

Commentary, June 22, 2018

POLITICS, CURRENCY AND ELECTIONS: THE CASE OF TURKEY

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In a financially fragile country, it may happen that the government does not share the logic of the financial markets, or the need to have an independent central bank. However, a government cannot afford to act against this logic. Otherwise, it would run the risk of suffering from currency turbulences, as it was the case of the Turkish lira last May.

Politics, currency and elections: these three elements are deeply intertwined. Recent evolutions in Turkey speak volumes about what may occur at a macro-economic level when political short-term objectives simultaneously clash with the mechanisms of financial markets on the one hand, and with the institutional pattern of political economy on the other. In this regard, the key player is the Turkish President Recep Tayyip Erdoğan. On May 11, 2018 the Turkish President in London expressed his disappointment at "the mother of all evil", referring to the policy of raising interest rates carried out by the Turkish Central Bank. Due to a severe worsening of Turkish economy, the Central Bank had decided to

adopt a more restrictive monetary stance. In fact, Turkey seriously risks spiralling down into inflation, devaluation and recession, triggered and fuelled by the combination of excessive private debt with a lax fiscal policy.

This mechanism is based on three main components: first, an excessive public and/or private debt, which usually marks the expansionary phase of the economic cycle. The case of Turkey is similar to that of other emerging countries, since global financial markets have been flooded with dollars at extremely low rates, thus making it convenient to increase the stock of securities denominated in foreign currency. Today's step-by-step normalisation of the US monetary policy makes such debts less and less sustainable.

The second component is the ensuing need to reduce the excessive debt, which in Turkey is intended as a downward pressure on the exchange rate and an upward pressure on inflation, with the risk of triggering the vicious circle between devaluation and cost-induced

inflation. Thirdly, it is key to avoid the risk that the explosion of this excessive debt would also unleash economic recession. In these cases, political economy has to solve a dilemma: a restrictive monetary and fiscal policy can halt the mutual fuelling of devaluation and inflation, yet economic growth risks being halted at the same time. On the eve of the elections, Erdoğan cannot afford this risk. Against this background, the Turkish President has launched an interesting example of populist policy.

All populist economic policies, whether left- or right-wing, have three main common features: first, they countervail the interests of the so-called "elites", thus suggesting their underlying redistributive nature; second, they are also short-sighted, since they claim to protect alleged spread interests on a short-term perspective, while overlooking the long-term effects for the community as a whole; third, and consequently, populists claim that the independent agencies that usually characterise liberal democracies act in the interests of the powerful elites.

Erdoğan has presented a populist monetary policy based on two principles. Inflation expectations relate directly to nominal interest rates: therefore, restrictive monetary policies

have inflationary outcomes, with redistributive effects that damage the population. Consequently, it is necessary to exercise extensive political control over the Central Bank, which is blamed for this, together with the usual suspect of the "overseas origin". Hence, in one shot, Erdoğan has challenged both the logic of financial markets, which claims that an inflationary risk has to be managed through a restrictive monetary policy, and the institutional one, whose landmark is that monetary policy should be entrusted to independent institutions.

Erdoğan's bet in London obtained the opposite effect to the solution offered in 2012 in the British capital by Mario Draghi through his "whatever it takes" strategy: on that occasion, Draghi saved the euro, while Erdoğan's plan backfired, weakening the Turkish lira, which reached a 21% de-evaluation on a yearly basis just a few days after Erdoğan's speech in London. As a result, the Turkish Central Bank was allowed to raise the interest rates by 300 basis points, in an attempt to halt the currency outflow.

The bottom line is that challenging the rationale of financial markets and institutional patterns by using an electoral and/or ideological short-term strategy may well end up being a risky business.