Capital Flows & Financial Fragility in Turkey & Lessons for Europe’s Periphery

Özlem Onaran

Istanbul Technical University
Motivation

• Speculation-led growth and fragility in Turkey: Does EU make a difference or “can it happen again”?  
  – Berlin, October 2005
• May 11: increase in the US interest rates; the financial turmoil and speculative rush out of the emerging markets  
  – Currency depreciation from May 10 to June 30  
  – Hungary 8.7%;  
  – Turkey 18.9% (Istanbul Stock Exchange CI fell by 32.3% (USD))  
  – not selective: Brazil, South Africa, India (no CA deficit), also Poland, Slovakia.
• September political turmoil in Hungary and Poland,  
  – Forint depreciated by 2.3%, Zloty by 1.3% (18-22 Sept)  
  – Turkish Lira has depreciated by 6.1% (19-25 Sept).
• Change in short-term memory, increase in ‘risk apatite’  
  – Turkey: CB lending rate increased from 16.25% (April) to 22.5% (4 steps)
• Did “it happen again”?  
• Or “irrelevant at best, extremely dangerous at worst”?  
• Or ‘a drama not a crisis’?, “a bit of profit-taking“  
• “just a correction”? ‘a Turkish bath?’
What would you do?

• Gas leakage in your apartment
  🚨
  • Wait?
  Or
• Reapair?
• How stable is the recovery in Turkey?
• How sustainable is speculation-led growth?
• Not moral hazard – private profit maximization
  – Who postpones solutions?
  – Who gains?
  – Who loses when burst?
Structure of the presentation

• Global turbulences
• A Minskian approach to speculation-led growth in an open economy
• Financial fragility and speculation-led growth in Turkey
• Lessons for Europe’s periphery
• Policy Conclusion:
  – Financial regulation and capital controls
Global turbulences and emerging markets

• possible slow down in the US & China on the emerging economies
  – contraction in export-markets,
  – decrease in the risk appetite / increase in the risk perceptions,
  – increase in the interest rates
  – decline in the private capital flows towards ‘riskier’ markets

• Who will be affected?
  – high external financing needs,
  – high ratios of short-term external debt,
  – a large share of foreign currency denominated/indexed debt
  – weak domestic banking systems

• Turkey & Hungary among the most vulnerable countries
  – interest rate & indebtedness
  – exchange rate overvaluation & capital flows
Minskian Model: Financial openness, Financial fragility & speculation-led growth

- External liberalization (Capital account liberalization)
  - financial liberalization in domestic market
    - high interest rate or financial returns
- initially low expected exchange rate depreciation
- wide arbitrage
- capital inflow
- Initial capital flows boost domestic growth
- boom euphoric expectations
- High risk and high return projects
  - short on FX, long on local assets
  - Maturity mismatch
- currency appreciation
- Financial fragility to domestic and international shocks
  - Keynes 1936, Minsky 1986, Scott 95, Grabel 99
  - Foley 03, Arestis & Glickman 02, Silva 02, Kregel, 00
Boom-Bust cycle

• High indebtedness
• current account deficit increases
• Expected depreciation rate increases
• Higher interest rate is needed to attract more capital
• Downturn inevitable
  – illiquidity and insolvency
  – Bank distress and loan defaults - Credit crunch
  – When?
  – length and depth of cycles are variant
  – no high interest rate can prevent it
  – Some domestic and foreign players can make gains over the cycle by getting out while the currency weakens.
• speculation-led regime creates economic interests that are not likely to disappear
Expectations: Rational or endogenous?

• “Others (analysts) ascribe the change of mood to sudden dislike of risky assets, as if investors had woken up on May 11th with pressing need to dump Brazilian shares or copper futures and buy something safer. This may sound far-fetched, but it makes some sense. Higher volatility means it is easier to lose money on risky assets...” Economist, June 10

• Ups and downs in ‘sentiments’ and ‘apetite’
  – „Investors are now bargain hunting, even in the most vulnerable markets.“Economist, July 8
  – Coercive competition

• Conventional wisdom – conventional panic
• Endogenous cycles of over optimism and pessimism
• cycles of stability and instability,
• Waiting for the ‘big one’ US recession
Speculation-led growth in Turkey
Capital inflows** and growth


**Financial account+net errors and ommisions
A new fragility: increasing private investment financed by debt

Private Investment/GNP (%)

- Total
- Machinery
- Construction
Increasing private foreign debt

![Chart showing increasing private foreign debt](chart.png)
EU’s periphery

Current Account Deficit/GDP (%)
2006* for Europe & Crisis years for others

Source: For the CEECs and SEU Vienna Institute for International Economic Studies Research Report, 2006 forecast; for the crisis years in other countries Economic Intelligence Unit (EIU).
Leading Indicators of crisis

- Short term debt/international FX reserves
- Current account deficit / international FX reserves
- Current account deficit / GDP
- Total or short term foreign debt / exports
- Open position of the banking system / international reserves
- Bank credit / international reserves
- M2 / international reserves
- Appreciation rate of domestic currency
- Volatility in capital flows
- Volatility in short term interest rate

Source: Uyaur. 2001
Lessons for EU’s periphery

• Which critical values are an invitation to crisis?
  – 25% real appreciation & 4% (5%) Current account deficit/GDP (Dornbusch 2001)

• Changing conventional wisdom with EU?
• Supported by fundamentals?
• Would the markets care
  – whether the appreciation of the currency is a natural transition or catching up phenomenon?
  – differences in the way current account deficit is financed (in the NMS heavily through FDI)?
  – reinvested or repatriated profits & current account deficit?

• How long? Depend also on recent history:
  – how recently and how badly punished by volatility
  – How long the boom has been underway
• turbulences despite the country’s fundamentals?
Policy implication

• Market economies: risky investment practices, shaky financial structures
• Market economies alone can not lead to stable full employment.
• cases in defence of financial regulation and capital controls
• responsibility of the EU:
  – reconsider the policies regarding the capital flows
• cohesion policy in order to achieve a sustainable process of integration
  – Not reliance on private capital flows