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Swimming Against the Tide, Toward a Cliff?

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Hyperinflation: An old and familiar foe

According to the latest official figures, prices in Turkiye (formerly known as Turkey) are rising faster than they did in the last two decades. The annual inflation rate peaked at 78.62% in June 2022, and transport and housing costs were the most prominent contributors. This extraordinarily high inflation rate puts Turkiye in 6th place, just behind Lebanon, Sudan, Zimbabwe, Venezuela, and Syria in global inflation rankings. Some independent researchers, however, estimate the annual inflation rate to be much higher, twice the official figure.

Fighting a dragon with kerosene

Turkiye's economy struggles with the same global forces as any other country in the World. The supply shortages in commodities, energy, and various food products are putting continuous pressure on prices. What sets Turkiye apart is the methods it uses to combat inflation. While central banks worldwide increase interest rates to cool demand and tame inflation, President Recep Tayyip Erdogan ditched the introductory level macroeconomics textbooks and cut interest rates, hoping to boost the economy. Erdogan has defended his "unusual" choices, arguing that lower interest rates will support production and exports and, therefore, cool inflation down through the supply side.

Moreover, he also described interest rates as "the mother and father of all evil". He has opted for more unorthodox policies to control inflation like a government scheme called "foreign exchange rate protected Turkish lira deposits". In this scheme, the opportunity cost arising from the appreciation of foreign currency types is guaranteed in case of an appreciation rate exceeding the determined TL interest rate on the maturity date of the deposit. The "innovative" policy is causing a lot of public outrage in Turkey, with its very high cost on the Treasury, while not being able to attract deposits into banks.

Having mild, moderate, and severe burns all at once

Turkish economy grew 11 percent in 2021, the fastest among the G20 countries. Yet, the high growth rate defied Okun's law, and the unemployment rate stayed persistently high at around 11%. One of the most celebrated and famous Turkish economists, Daron Acemoğlu, explains this curious fact with the lack of "quality" growth - sustainable growth that increases productivity and leads to an increase in employment. It is also a well-known fact that Turkish growth was mostly driven by the construction sector, with limited employment opportunities. Furthermore, professor Acemoğlu highlights that Turkish institutional quality indices severely deteriorated in the last decade, which led to a decline in democratic principles and more income (and wealth) inequality.

Moreover, cutting the interest rate from 19% to 14% caused a steep depreciation of the Turkish lira, which severely increased import costs, and thus making life more and more difficult for ordinary Turkish citizens. Rising import costs also increase the need for foreign currency, which was close to USD200bn this year. As a result, the foreign trade deficit has also widened, and the cost of insuring exposure to Turkiye's sovereign debt (Credit default swaps, or CDS) constantly reached new heights. As a result, the premium demanded by investors to hold Turkish debt over the safe haven U.S. Treasuries is now in the same league as that of Russia.

A Possible Default by default?

The question in everyone's mind is whether a sovereign default is possible for Turkiye, and looking at CDS data, it seems most investors have a dire prediction. Under rising CDS

pressure, the yield on the country's 10-year dollar bonds also rose to an all-time high. Many economists also expect that geopolitical developments (War in Ukraine, for instance) will be a more significant determinant for global financial markets for the remainder of the year than the macroeconomic fundamentals (e.g. depreciation of the currency). This would undoubtedly hurt countries like Turkiye, whose exports are heavily dependent on Europe - regardless of the competitive advantage, the currency depreciation provided.

On one hand, the Turkish government has lower debt than many of its peers, like Greece. Debt as a percentage of GDP, on the other hand, may not be the most reliable indicator. Turkish private sector is crippled with high debt, and many sovereign risk assessment agencies highlighted the high leverage of the private sector as a significant risk factor. Also taking into consideration the investor sentiments, nobody knows how long investors will trust Turkiye to be able to make repayments in the midst of a turmoil. Fitch and S&P downgraded Turkish sovereign risk ratings within the last year, and all major assessment agencies consider the economic outlook "negative". Therefore, Turkiye seems to be heading to a cliff, and it is anyone's guess what happens after the fall.

Do we have to jump off the cliff?

Then, the next question becomes whether the cliff can be avoided. Many economists agree that Turkiye has passed a critical threshold and "fine-tuning" measures are longer viable. Instead, the current consensus recommends a complete overhaul of the macroeconomy with some structural reforms. To start with, the central bank's independence has eroded since AKP came into power, and many observers highlight the lack of autonomy as the main culprit for the Central Bank's poor performance. Previous economics literature showed a statistically significant negative relationship between the central bank's independence from the government and the country's inflation rate. Leaving the monetary policy choices to non-partisan bureaucrats seems to be the best medicine – also for Turkiye.

Regarding fiscal policy, abandoning the FX protected deposit scheme would give the government some degree of freedom to spend its budget in productive ways. Research in macroeconomics documented that government spending on health, education and infrastructure are growth-enhancing. Turkiye, without a doubt can benefit from improvements in her health and education sectors. For example, the global ranking of Turkish students in the Programme for International Student Assessment (PISA) has continuously deteriorated in the last 2 decades. Among OECD countries, Turkey has one of the lowest health expenditures as a percentage of the GDP and in a recent survey, 45% of the population reported problems with accessing health services. Thousands of Turkish doctors and nurses also have left Turkey for Western Europe, mainly Germany, in recent years. Needless to say, this exodus is caused by not only the economic crisis, but also by poor working conditions and the threat of violence.

However, apart from sound monetary and fiscal policy, Turkey also desperately needs good governance. Improving the legal system, for instance, and ensuring its independence from the executive branch, as well as and decreasing widespread corruption would attract foreign investment moving forward. In addition, reducing policy uncertainty would help to consolidate corporate and banking balance sheets.

All these structural reforms, however, need political will. And whether that aforementioned political will exists, is the million-dollar question.