Confluence Investment Management

Bi-Weekly Geopolitical Report

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The Turkish Experiment

The Turkish economy is being roiled by spiking inflation and a sharp decline in the Turkish lira (TRY). The orthodox response to such a macroeconomic crisis is austerity. Fiscal and monetary policy become tight; taxes are raised, or spending is cut, or both occur and interest rates are increased. The goal is to depress domestic demand because the root cause of these problems is usually a persistent current account deficit. Reducing domestic demand usually leads to a reduction in the current account deficit.

Turkish President Erdogan has adopted a heterodox response to the current crisis. He has fired numerous officials of the Central Bank of the Republic of Turkey (CBRT) over the past two years who insisted on raising interest rates to address the aforementioned problems. Since July 2019, when Erdogan relieved Murat Cetinkaya of the governorship of the CBRT, he has installed three governors in less than three years. Erdogan believes that increasing interest rates leads to higher inflation on the idea that increased borrowing costs will be applied to prices. This position is at odds with the normal prescription for addressing an inflation and currency crisis.

In this report, we will begin with a review of the basic economics of savings balances and how current account deficits are created and funded. From there, we will provide an examination of Turkey's current economic situation. The next section will deal with the government's response. We will close with market ramifications.

The Economics of Savings Balances

GDP = C + I + G + (X-M)

Gross domestic product is the combination of consumption (C), investment (I), government spending (G), and the trade balance (X-M). All things produced and consumed must fall into the above equation's components—in other words, everything produced is either consumed by households, represents investment for firms, consumed by the government, or consumed by foreigners via exports and domestic consumers/domestic firms' investments via imports.[1] From the funding perspective, the domestic economy comprises consumption, saving, and taxes.

GDP = C + S + Tx

In this second equation, C and I still reflect consumption and investment, respectively, but S is gross private saving and Tx is taxes.

So, by equating these two together, we get the following:

C + S + Tx = C + I + G + (X-M)

Rearranging again gives us this identity:

S + Tx + M = I + G + X

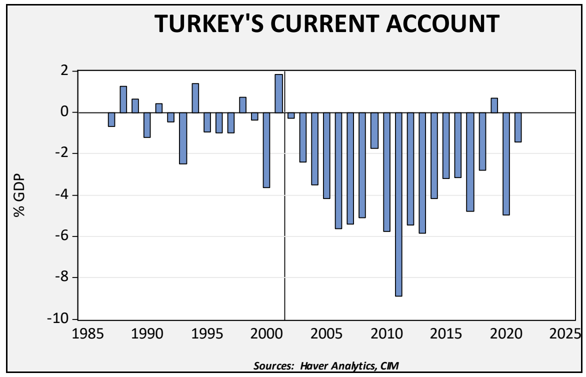
Simplifying and rearranging again:

0 = (I-S) + (G-Tx) + (X-M)

[1] To avoid double-counting, imports are subtracted from GDP.

This identity means that the private investment/savings balance (I-S) plus the public spending balance (G-Tx) is equal to the trade account. This is true in the same way a balance sheet is true—the numbers will simply add up that way. So, a trade deficit doesn't occur because our goods and services fail to sell well abroad, or because foreigners are evil and are taking advantage of us.[2] The bottom line is that the current account (trade, mostly) deficit occurs due to investment exceeding domestic saving or the government running a large fiscal deficit.[3] In general, as long as foreign investors have confidence that a nation's policymakers will protect foreign investors, the nation can run persistent current account deficits. But, if foreigners lose confidence, the orthodox response is to rebuild domestic saving. This can be done by reducing private investment relative to private saving or running a fiscal surplus.

Turkey has been running persistent current account deficits.



This chart shows Turkey's current account scaled by GDP. The chart clearly indicates Turkey has been running persistent current account deficits. We have placed a vertical line designating when Erdogan took power in Turkey. Initially, he was not able to officially hold office even though he led the AKP to an electoral majority. His public support of Islam made it illegal for him to hold public office until the law was changed. But, since 2002, Erdogan has effectively been in power.

