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MACROCOSM

No Pardon for This Turkey

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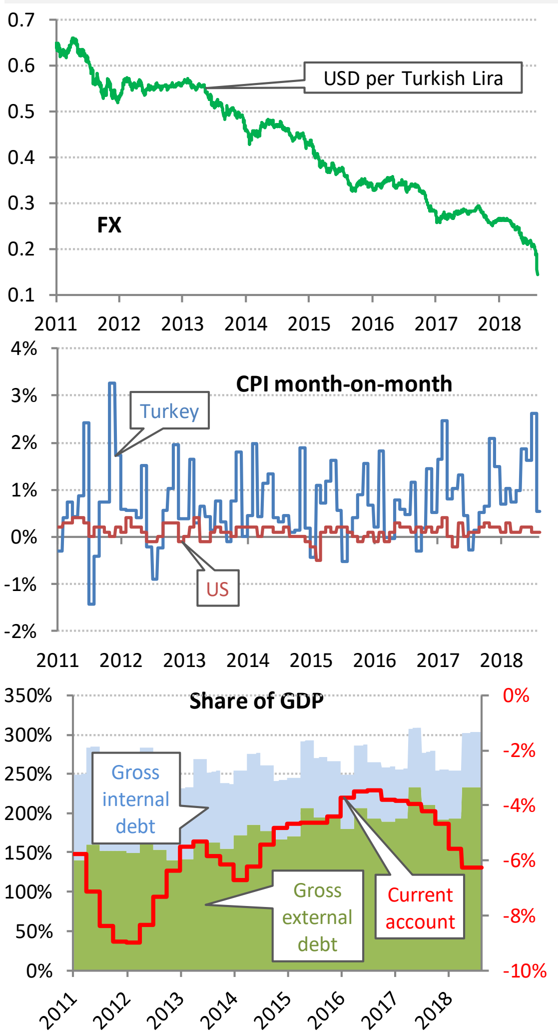
Donald Luskin

Turkey is a hostage in the US-China trade war. Trump has to show he's willing to shoot it.

Nothing in the economic numbers supposedly underlying Turkey's currency crisis is new (please see the charts below). So why the tipping point *now*? This may be a rare case of something going wrong in the world for which President Donald J. Trump is automatically blamed, but where for once he actually really is responsible, at least indirectly. It's not the supposed moral equivalence of Trump and Turkey's sultanic president Recep Tayyip Erdogan. To be sure, Erdogan's increasingly reckless and nepotistic rule over the economy has frightened investors – much as the worst phase of the European debt crisis earlier this decade was triggered by similar antics by Prime Minister Silvio Berlusconi (see "Rome Makes Athens Look Good" November 10, 2011). *But we think the core driver here is that Turkey is a highly salient symbol of the collateral damage in emerging markets, which we warned about as a spillover of Trump's high-pressure trade negotiation with China* (see "Is Trump Really Bluffing on Tariffs?" June 22, 2018).

Turkey economic indicators



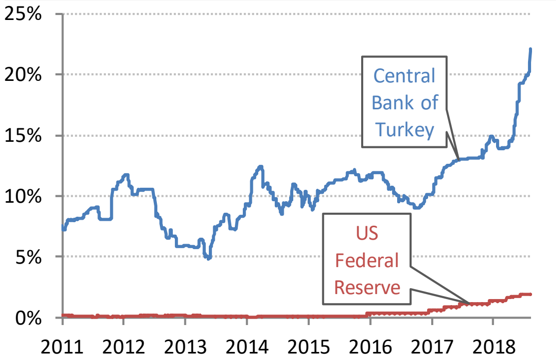
Source: Bloomberg, TrendMacro calculations

- Even the recent dramatic weakening of the lira is just a continuation of a trend long in place (please see the top chart at left).
- Inflation and the current account deficit aren't

Update to strategic view

EMERGING MARKETS MACRO, ASIA MACRO, EUROPE MACRO, FX: The Turkish crisis is only an extension of negative trends in place for many years. It is not the result of rising US interest rates – the USD/lira carry trade has been a loser for many years. Turkey, like other emerging markets, is collateral damage in the US-China trade war in which longstanding instabilities are exacerbated by tariffs, sanctions and other pressure-tactics, including possible denial of an IMF bailout. The crisis makes Turkey a hostage in the trade war, whom Trump must be seen as being willing to shoot, lest he lose negotiating power with China. We doubt that a worst-case in Turkey is sufficient to trigger a global financial crisis. If Erdogan backs down and Trump reduces tariffs and rescinds sanctions, the shame for China to back down would be lessened, and Trump will have demonstrated that he will remove pressure once placated. We expect resolution before the US mid-terms, with the emerging markets the greatest beneficiaries of a global relief rally.

