Turkey’s hot-money problem

By Bilge Erten and José Antonio Ocampo
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The ongoing financial volatility in emerging economies is fueling debate about whether the so-called “Fragile Five” – Brazil, India, Indonesia, South Africa, and Turkey – should be viewed as victims of advanced countries’ monetary policies or victims of their own excessive integration into global financial markets. To answer that question requires examining their different policy responses to monetary expansion – and the different levels of risk that these responses have created.

Although all of the Fragile Five – identified based on their twin fiscal and current-account deficits, which make them particularly vulnerable to capital-flow volatility – have adopted some macroprudential measures since the global financial crisis, the mix of such policies, and their outcomes, has varied substantially. Whereas Brazil, India, and Indonesia have responded to surging inflows with new capital-account regulations, South Africa and Turkey have allowed capital to flow freely across their borders.

Consider Turkey’s response, which has been characterized by an unwavering commitment to capital-account openness. Though political developments in Turkey have been attracting the most attention lately, the country’s current crisis is rooted in economic weaknesses, reflected in declining investor confidence and the sharp depreciation of the lira’s exchange rate. This instability has raised fears of emerging-market contagion, with South Africa especially susceptible, owing to its capital-account openness.

In lieu of capital-flow restrictions, Turkey’s monetary authorities began to cut overnight borrowing rates in November 2010, in order to reduce the profitability of the carry trade (purchases of foreign-currency assets to take advantage of a higher interest rate). The hope was that longer-term capital flows would finance the widening current-account deficit, which exceeded 8% of GDP at the time, mitigating the risk of a sudden stop in external financing.

While many market observers applauded Turkey’s central bank for its bold, unorthodox policy mix, the International Monetary Fund criticized the Turkish authorities for increasing inflation expectations and fueling further credit growth. But the IMF did not explicitly recommend that Turkey employ capital-account regulations, despite the mounting evidence from its own staff that the introduction of such rules was working in many emerging markets’ favor.

Without capital-account management, Turkey’s central bank expected to achieve financial and price stability by complementing the reduction in overnight rates with domestic macroprudential tools aimed at reducing excessive credit growth. The main measures to control credit growth were a gradual increase in reserve requirements, beginning in 2010; some restrictions on consumer loans; and the introduction of credit-growth caps in the second half of 2011.

Officials argued that such tools are more effective than capital-flow measures, which “are, in general, hard to implement and rather easy to circumvent.” But domestic prudential measures could have only a limited effect on the rate of credit growth, because the growth was driven primarily by booming capital inflows.

Thus, domestic credit growth began to decelerate only in August 2011, when the escalation of the eurozone crisis made global investors more wary of risky emerging markets. Paradoxically, while Turkey’s

monetary authorities acknowledged this relationship, they continued to attribute the decline in credit growth to the success of their prudential measures.

Then, last May, the US Federal Reserve announced its intention to begin to “taper” its multi-trillion-dollar asset-purchase program – so-called “quantitative easing” – triggering large-scale capital flight from emerging markets. There was no denying it: the emerging-market capital explosion was over, and the credit and asset bubbles that it had fueled were in danger of imploding.

By contrast, Brazil and India did not shy away from reimposing capital-account restrictions. Both economies are now far less fragile than Turkey and South Africa.

Given this, perhaps the real question is why Turkey refrained from using capital-account regulations, when almost all of its emerging-market counterparts were using them in some form. Was the financial sector too powerful for its policymakers? Were its central bankers too committed to the IMF’s previous view that inflation-targeting can work only under conditions of capital-account convertibility? Or was it because politicians benefited from the economic boost that inflows of short-term “hot money” provide, and thus were willing to ignore the consequences?

If there is a lesson to be learned from Turkey’s monetary-policy experiment, it is that domestic prudential regulations and monetary-policy tools should be viewed as complements to – not substitutes for – capital-account management. As for Turkey, its only hope to avoid an even deeper economic crisis is to take determined action to mitigate the economic risks that have been allowed to accrue over the last few years. Given the political instability that the country is currently facing, however, such an outcome is uncertain, at best.

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