Turkey’s Currency Crisis: What Happened, What’s Next, Why It Matters

Turkey’s political and economic crisis has sent its currency tumbling to a record low against the U.S. dollar Friday and unsettled investors amid fears that the contagion may spread from the small southern European economy into financial markets around the world.

So what’s going on in Turkey, and why are its problems triggering such a significant reaction from investors as far away as Tokyo and Toronto? Let’s take a look as the origins of the country’s crisis and what it could mean for global financial markets as we head into the autumn.

The Beginning

Turkey’s President, Recep Tayyip Erdogan, has dominated the country’s political and cultural landscape for much of the past 15 years, winning praise from international investors — and the support of the United States — for steering the country’s reform program, reducing its crippling inflation rate, growing the economy by around 60% in real terms and brokering a difficult peace agreement in the unsettled southeastern region of Kurdistan.

However, a failed 2016 coup, as well as a series of terrorist incidents related to the fragile Kurdish peace, sparked a notable change in Erdogan’s leadership. Once he regained power in Ankara, Erdogan and his Islamist AK Party plotted a far more conservative course of government, shutting down media outlets, arresting judges and opposition lawmakers and, most notably for foreign investors, pressuring policymakers at the country’s central bank.

Enemy of Interest Rates

Erdogan's political shift, however, could only be deemed successful by the western-influenced Turkish population if he was able to deliver strong economic growth alongside it. For that reason, he thought it necessary to both urge the country's banks to lend more money to fuel its expansion, while simultaneously calling for the central bank to cut interest rates in order to make the loans more attractive.

"I am an enemy of interest earnings. I see it as a tool of exploitation," he said in October 2016, a view he upgraded earlier this year to "the mother of all evil".

The unsurprising result was a surge in inflation, which now sits at just under 16%, and the long, steady decline in the Lira, which fell 18% against the dollar in 2016 and traded at 3.42 to the dollar in early 2017.

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The Lira slumped to a fresh all-time low of 6.4915 against the dollar Friday, extending its year-to-date plunge past 30%, before paring the decline to 5.99 after a trade delegation of senior government officials left Washington yesterday with no verifiable progress on the White House's decision to review Turkey's "duty free" access to the U.S. market.

That restriction is part of an ongoing spat with Ankara over the arrest of the evangelical American pastor Andrew Brunson, whom officials accuse of involvement in the failed 2016 coup.

The modest rebounded was snuffed out, however, by a defiant speech from President Recep Tayyip Erdogan, who urged Turks to take the gold from "under their pillows" and convert it into lira, vowing that "we are only responsible to our own people and our own righteousness."

President Donald Trump responded via Twitter shortly after, announcing he would double the level of tariffs applied to Turkish steel and aluminium imports, a move that extended the lira's decline past 6.53 against the dollar and pushed U.S. equity futures deeper into the red.

Turkey is the world's ninth-largest steel exporter, according to IHS Global data, with around 12% of its total going to the United States, its single biggest buyer.

Donald J. Trump

✔*@realDonaldTrump*

I have just authorized a doubling of Tariffs on Steel and Aluminum with respect to Turkey as their currency, the Turkish Lira, slides rapidly downward against our very strong Dollar! Aluminum will now be 20% and Steel 50%. Our relations with Turkey are not good at this time!

Dollar Dollar Bills Y'all

Turkey's biggest, and most immediate, problem is linked to the fact that it can't support the Lirawith conventional means: Erdogan won't allow the central bank to raise its benchmark lending rate (which sit at an eye-watering 17.75%) and doesn't have the requisite amount of U.S. dollars to defend its decline on foreign exchange markets.

In fact, it holds virtually no U.S. dollars in its $80.7 billion worth of foreign currency reserves despite shifting more than $1.7 billion worth of goods to the United State each year. And while China recycles much of its trade cash into U.S. government bonds (it owns around 6.8% of the $18 trillion in outstanding US debt), Turkey prefers to purchase gold, which as fallen more than 7.4% in dollar terms over the past give years, again thanks to its President's feelings on the mendacity of compound interest.

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Erdogan is left with few choices at present, with the option of backing down on his distaste for interest rate hikes, issuing capital controls or seeking bailout support from the International Monetary Fund.

However, comments last night at a rally in the Black Sea province of Rize suggest he's not ready to reach for any of them;

“Don’t forget, if they have their dollars, we have our people, our God,” he said. “We are working hard. Look at what we were 16 years ago and look at us now.”

Bank On It

European lenders might be the first, and most significant, casualties from the Turkish meltdown, given their expose to the domestic market on their already-fragile balance sheets. Three major regional lenders — France’s BNP Paribas (BNPQY) , Spain’s (BBVA) and Italy’s UniCredit (UNCRY) — slumped to the bottom of the Stoxx 600 Friday amid reports that the European Central Bank has expressed concerns for their potential vulnerability to Ankara and their collective €135 billion exposure.

As we’ve seen on many occasions, in Europe and elsewhere, if banks aren’t sure what’s on a rival’s balance sheet, they’re not likely to lend them money. And if they stop lending to each other, it’s not long before they stop lending to the broader economy, which is exactly what Europe doesn’t need as it grapples with Brexit risks and negotiates a new trade arrangement with the United States.

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The euro fell to a 14-month low of 1.1458 against the dollar Friday, while benchmarks in Germany and France fell more than 1%, amid the global market upheaval.

The euro’s decline has pushed the U.S. dollar index, which tracks the greenback against a basket of six global currencies, to a July 2017 high of 96.05 and taken benchmark 10-year U.S. Treasury yields to a multi-week low of 2.89%.

Further emerging market weakness, which would drive the U.S. dollar higher, could both slow the Federal Reserve’s projected path for rate hikes and blunt the ability of American companies to sell their goods in overseas markets as low-priced competitors undercut the surging greenback.

Why it Matters

Turkey’s economy, at around $860 billion, isn’t terribly huge, but it’s four times larger than Greece and around 6.5% of total Eurozone GDP. It’s also a key NATO ally with around 80 million people that sits in one of the most strategically import areas on the globe and has acted as a wedge between Europe and the Gulf region for more than half a century.

A spiralling crisis could entice the more than 3 million Syrian refugees currently residing in Turkey, as well as Turks themselves, into migrating further into the EU, a move that would only harden the resolve of populist political movements in Italy, where the government is already debating the scrapping of a balanced budget clause in the constitution, and elsewhere.

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