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Blog Post

August Tribulations

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Thin trading, limited short-positions and curbed limit authorisations are regular characteristics of August holiday periods, ensuring that capital and financial markets are susceptible to excessive bouts of volatility. These factors, coupled with junior traders' often peripheral knowledge of key emerging markets can result in significant speculative pressure against specific currencies.

This year however, the usual seasonal factors have been exacerbated by adverse political factors and easing economic conditions. In terms of output prospects, with the notable exception of the United States, apparently benefitting from President Trump's stimulus package, there is evidence of weakening performance and dampening market sentiments. Furthermore, it would be an understatement to suggest that the global trade, financial and diplomatic architecture is having profound difficulties accommodating the brusqueness of Trump's diplotweets. Not only have the G7, WTO and assorted international groupings come under critique but individual states subjected to apparent sanctions by twitter – the latest being Turkey.

The apparent intention by the United States to impose punitive sanctions against Turkish-originated steel and aluminium imports, on ostensibly political grounds, has come at critical juncture when international investors have been re-assessing the medium-term credit-worthiness of the Eurasian Republic. Not only has President Erdogan pursued an increasingly authoritarian government approach in the aftermath of the 2016 unsuccessful coup attempt, but also fiscal discipline was eroded in the approach to this year's Presidential election (which saw Turkey revert to an Executive Presidency, abandoning the primacy of the Grand National Assembly, the Parliament). With inflation mounting, at 15.85% y-o-y in August, it is at is highest level since the first quarter of 2004, and there are concerns that an economy prone to hyperinflation in the past (it peaked at 105% in 1994 and 111% in previously in 1980) could be entering a new period of acute price pressures. Orthodox monetary policy would indicate that interest rate tightening would be an option to curb such pressures, however the President has suggested that he sees hiking interest rates, currently at 17.75%, as stimulating rather than eroding inflationary pressures. This policy stance exacerbated speculative currency movements, with the Turkish Lira falling to a record low of 7.2149 against the US$ last Monday. Although the currency recovered over the course of the week, trading at 6.1710 by Friday, this was largely a result of the central bank tightening monetary policy via regulatory (curbing swaps and forwards) and reserve requirement (for domestic financial institutions) adjustments. Past chronologies of emerging market currency crises would suggest that recourse to an IMF stabilisation package will be

required, especially given the Republic's estimated US$220 billion in external financing requirements this year. However, Erdogan seems ideologically opposed to accepting IMF conditionality in principle, and appears to have made overtures to Russia, China and Qatar to secure replacement financing – with Qatar already willing to provide an immediate US$15 billion. Whether such alternative sources can provide sufficient funding remains open to question, and in the absence of an approach to the IMF, it may prove that Turkey may establish a currency board to effect management of the Lira.

With an economy equivalent to 1% of global GDP, Turkish instability is having a wider impact on emerging markets. With volatility at enhanced levels, the Bank of America Merrill Lynch emerging markets currency indicators are at volatility peaks not recorded since the global financial crisis (2008) and China's WTO accession (2002). Whilst a range of currencies have come under pressure, Turkey is nevertheless only one factor, with US monetary policy tightening and the potential unwinding of QE adding to the shift in portfolio emphasis toward safe havens such as the US$, Swiss Franc and Japanese Yen. Although Turkey can expect some respite as a result of next week's public holidays, in the absence of any meaningful reconciliation with Washington (which is again suggesting it may impose further sanctions) it may prove unlikely until after Turkish local elections early next year. Accordingly, contagion fears may not simply be confined to emerging markets, with EU banks exposed to any deterioration in Turkey's capacity to service its public and private external financial obligations. Italy (with its own domestic non-performing loan problems), Spain and France are seen as vulnerable. It does, however, seem that Turkey will be unable to avoid a credit downgrade.

The Turkish crisis highlights the complexity of international relations and alliances. As a member of the EU Customs Union EU member states may, although not obliged to, feel the need to support Turkey in its trade conflict with the US, notwithstanding their concern over Erdogan's domestic policies. This is something the German government may be edging toward. While Qatar's support of Turkey, when it is in current conflict with other Gulf states led by Saudi Arabia, places US alliances in the Arabian Peninsula in potential jeopardy. More broadly, Trump's somewhat cavalier approach to NATO throws the whole post-war system into question.

Against this backdrop of international market instability, Britain continues to prevaricate on its preferred option for exiting the EU, with the EU seemingly becoming more intransigent in its positions. Indeed, rather than it being simply a choice between reaching a mutually agreed exit strategy and a so-called "No Deal" exit on WTO terms, there is increasing speculation that there is a third solution, namely leaving without reconciling WTO arrangements, legal or physically, beforehand. The ratings agency Fitch has recently raised the probability of a problematic difficult exit.