Support for Turkish lira cannot be sustained

- The Turkish authorities have kept a tight grip on the lira in recent weeks but we don’t think that this can continue for much longer and expect the currency to fall by 20% against the dollar by end-2020. The longer that policymakers intervene to prop up the lira, the greater the risk of a disorderly adjustment.

- The lira has been trading in a very tight range at close to 6/$ for the past couple of weeks. (See Chart 1.) It broke through this threshold on Friday but, in a bid to limit downward pressure on the currency, the Turkish authorities announced tighter restrictions on banks’ swaps and similar transactions with foreign banks. This move is widely seen as an effort to stymie speculation against the lira.

- These latest efforts to manage the lira are reminiscent of similar attempts last year. In the run-up to local elections in March 2019, the central bank intervened to prop up the lira with the help of currency swap agreements. (See here.) Once the elections were out of the way, intervention was scaled back and the lira subsequently fell by 10% against the dollar within the space of a month.

- We suspect that intervention will prove futile again, for two key reasons. First, it will cause macroeconomic imbalances to build. Crucially, inflation in Turkey is much higher than in its major trading partners and so keeping a stable nominal exchange rate will cause the lira to appreciate in real trade-weighted terms. This will erode Turkey’s external competitiveness, thus dampening exports and making imports more attractive, causing the current account position to deteriorate.

- Indeed, there are already signs that Turkey’s strong recovery over the past year is fuelling a fresh worsening in the current account position – our seasonally-adjusted measure of the current account posted its largest deficit in November since before the 2018 currency crisis. (See Chart 2.) Of course, a wider current account deficit could be sustained if the authorities raised interest rates in order to entice stronger capital inflows. But, for now at least, the focus looks set to remain on loosening monetary policy. (See here.)

- Second, policymakers have limited firepower to sustain a defence of the lira. On the face of it, FX reserves are large at $106bn. But these pale into comparison with the country’s gross external financing needs (i.e. the current account deficit plus maturing external debt over the next 12 months) of around $190bn.

- What’s more, Turkey’s FX reserves are flattered by banks’ holdings at the CBRT of foreign currency under the “reserve option mechanism”. Stripping these out, Turkey’s net FX reserves stand at just $37bn. The CBRT may be using currency swaps again, although it has diverted these operations to the stock exchange where there is little public information. And indirect intervention through state banks cannot be maintained.

- The upshot is that we think that the authorities will ultimately have to loosen their grip on the lira and we expect the currency to depreciate by around 20% against the dollar by year-end, to 7.50/$. This is one reason why we think that the CBRT will reverse course and hike interest rates later this year. (See here.)

- Taking a step back, increasing efforts to influence the exchange rate are simply another angle through which President Erdogan is putting pressure on the authorities to take a more interventionist role in the economy. This is something we’ve warned about for some time. (See here.) The key risk is that the authorities hold on to the lira for too long, ultimately leading to a more disorderly adjustment in the currency. This would particularly be painful given the context of Turkey’s large foreign currency debts.

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**Chart 1: Turkish Lira (vs. $, Inverted)**

Lira weaker against the dollar

**Chart 2: Current Account Bal. (Seasonally-adjusted, $bn)**

Sources: Refinitiv, Capital Economics

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