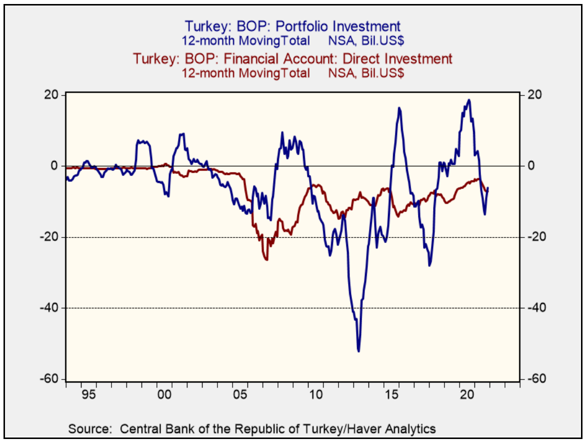
A current account deficit gets funded by attracting foreign saving through investment or by drawing down foreign reserves. There are two types of foreign investment—portfolio investment and direct investment, which is foreigners either building "greenfield" businesses or buying existing ones. Portfolio investment can be in either equity or in fixed income. As a general rule, we can gauge the confidence of foreign investors by what they invest in; if the bulk of investment is direct, investors are confident enough to build or hold an asset that is illiquid.[4] On the portfolio side, equity is considered a sign of confidence relative to fixed income. After all, the latter pays interest, which is an incentive to invest. The least confident foreign investors only hold short-term fixed income.

[2] Actually, foreigners might be, but not in the way it is usually portrayed in the media. The regular narrative suggests that foreign governments subsidize exports or apply trade barriers to imports. That may be true, but macroeconomically this leads to less foreign consumption and higher foreign saving. If foreigners oversave, they will run a trade surplus; so, by depriving themselves of consumption, they provide exports (saving) to the world. This outcome can be a deliberate policy, which could be described as confiscating foreign demand.

[3] Even that can be complicated further; for example, the "bond conundrum" of the period in the early 2000s was caused by foreign oversaving that depressed U.S. interest rates despite tighter monetary policy.

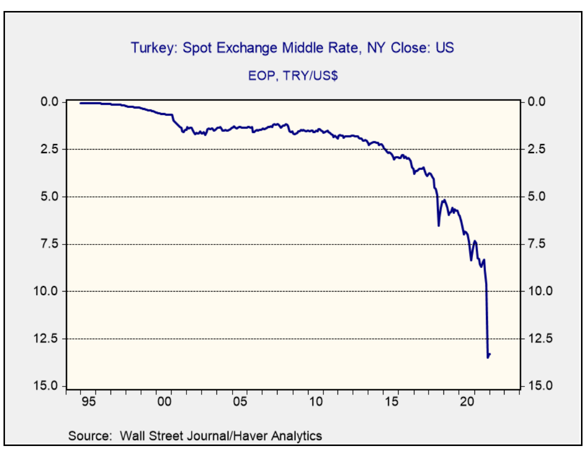
[4] Buildings are hard to move as are the physical locations of businesses.

As the chart below shows,[5] Turkey saw large direct investment inflows in the first decade of the century, early in Erdogan's rule. However, those flows have slowly dwindled over time. Portfolio investment, on the other hand, has seen wide swings.



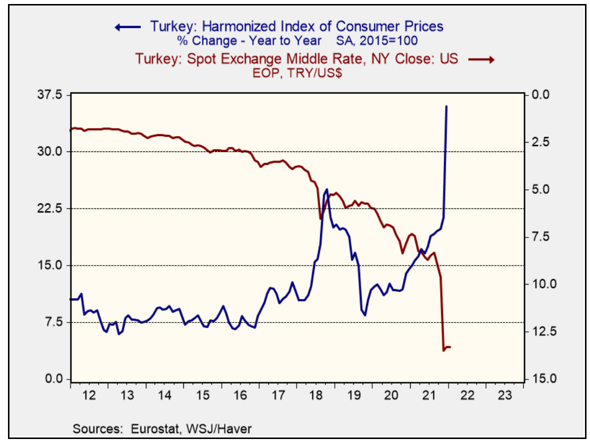
Foreign investors can be fickle. The outflows (positive levels) seen in 2016 are likely tied to the failed coup.[6] Outflows in 2020 were caused by the pandemic. Although concerns about domestic policy can make foreign investors "nervous," overall political instability can as well.

The lira/U.S. dollar (TRY/USD) exchange rate has been on a steady decline for years.

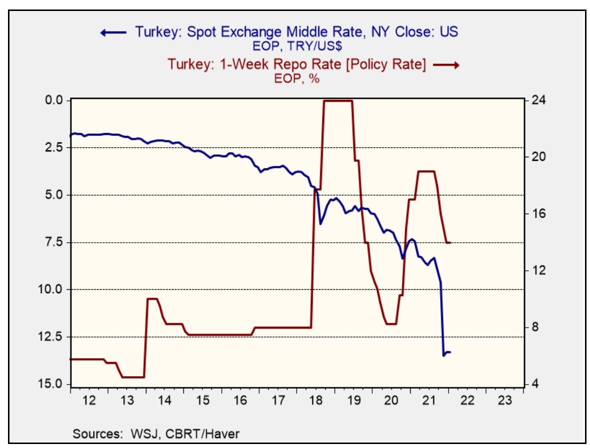


[5] In balance of payments notation, a negative sign means an inflow from foreign investors, while a positive sign means an outflow.
[6] See *WGRs*, "The Turkish Coup, Part I (7/25/2016), II (8/1/2016), and III (8/8/2016)."

