Turkey and the Taper Tantrum

Modi and Jokowi's Lessons for Erdogan

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In May 2013, the U.S. Federal Reserve made the unexpected decision to begin scaling back, or “tapering,” the bond-buying program it had adopted in the wake of the financial crisis. The move triggered a sharp sell-off of assets from emerging markets, which had been the greatest beneficiaries of the ultra-loose monetary policies of the world’s main central banks. That was bad news for those countries that had used the easy money to fund themselves. The “taper tantrum,” as it became known, recalled the American investor Warren Buffet’s old line, “You only learn who has been swimming naked when the tide goes out.”

Nearly one and a half years later, the Fed is fully ending its asset purchases and preparing to raise interest rates sometime in mid-2015. Once again, Fed policy is revealing which emerging markets have strengthened their defenses against a tightening in U.S. monetary policy and which remain vulnerable.

For its part, Turkey is firmly in the latter camp.

Although Turkey’s economic fundamentals are incomparably stronger than in 2001, when it suffered a major banking crisis, the country has thrown caution to the wind -- even after Morgan Stanley singled it out last year as one of several risky emerging markets known as the Fragile Five. The countries on this list -- Brazil, India, Indonesia, South Africa, and Turkey -- are, to varying degrees, overreliant on foreign capital to finance their current account deficits. When the Fed signaled its intention to start withdrawing monetary stimulus, these deficits became more difficult to finance as international investors reduced their exposure to emerging markets.

Turkey was the most fragile of the five. At the end of 2013 -- about half a year after the Fed announced the taper -- Turkey’s current account deficit amounted to nearly eight percent of GDP -- more than double the shortfalls of India and Indonesia. More worryingly, the bulk of Turkey’s current account deficit was financed by short-term capital inflows -- that is, purchases of bonds and equities -- as opposed to more stable foreign direct investment.

Things got worse in January 2014, when a sharp sell-off of emerging-market assets led to a steep fall in the value of the lira, Turkey’s currency, against the dollar. In a last-ditch effort to shore up the lira, the
The central bank used a late-night emergency meeting to raise Turkey’s main interest rate from 4.5 percent to 10.5 percent.

The “midnight hike,” together with increasing willingness among investors to dip back into emerging markets, seemed to help stabilize Turkey’s financial markets -- so much so that the central bank started cutting interest rates in April 2014 despite a surge in Turkey’s inflation rate to 9.4 percent (up from 7.4 percent at the end of last year and nearly double the central bank’s target). Such poor economic decision-making cost Turkey’s central bank its last remaining shred of credibility. Not helping were concerns about Turkey’s involvement in the U.S.-led military campaign against the Islamic State of the Iraq and al-Sham (ISIS).

With investors now fretting about the timing and pace of a further tightening in U.S. monetary policy, Turkey is paying a price for its financial imprudence. Over the past month, the lira has lost about 3.5 percent against the dollar, and Turkish stocks have fallen a whopping 15 percent in the last three months. The yield on Turkey’s ten-year local currency bonds has shot up nearly 50 basis points since the end of July to nine percent.

Turkey’s imprudence stands in stark contrast to the efforts by India and Indonesia -- two other fragile five nations -- to allay market concerns by strengthening their financial policies and indicating that they will soon implement much-needed fiscal and structural reforms.

In India, the central bank’s inflation-fighting credibility has improved significantly since the respected economist Raghuram Rajan took its helm a year ago. Rajan has struck a hawkish tone -- he raised interest rates immediately after he was named to the post despite a slowing recovery -- and made it clear that his overriding priority is curbing inflation, which, at around 6.5 percent, is still the highest in Asia. Investors also applauded the victory of the business-friendly Narendra Modi in India’s parliamentary election in May.

In turn, over the past three months, Indian equities have risen slightly compared with a seven percent decline for emerging market stocks as a whole. The rupee, India’s currency, has lost just 0.6 percent against the dollar over the past month.

Indonesia has impressed the markets too. Last year, the country’s central bank rose interest rates 175 basis points to 7.5 percent, partly in order to defend the rupiah, Indonesia’s currency. Just as important, it has held them at this level, helping bring down inflation to 4.5 percent, from over eight percent at the start of this year. And Indonesia now has its own Modi, Joko Widodo, the reform-minded governor of Jakarta who won the country’s presidential election in July and has pledged to reduce Indonesia’s massive fuel subsidy bill and introduce other reforms to make the country more competitive.

Since the beginning of this year, Indonesian shares have surged 17 percent, compared with a 1.1 percent decline in emerging market equities as a whole. And the yield on Indonesia’s ten-year local currency bonds has even fallen slightly since the beginning of this year.

In short, markets are clearly differentiating between the members of the Fragile Five that have made wise reforms and those that haven’t. (Brazil and South Africa are in recession and flirting with it, respectively.)
Their commodity exports to China have fallen sharply, domestic demand -- particularly investment -- has declined significantly, and growth has petered out because of a dearth of structural reforms.) It is unclear how much more severely investors will penalize Turkey in the coming weeks and months, but the damage is already done. Turkey’s central bank has a serious credibility problem which markets are no longer willing to ignore.

The good news is that the central bank has at least stopped loosening monetary policy in the face of high inflation. At its monthly meeting in September, it decided to keep the country’s main interest rates on hold. The bad news is that it took a sharp market sell-off to force the bank to come to that policy. And that suggests that if sentiment toward emerging markets were to suddenly improve again -- a distinct possibility given how fearful the Fed is about raising interest rates prematurely -- Turkey’s central bank would slip back into its bad old ways.

Turkey must strengthen its defenses by attending to its domestic and external vulnerabilities. Its central bank should not think about cutting rates further until inflation is firmly under control. The government, for its part, needs to implement fiscal and structural reforms to rebalance the economy away from consumption in order to lower what remains a dangerously high current account deficit. If sentiment toward emerging markets deteriorates sharply once more, Turkey will be one of the hardest-hit emerging markets because it has allowed itself to remain dangerously exposed.

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