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Lessons for India from the Turkish Lira crisis

The Turkish experience illustrates the repercussions of capital account convertibility on exchange rate volatility and imported inflation that completely obliterates any independence over fiscal and monetary policies

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(Image: Reuters)

Within a span of just ten days, between August 3 and August 13, 2018, the Turkish lira (TRY) depreciated by almost 40% to an all-time low of 6.9 TRY/USD. In comparison, Turkey's present predicament seems worse; earlier this year, in February, the lira was below 7 TRY/USD but by December 3, 2021, it had depreciated by almost 100%. While the 2018 crisis was triggered by US sanctions and the expected impact on its exports, the situation is not the same currently. Riding on the recovery of tourism, Turkey reported a current account surplus of USD 1.7 billion in September 2021, as compared to a deficit of USD 2.3 in September 2020. What then ails the lira and what are the lessons for India?

The underlying cause of the crisis is considered to be President Recep Tayyip Erdogan's interest rate policy. Contrary to conventional economic wisdom, Erdogan has consistently batted for low interest rates as a way to tame Turkey's high inflation problem, which has accelerated to 21% (annually). The argument made by him is that low interest rates will lower aggregate demand by reducing government expenditure (on interest payments) and at the same time, encourage private sector investment and production, thereby raising higher aggregate supply. Higher interest rates would instead have the opposite effect on aggregate demand and supply, thereby accentuating Turkey's inflation problem.

In pursuit of this policy, Turkey's current phase of woes began when Erdogan abruptly sacked the hawkish central bank governor, Naci Agbal in March this year when he raised the one-week repo rate by 2% to 19%. The appointment of the more accommodative Sahap Kavcioglu led to a sharp reaction in foreign exchange markets, hammering the lira down by more than 15% on March 22, 2021. Although no immediate action was taken to cut rates at that time, the current account surplus in September 2021 possibly instigated Kavcioglu to lower interest rates. A sharp 2% cut in November brought the repo rate down to 15% but soon resulted in the lira tumbling down to its current level of 13.70 TRY/USD. With Erdogan unwilling to change his low interest rate policy, the Turkish economy has repeatedly faced a forex crisis, in 2018, 2020 and again this year.

The answer to Turkey's perpetual crisis can be understood with the Fleming-Mundell theory of the policy trilemma wherein they argued that a fixed exchange rate regime, capital account convertibility and independent monetary policy are incompatible. Although the exchange rate of the Turkish lira is not fixed, it is evident that even a semblance of stability in exchange rates is difficult to achieve with full capital account convertibility and independent monetary policy. A slight assertion of independent monetary policy through a lowering of interest rates immediately draws several key economic parameters into a vicious worsening spiral of depreciating exchange rates, rising imported inflation and capital flight.

Since 1989, Turkey allowed the full convertibility of the lira wherein individuals can buy, sell or hold foreign exchange with banks in Turkey or abroad, and even use foreign currency banknotes in Turkey. The rules for export-oriented businesses were also liberalized, allowing them to retain earnings with foreign banks and without any necessity to convert foreign exchange earnings into lira. With this freedom, any anticipation of the depreciation and imported inflation prompts households to convert their savings into dollars and gold. In 2001, Turkey further integrated itself into global financial markets by letting the lira float freely in 2001, only to be followed by a severe recession that was induced by a steep increase in interest rates to stem the collapse of the lira.

Turkey's predicament has clear lessons for India, in particular, the repercussions of capital account convertibility on exchange rate volatility and imported inflation that completely obliterates any independence over fiscal and monetary policies. In spite of highlighting several concerns over full convertibility of the rupee, Rabi Shankar, Deputy Governor of the Reserve Bank of India [RBI] in a recent speech indicated India's inevitable progress towards capital account convertibility: 'the rate of change in capital convertibility will only increase with each of these and similar measures.' Demarcating the role of the RBI as a regulator, he cautions that 'market participants, particularly banks, will have to prepare themselves to manage the business process changes and the global risks associated with capital convertibility.'

Full convertibility puts enormous pressure on domestic companies which have borrowed internationally. Although public debt in Turkey is just about 40% of GDP, its corporate sector is highly leveraged with debt to GDP at about 170% with a substantial portion of this denominated in dollars or euro. European banks are particularly highly exposed to default risks by Turkish companies on account of a depreciating lira. In India, corporate debt stands at about 60% of GDP, while external corporate debt is about 19% of GDP. While this is significantly lower than Turkish levels, the impact on India companies on account of a depreciation of the rupee could be severe, given that a McKinsey **Report** of 2019 showed that Indian corporates (43%) were under the highest stress to service debt obligations across Asia. While capital convertibility allows greater access of the private sector to global finance, the risks can be cataclysmic not just for borrowers but also for the population-at-large from a depreciating currency and imported inflation.

A recent **report** from the Institute of International Finance (IIF), has warned that 'sudden stops' in international capital flows – 15.6 billion USD in November 2021 as compared to 115.5 billion USD in November 2020 – are putting enormous pressure on emerging markets to increase interest rates or face a depreciation in their currencies, which are still struggling to recover from the (ongoing) pandemic. India too has witnessed depreciation of the rupee from 73.8 INR/USD to 75.39 INR/USD between November 8 and December 3, 2021.

Global financial integration will mean India foregoing its monetary independence and adhere to the needs and expectations of international capital rather than leveraging it for domestic contingencies and national interests. As rightly pointed by Rabi Shankar, 'further public debate is warranted to continue along this process of capital account convertibility [in India].'

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Views are personal and do not represent the stand of this publication.