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Erdogan's Witch Doctor Approach to Turkey's Economic Crisis

He Must Be Hoping for a Miracle

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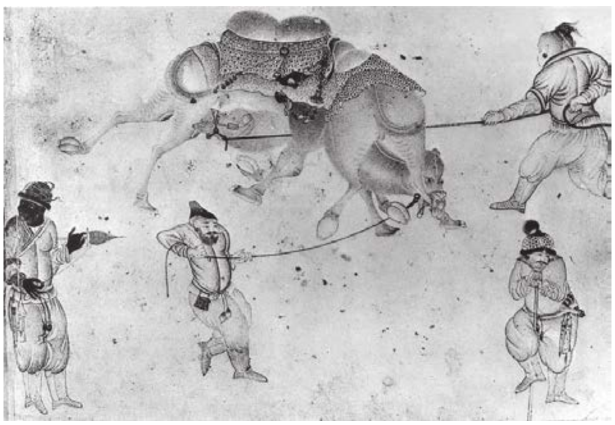

Turkey's current economic free fall — reflected most starkly in the Lira losing one-half its value in a year's time and a dramatic loss of confidence by investors both within the country and abroad — has been in the making for more than a decade and a half.

In no small way, this is due to the micromanagement of the economy utilizing contrarian policies by Turkey's autocratic ruler, Recep Tayyip Erdogan, ever since his rise to prime minister in 2003 and his election as president in 2014. As Erdogan continues his self-defeating economic approach — indeed, doubling down on it as the crisis deepens — frankly it's hard to see a way out of the mess.

The big picture problem for the Turkish economy has been its long-standing low national rate of savings by households, firms and government.

Turkey has one of the lowest saving rates in the world, especially when compared with cohort countries. In order to grow, Turkey has become a large net borrower from the rest of the world.

The result is the nation's current account deficit has been ballooning year after year.

Ninety per cent of external public and private sector debt is denominated in foreign currencies. That fact in and of itself is not problematic. But because of Turkey's falling currency, that debt just got a whole lot more expensive, and the price tag is rising each day.

The usual course for governments to get assistance to repay their liabilities is to get financing from the International Monetary Fund (IMF). But Erdogan has signaled he does not trust "Western" institutions and has shunned the IMF. That is not the best signal to send to your citizenry if one wants to inspire their confidence to save more.

Turkey's large businesses and banks have been borrowing heavily often in foreign currencies to take advantage of low interest rates abroad to grow at home, particularly in developing mammoth construction projects awarded by Erdogan's public procurement contracts. About $300 billion of Turkey's corporate debt is dollar denominated.

Such large borrowings cannot last forever, however, especially when they are not used to finance long run investments that engender sustainable growth, such as in education and health care.

The demand surge produced by Erdogan's favoured investments — in the materials, labour, and consumer markets — has heightened inflation and drove down the value of the lira. Today, inflation is 18 per cent.

Combating inflation ultimately requires raising interest rates, an action Erdogan loathes on philosophical — almost theological — grounds. His view, espoused publicly time after time directed at the country's central bank, is that higher interest rates benefit the rich while exacting costs on the middle and lower classes.

For a long time, the central bank did not challenge Erdogan and kept its benchmark rate at just 17.75 per cent — meaning the real (adjusted for inflation) interest rate in Turkey was less than 1 per cent. This artificially low interest rate only engendered even more borrowing — just the opposite of what is needed to boost the saving rate.

The consequence? Erosion of the bank's credibility and independence. If that wasn't enough, Erdogan appointed his son-in-law as the economic tsar, further politicising the central bank.

Repairing the loss of confidence in a central bank to act independently takes years — if not decades — to accomplish.

But on September 13, the central bank defied the president and hiked its benchmark rate to 24 per cent and the value of the lira rose significantly. Hopefully, Erdogan can learn from this. The question now is: will the central bank continue its path toward rationality?

Attention is now on fiscal policy. Erdogan's toolbox seems rather empty here. Rather than using the executive branch's tax and spending instruments to condition people's incentives in the marketplace, he has exhorted the population to curb their consumption habits.

That strategy almost always falls flat on its face.

At the same time, Erdogan has been talking down foreign investors, preferring to give public procurement contracts to local firms. Foreign investors don't need much of hint to know when it's time to proactively pull out.

But when they do, the economic confidence in the host government policy apparatus is shot.

Erdogan has also made things worse at home by challenging erstwhile friends abroad. You might think since both Erdogan and US President Donald Trump have one-man ruler tendencies and are thus kindred spirits (think Putin, Xi and Kim), Ankara might want to cozy up to the White House.

And for Washington, being closer to Turkey would be wise since Turkey is a NATO ally and occupies a pivotal transcontinental land mass bridging Europe and Asia.

Instead, Erdogan spurned a request from Trump to allow the return of a priest to the US being detained in Turkey for political reasons. Trump's response? Doubling US tariffs on steel and aluminum exports from Turkey.

Perversely, but regrettably not surprising, Trump cited Section 232 of US trade law, which gives presidents the authority to take trade actions against countries whose imports threaten US national security.

Even putting aside that the return of a priest does not fit that rationale, the move by Trump — who has a misguided obsession for lowering bilateral trade deficits — is difficult to justify: the US trade deficit with Turkey is a puny 0.03 per cent.

Still, Erdogan should have known better. It's not as if Trump has been shy about slinging tariffs here and there.

The prospects for Turkey's economy in modern times have never been dimmer.

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The link to the column is here.