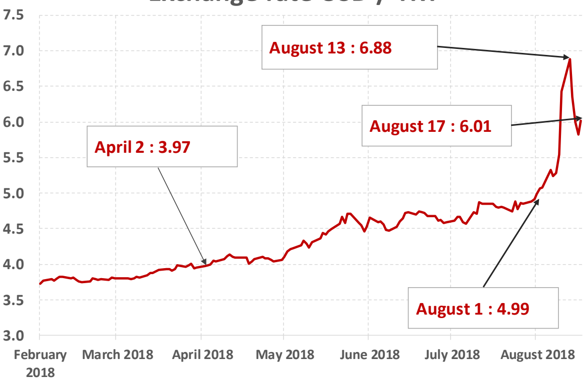
Turkey: full-blown currency crisis and Mundell's Impossible Trinity will lead to cyclical contraction

Turkey's financial crisis is now unfolding. Highlighted by our tools as particularly vulnerable, the trigger came with the combination of larger global risk aversion, domestic policy uncertainties and a flare-up in political tensions with the US. Looked-at through the so-called Mundell-Fleming Trilemma[1], potential outcomes are limited and all portend more acute difficulties in the short-term. Monetary and fiscal "over-kill policies" are needed to push the currency back to fundamental values and avoid either a protracted period of difficulty (in the case of capital controls / debt restructuring occur) or acute inflationary and banking pains (if the currency is not stabilized).

Full-blown currency crisis

The Turkish Lira (TRY) went into a tail-spin over the past weeks, collapsing from USD/TRY 5.23 on August 3rd to 6.88 on August 13th, before recovering irregularly to USD/TRY 6.0 on August 20th. Turkish authorities are trying as best as they can to calm markets, with both talks and policy substance, but so far not fully convincing.

Exchange rate USD / TRY



Sources: Datastream, TAC ECONOMICS

As mentioned in our early-June 2018 Monthly Comments, Turkey was highly vulnerable to both international conditions and domestic policies, and our tools have raised two WatchList Indications for potential systemic shocks, on the business cycle or activity and on the exchange rate, the latter in last April!

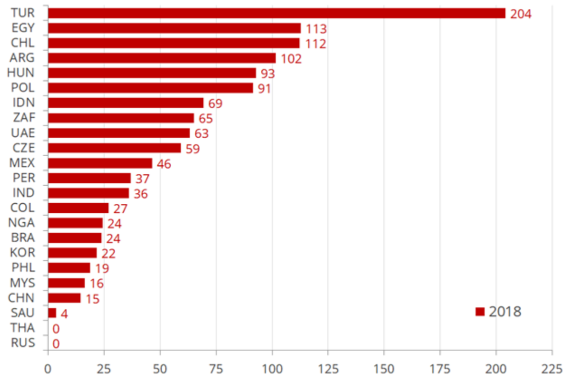
We previously assumed that Turkish authorities would have no choice but to tighten massively their monetary policy. Political developments ("triumphant" election of Mr. Erdogan as all-powerful President of the country, tensions with the US about an imprisoned US evangelical pastor) came-in to blur the outlook, increase worries about policy reaction and led to self-reinforcing mechanisms.

At more than 200% of current foreign exchange reserves, such fx requirements are excessive so that any problem in roll-over or access to market / banks' funding, or any (domestic) capital flight can mechanically create major tensions calling for immediate central bank actions.

External financing constraints are overwhelming

Turkey's vulnerability comes from its excessive borrowing requirements in foreign currency: very large short-term debt to be rolled-over, large amortization on long-term external debt (in total, USD 170bn due for the whole year 2018) add to a substantial current account deficit.

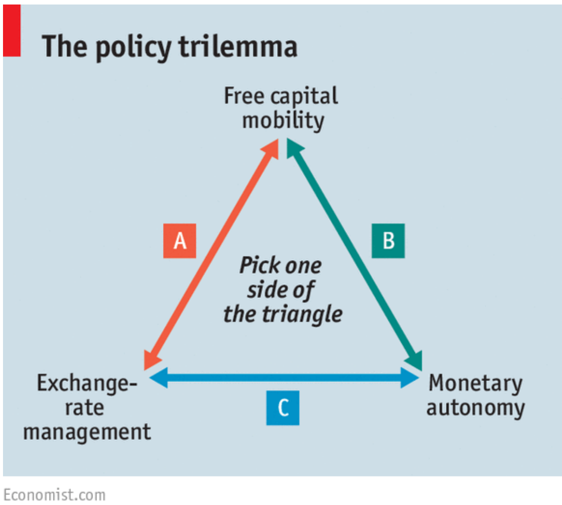
Fx borrowing requirements in % of Fx Reserves



Sources: Datastream, IMF, TAC ECONOMICS

Fx reserves were at USD 101bn at the beginning of August, of which USD 22bn are gold and USD 40bn were made of compulsory reserves on fx commitments by Turkish banks, part of which was released on August 10 to improve banks' liquidity in both TRY and fx.

Few options left: follow the Trilemma



Maurice Obstfeld, now the IMF chief economist, presented the model they developed as a "trilemma" in a 1997 paper.

[1] The theory of the policy trilemma is credited to US economists Mundell and Fleming, who described the relationships among exchange rates, capital flows and monetary policy in the 1960s.

The Impossible Trinity refers to the choice required from any policy maker regarding currency, capital flows and monetary policies. In the current case of Turkey, the options could be summarized as follows:

1- If Turkish authorities aim at stabilizing / pushing back the exchange rate to more "fundamental values" (probably around USD/TRY 5.00-5.25 when considering the inflationary impact of the past depreciation), and if they want to maintain capital mobility as they need to attract inflows, the only option is a very tight economic policy (increase in policy rates by a minimum 250-300bp, rapid reduction in domestic demand to support external accounts and avoid excessive inflationary pass-through), whatever the costs on an economic crash landing. This would be the best "technical" option, with a short duration if policies are convincing, but it has a clear and visible "political" cost for President Erdogan. Notwithstanding the stability in policy rates, the central bank has already started to provide liquidity at higher rates through specific refunding operations, local currency bond rates have jumped massively and a drastic cut in public spending is being mentioned. This remains our central scenario so far, once again validating the WatchList Indication on an upcoming acute cyclical reversal. It would still need to be associated with an "official" increase in policy rates (by at least 200bp) and some form of access to international liquidity, e.g. the potential USD 15bn loan from Qatar or potential support from Russia.

2- If economic, social or political risks associated to such a "monetary over-kill" are considered as too large, and if the aim is still a stabilization of the exchange rate, then the only option is the imposition of some sort of capital controls. They would probably be in the form of maturity extension, forced roll-over or outright fx debt restructuring; important in Turkey's case, the sovereign's financial position is strong, with limited exposure to foreign currency loans and a large portion of debt at fixed interest rates.

In both cases, the scenario would entail a large wave of corporate difficulties, and our research suggests that construction, energy, mining and food services are more vulnerable. Part of the central bank actions aim at alleviating the financial burden on indebted corporates by providing large TRY liquidity to banks and reducing their reserve requirements.

3- The last option is to let markets find a new equilibrium for the TRY while keeping a lid on monetary policy to avoid a crash landing, and keeping capital flows untouched. This is both the most unpredictable scenario (where would be the floor: potentially around USD/TRY 9-10; what would be the impact on inflation and the banking system?), and to us the least likely scenario.