This chart shows how many lira it takes to buy a dollar. The drop in the exchange rate coincides with rapidly rising inflation.



In 2018 and in late 2020, when there was an acceleration in TRY depreciation, the Central Bank of the Republic of Turkey (CBRT) would raise interest rates to stem the currency weakness.



This action would improve foreign investor confidence and stabilize the currency. However, as noted above, Erdogan's decision to fire central bank heads who raise interest rates has led to a change in the policy of hiking rates in response to currency depreciation. As the above chart shows, the CBRT has been cutting interest rates and the exchange rate has been falling too.

The Theory Behind Erdogan's Heterodoxy

Standard economics holds that there is an inverse relationship between interest rates and inflation. Or, more specifically, it harkens back to Knut Wicksell, who postulated that there is a "natural" rate of interest that balances saving and investment. If a central bank sets the interest rate below the natural rate, inflation develops. In the opposite case, setting the policy rate above the natural rate leads to recession.[7]

The economist Irving Fisher used a simple equation to postulate a radical proposal.

$R = r + i$

In this equation, "R" is the nominal rate, "r" is the real rate, and "i" is inflation. The central bank controls R. Let's assume the real rate, r, is 2% and the central bank sets the policy rate at 5%. For the equation to work, inflation must be 3%. The ramifications of this theory are obvious; if the central bank wants lower inflation, it needs to lower interest rates!

The debate over this theory is vigorous. We won't go into the academic debate in detail, other than to observe that the issue comes down to the direction of causality. Fisher believed that r was mostly unchangeable. That probably isn't true. Logically, the equation can be described as suggesting that the use of umbrellas causes it to rain. Thus, if we want dry weather, people should leave their umbrellas at home.

Still, even though Neo-Fisherian ideas may not be mainstream, in the hands of a policymaker, it can be a useful tool. Erdogan can argue that there are some economists that agree with his notion that cutting interest rates will reduce inflation. Erdogan wants a robust economy and doesn't want foreigners interfering with his governance of the country. By opposing interest rate hikes, he is hoping to lift growth and is spurning the advice of the foreign mainstream; after all, the IMF would not condone a Neo-Fisherian policy solution. It should also be noted that the weak exchange rate will tend to boost exports, meaning the government isn't all that worried about the recent decline in the currency.

Dealing with the Economy

Despite the intellectual discussion above, Turkey has real economic problems. As noted earlier, inflation is elevated. Inflation causes hardship; households are cutting back on spending and are cashing in precious metals long held for saving. In fact, Erdogan has recently taken a step that authoritarians tend to do when receiving bad news—the head of government statistics was fired for releasing inflation data. Inflation appears to be contributing to "brain drain," when the skilled leave the country for better opportunities. The currency is in free fall. Both outcomes are related; a weaker currency drives up import prices. Imports represent 34.7% of GDP and have been steadily rising.[8]

Clearly, something has to be done. Erdogan has made two important policy actions to try to improve the economy. First, he unveiled a scheme designed to encourage households to own lira deposits. In countries with persistent currency depreciation, households and firms will often hold foreign currency deposits. In Turkey, foreign currency holdings have a 60% share of total deposits. To get households to shift from dollars to lira, the government has created accounts that will compensate the depositor for a given level of lira depreciation. The

[7] Federal Reserve discussions of R* are based on this theory.

[8] In 2000, imports represented about 20% of GDP.

accounts pay 14% interest and must be held for a year.[9] If the currency depreciates by more than 14%, the government will compensate the difference. The accounts will have stiff penalties for early withdrawal.

Why would the government do this? The goal is to decrease dollarization of the economy. If households desire dollars, the demand for dollars encourages depreciation. If these accounts lead to less dollar demand, it should allow the exchange rate to stabilize. The downside is that if the TRY does depreciate, the government will be forced to expand its spending to make up the difference. As the saving equation above shows, a larger fiscal deficit could cause the current account deficit to deteriorate further. The Erdogan government is hoping that by taking away the perceived risk of currency depreciation, households will reduce their dollar demand; if the program fails, the fiscal spending could further undermine confidence. It's a bold strategy.

