Euromoney Country Risk

Turkish political risk compounds vulnerability to US tapering
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By ECR - Jeremy Weltman, **Thu Jan 30, 2014**

Central bank takes action to mitigate a prolonged lira slump.

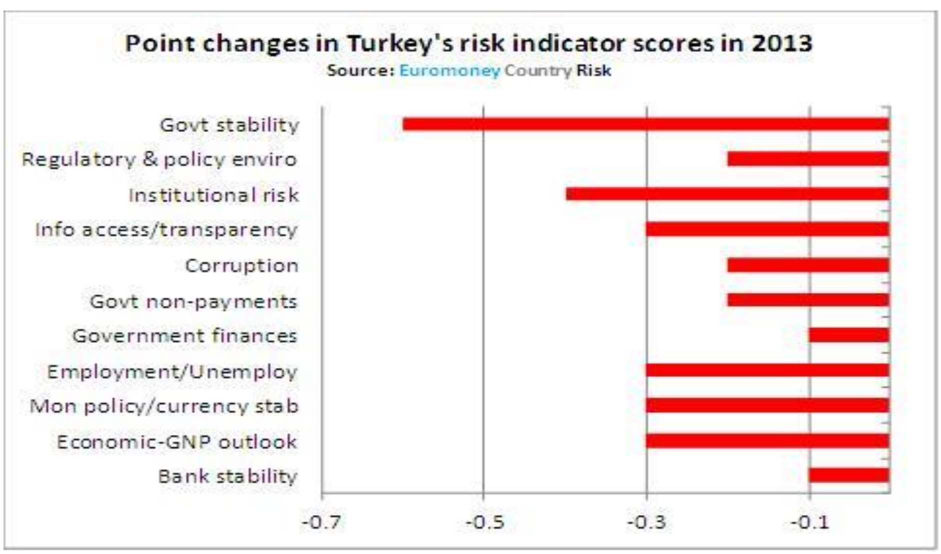
The central bank's decision to sharply increase interest rates on Tuesday to shore up the currency will undermine growth prospects, but is intended to mitigate a crisis that has its roots in a large current-account deficit exceeding $50 billion (more than 7% of GDP).

With dwindling reserves, this makes Turkey overly reliant on inward capital flows, especially as less than a fifth of its capital account is in the form of stable foreign direct investment.

The crisis has political elements, too, highlighting the government's poor policymaking and a corruption scandal affecting the Justice and Development Party of prime minister Recep Tayyip Erdogan.

Euromoney's survey contributors were on the ball last year, downgrading Turkey's score by 1.2 points – one of several large emerging markets to succumb to rising risk perceptions.

Scores for all five of Turkey's economic risk indicators were lowered, including monetary policy/currency stability – signalling lira depreciation and a higher inflation rate, which rose to 7.4% year-on-year at the end of 2013, missing the central bank's 6.8% target.



ECR expert M Nicolas J Firzli, director-general of the World Pensions Council, states: “The current retreat in emerging markets equities, bonds and currencies should come as no surprise to those old enough to remember the 1997 to 1998 Asian financial crisis.

“In many ways Turkey – along with Argentina and South Africa – offer ‘archetypal’ examples of the excesses that have come to define some key developing nations in the past 10 years: deep-rooted monetary complacency that the Fed’s overdue ‘tapering’ finally made visible, over-reliance on foreign investment in domestic assets – due to the lack of a solid national pension funds base that can act as a cushion in more sophisticated jurisdictions such as Chile, Mexico, South Korea and Hong Kong – and, more importantly, ageing-related public policy reforms.”

The government is at loggerheads with the central bank over tightening monetary policy, fearful of the political ramifications. The country has witnessed street demonstrations and is preparing for presidential and local elections this year, to be followed by parliamentary elections in 2015.

As Firzli explains: “In this new crisis, Turkey has the unenviable distinction of being the worst-case jurisdiction: its government has blamed the – rather predictable – fall of the lira on a sinister ‘interest-rate lobby’, abandoned its successful ‘zero problems with our neighbours’ stance in favour of foreign policy adventurism – openly encouraging insurgent groups in Syria and the North Caucasus – threatened Cyprus over the development of that EU nation’s natural gas resources, interfered aggressively in Israeli-Palestinian affairs, etc. ”

“And then, in January 2014, the Turkish government embarked on a mass purge of its – largely secular and western-educated – judiciary, thus jeopardizing two essential country risk indicators: an independent judiciary and respect for the rule of law. ‘*Countries are well cultivated, not as they are fertile, but as they are free*’ said Montesquieu: a maxim Prime Minister Erdogan should meditate as risk-averse institutional investors exit the country in droves. ”

All six of the country’s political risk indicators were downgraded last year, with government stability and institutional risk succumbing to the largest score-shifts.

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