Effective policy rates



Source: Bloomberg, TrendMacro calculations

any worse than usual. Gross debt-to-GDP isn't much worse, either – and far less than that of the US – though a greater proportion of it is externally funded (please see the middle and bottom charts on the previous page).

- *We definitely don't blame rising US interest rates*, supposedly having caused speculators to evacuate the emerging markets carry-trade.

Whatever may or may not be happening elsewhere, in Turkey's case, interest rates have risen further in Turkey than in the US – for years, not just in the recent crisis – making the carry-trade *more* attractive rather than less. *Besides, who's still in that trade anyway? It's been a loser forever* (we estimate an average monthly loss of 23 bp from 2011 through 2017, which excludes the enormous losses in the current crisis).

Is Turkey a proximate systematic threat?

- The truth is that no one knows, including the usual suspects rounded up by the media, doomsayers who claim "I told you so" (but too long ago to have been helpful), and now predict another Global Financial Crisis in the offing.
- Obviously worst case is if Turkey falls into recession, imposes capital controls, and experiences a wave of debt defaults and bank failures. The worst pressure-points among the indirect victims of that would be European lenders to Turkey, and the large French, Spanish, Italian and British banks that own large stakes in Turkish banks (most of whose debt is denominated in lira, not dollars). Miraculously, for once, Deutsche Bank doesn't seem to have stepped in it.
- The European Central Bank can't help Turkey directly (it's not a European Union member state, so it does not use the euro currency), but it can cover the fallout in Europe. Right now neither euro LIBOR/OIS spreads nor credit default swaps are acting like there's a lot of risk here.
- The International Monetary Fund could make a loan to the Turkish government to bail out itself or the banks. But it would impose conditions of fiscal and monetary austerity that, at least right now, Erdogan would be unlikely to accept.

But even if Erdogan accepted the terms, the U.S. would have to approve any IMF loan, and at the moment it is highly doubtful Trump would let it do so. Surely markets are concerned that with Trump having already raised tariffs and imposed sanctions on Turkey as the crisis has deepened –

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kicking Turkey while it's down, as it were – he is effectively signaling that he won't allow there to be an IMF safety net.

- *Trump can't and won't back down, because what's happening in Turkey is a miniature version of what's happening in China – the intensification thanks to US pressure-tactics of longstanding economic risks* (see "China is Losing the Trade War with Trump" July 29, 2018). *To back down in Turkey would be to back down in China, which makes Turkey merely a hostage in the US-China trade war. Trump's only move here is to shoot the hostage.*
- That could all change in a flash, if Erdogan backs down and releases the US pastor being detained in Turkey for his alleged involvement in a failed coup. That would get the tariffs reduced and the sanctions removed, and *send three signals that would be very positive for markets: (1) to Turkey, that Erdogan can act responsibly, (2) to China, that there's nothing uniquely shameful about giving in to Trump's pressure tactics, and (3) to the world, that giving Trump what he wants does get the pressure removed.*
- As we have said many times now, we expect all this to be resolved successfully, and likely before the US mid-term elections (that's when Trump will be most willing to make a deal, in order to bring home trophies for the GOP). The biggest beneficiaries will be the emerging markets who will enjoy a significant relief rally.

Bottom line

The Turkish crisis is only an extension of negative trends in place for many years. It is not the result of rising US interest rates – the USD/lira carry trade has been a loser for many years. Turkey, like other emerging markets, is collateral damage in the US-China trade war in which longstanding instabilities are exacerbated by tariffs, sanctions and other pressure-tactics, including possible denial of an IMF bailout. The crisis makes Turkey a hostage in the trade war, whom Trump must be seen as being willing to shoot, lest he lose negotiating power with China. We doubt that a worst-case in Turkey is sufficient to trigger a global financial crisis. If Erdogan backs down and Trump reduces tariffs and rescinds sanctions, the shame for China to back down would be lessened, and Trump will have demonstrated that he will remove pressure once placated. We expect resolution before the US mid-terms, with the emerging markets the greatest beneficiaries of a global relief rally.