The initial reaction to the plan appeared supportive as the TRY rallied on the news. However, there were reports that the CBRT also intervened by selling dollars, which is a drain on reserves. At present, the plan may have arrested the decline in the TRY, but it doesn't address the underlying concern about policy not appropriately balancing saving and investment.

The second program initiated by Erdogan is expanding currency swap lines with regional governments. Turkey announced lines have been established with Qatar and the UAE and there are talks about a line with Azerbaijan. These swap lines essentially facilitate trade in local currencies. The lines themselves boost the reported level of reserves, although holding reserves in dirhams[10] has less buying power than dollars or euros. Still, if Turkey, the UAE, Qatar, and Azerbaijan can increase trade and not use dollars, it should preserve hard currency reserves that might have been used to facilitate trade with these countries.

An Observation

Inflation is a challenge for all economic actors. In addition to the obvious day-to-day concerns about making ends meet, inflation distorts the unit of account function of money. Undermining money is dangerous for any society.[11] Whenever we see rapidly rising inflation in any nation, we pay close attention because it can act as a natural experiment for seeing how actors behave.

This chart shows the MSCI Turkey stock index in TRY terms with dividends and the level of CPI both indexed to August 2018, when currency depreciation accelerated. Although the equity index has, at times, clearly underperformed inflation, it has generally moved higher with price levels.

[9] Observant readers will note that this is a deeply negative real interest rate.

[10] Currency of the UAE

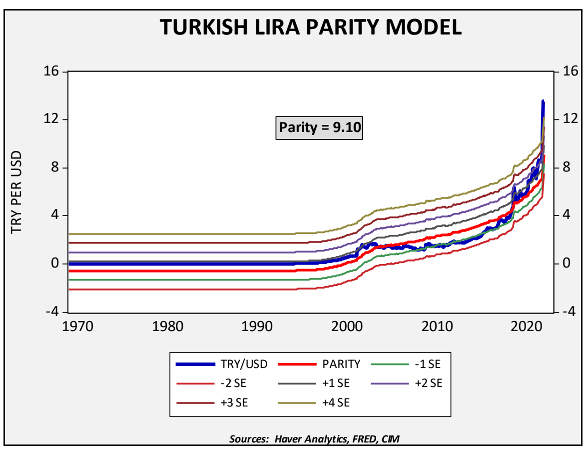
[11] "The best way to destroy a capitalist system is to debauch the currency." This quote was ascribed to Vladimir Lenin by John Maynard Keynes in his work *The Economic Consequences of the Peace*. Although this sounds like something Lenin would say, there is no evidence he ever said it. But, the truth of the comment still holds.

Although inflation is usually a bearish factor for equities, if transaction costs are low enough, equities may offer some protection against inflation.[12]

Ramifications

For dollar investors, Turkey is fraught with risk. The MSCI Turkey index denominated in dollars has seen double-digit annualized losses for the past three months. However, at some point in the future, Turkish assets may become attractive.

First, general elections will be held by or before June 18, 2023. Given the state of the economy, opposition to Erdogan will likely be elevated. Current polling suggests that Erdogan would not win outright and would face a runoff vote, although he would likely prevail in the second election. Still, if he were ousted and orthodox policies were implemented, the exchange rate would be undervalued and Turkish assets would likely rally.



The current exchange rate is more than four standard errors from purchasing power parity, suggesting the financial markets have discounted a good bit of bad news for Turkey. At this juncture, we believe it is too early to step into Turkish assets, but if some clarity develops on the policy front, there is ample room for a strong recovery.

More broadly, the West really can't afford to see Turkey face an economic crisis. Turkey acts as a barrier of sorts to Middle Eastern refugees, so if it decides to open its borders, the impact on Europe would be profound. Turkey is a key nation in an unstable region; major oil and natural gas pipelines traverse the country. Also, Turkey has sold some important weaponry to Ukraine. If the current crisis were to worsen, perhaps the guaranteed currency accounts described above fail to stabilize the TRY, the West may be inclined to encourage the IMF to provide financing at favorable terms.

Overall, we have our doubts that Erdogan's schemes to stabilize the economy will work and probably the most favorable outcome for foreign investors would be a new government. For now, we believe Turkey is appropriate for only the most risk-tolerant investors.

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[12] It is also worth noting that the rise in Turkish equities is in local currency only. In dollars, the MSCI Turkey index fell 31.2% last year.

Confluence Investment Management LLC

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