To the point!

Cross-Asset- and Strategy-Research

A Postcard from Istanbul

LBBW_Research

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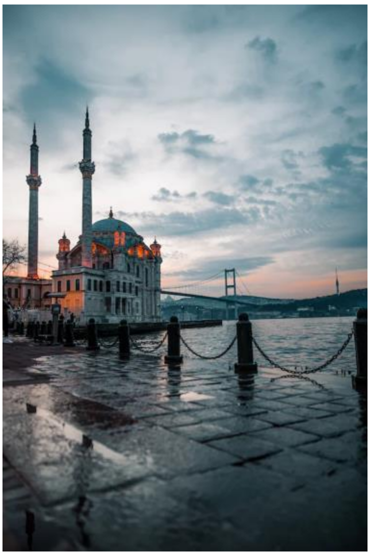
Turkey on the brink of a balance-of-payments crisis

Today I write to you from Turkey. A country with a fascinating culture and rich history, but, unfortunately, also a country with an uncertain economic future. The inflation rate is rising to ever new record highs. After already just below 20% a year ago, it reached almost 80% in July, with an upward-moving trend.

At the same time, economic momentum remains significantly below its potential. The average growth rate over the preceding five years (2018-2022) has almost halved compared with the previous five-year period, to 3.8%. This is still a respectable figure, but due to the rapid devaluation of the lira, the Turkish population's purchasing power is dwindling. Unemployment has risen structurally since 2012. According to UN estimates, after more than a decade of net immigration, Turkey has once again become a country from which more people emigrate than move in.



Erdogan's idiosyncratic monetary theory

A major factor behind the crisis in Turkey is the misguided monetary policy of a central bank that has been deprived of its autonomy over the years. President Erdogan (AKP party) fired no less than three governors since 2019, apparently because they did not follow his somewhat cranky monetary philosophy with sufficient enthusiasm. The last time a governor had been fired before was during the military coup in 1981.

Monetary policy out of control: inflation at 80% and rising

For Erdogan, the interest rate is the price of money. High interest rates to him mean higher costs and prices and therefore more inflation. It follows, for Erdogan, that interest rate cuts are a tool to combat inflation. Accordingly, the current governor (and AKP politician), who was appointed in the spring of 2021, has gradually lowered the repo interest rate from 19% to 13%.

The last time inflation was around 80% as today (1998), interest rates were also close to 80%. Back then, it took six years and two recessions to push inflation back below 10%.

The foreign exchange reserves have disappeared

Confidence in economic policy has suffered significantly. Since the beginning of the year until July, net portfolio investments of $5.7 bn have flowed out of Turkey (year-earlier period: -$0.1 bn, estimates by the Institute of International Finance).

The central bank is left without reserves

The central bank's foreign reserves have virtually evaporated as a result of misguided attempts to support the currency. In 2019, they stood at an, already modest $60 billion. Now, the net reserves are close to zero. No other emerging market is in a comparably weak position.

Presidential elections as a glimmer of hope?

The polls point to a change of power in 2023

Presidential elections must be held in June 2023 at the latest. The economic situation is taking the wind out of incumbent Erdogan's sails. The polls point to a change at the head of state. In the 2019 local elections, Erdogan's AKP already lost the mayoral seats in all of the country's major cities, including here in Istanbul.

A new president, if elected, will have a difficult legacy. The inflation rate will, most likely, be out of control when he takes office. The higher echelons of public institutions, from the judiciary to the central bank, are staffed with AKP loyalists.

Erdogan's successor must take a cue from the president who prescribed a comprehensive reform program for Turkey in 2002, thus advancing society and the economy.

His name? Recep Tayyip Erdogan.