Turkish interest rate leaps amid currency market turmoil

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The Turkish central bank has lifted its overnight borrowing rate from 7.75 percent to 12 percent in a desperate bid to halt the plunge of the lira. The massive hike, announced after an emergency midnight session of the bank's governing board on Tuesday, surprised financial markets, which generally anticipated a 2 percentage point rise. The announcement came amid warnings that any failure to act would result in "carnage."

The central bank's decision followed last week's fall of the lira to its lowest-ever level against the US dollar, bringing its slide so far this year to 10 percent. The bank said its new "tight monetary policy stance will be sustained until there is a significant improvement in the inflation outlook."

Turkey was at the centre of last week's financial storm, which sent the value of currencies in so-called emerging market economies plunging over fears that rising interest rates in the US would see money flood out. The crisis was triggered by the decision of Argentine financial authorities not to keep supporting the value of the peso, allowing it to drop by 12 percent, the largest fall since the financial crisis of 2001–2002.

Turkey has been particularly vulnerable to the global turbulence because it is running a current account deficit of $60 billion a year, some 80 percent of which is funded by short-term funds. It holds about $33 billion in foreign reserves, only enough to cover the cost of imports for one and a half months.

Other countries, including South Africa and India, which are also dependent on highly volatile capital inflows to cover balance of payments deficits, are further candidates for a major crisis.

The Turkish bank's decision is certain to deepen the political turmoil in the country, where Prime Minister Recep Tayyip Erdogan, embroiled in a bitter corruption scandal, had denounced those pushing for an interest rate rise as being engaged in a conspiracy. Speaking before the bank's extraordinary meeting, he said: "The Turkish economy will not be driven down by sabotage."

The key source of the turbulence in Turkey and other "emerging market" economies is not "sabotage" or a "conspiracy" but the consequence of the "quantitative easing" program of the US Federal Reserve. Trillions of dollars have poured into financial markets over the past five years in order to prop up the major US banks and finance houses.

Following the US Fed's decision last month to "taper" its $85 billion a month asset-purchasing program to $75 billion, interest rates are expected to start to rise in the US, reversing the capital flows. A study released earlier this month by the World Bank warned that in a worst-case scenario, "emerging markets" could see their capital inflows fall by as much as 80 percent.

If the Fed decides to further "taper" its purchases of financial assets after its meeting today, that could again trigger rapid currency movements.

Brazil's central bank governor Alexandre Tombini said the "vacuum cleaner" of rising interest rates in the major economies would suck money out of emerging markets and force their central banks to lift interest rates.

Yesterday, the Indian central bank lifted interest rates by 25 basis points, the third increase in the past six months. Other countries could soon follow the Turkish and Indian decisions.

While the consensus in financial markets appears to be that the South African central bank will not act, that could rapidly change. South Africa is running its largest-ever current account deficit. Last week, the rand fell to its lowest level against the dollar since October 2008, in the wake of the collapse of Lehman Brothers.

Brazil, Latin America's largest economy, is experiencing low growth and a current account deficit that has reached its highest level in more than a decade. Brazil's central bank has raised interest rates by 3.25 percentage points since last April, to 10.5 percent, in a bid to contain inflation and actively intervened in financial markets to try to prevent large shifts in the value of its currency.

Beside the rise in US interest rates, the other major factor in the currency storm is the impact of slowing growth in China and rising fears that the country's financial system could be heading for a crash because of the rapid rise in debt over the past five years.

In a comment published in the *Financial Times* on Monday, Ruchir Sharma, the head of emerging markets at Morgan Stanley Investment Management, warned that China faced a "serious risk of at least a major slowdown" and possibly worse.

"Forget Argentina," he wrote. "The big story of the emerging world is the black cloud of debt hanging over China." Sharma pointed out that other developing countries that experienced a credit boom on the scale of China had all suffered a credit crisis and a major economic slowdown. As a proportion of gross domestic product, China's debt has risen 71 percentage points, to 230 percent, over the past five years.

It is not just the rise in the amount of debt which is of concern. Five years ago, according to Sharma, it took an increase of $1 in debt to generate $1 of economic growth. In 2013, it took nearly $4, and one third of new debt goes to pay off old debt.

There is also nervousness about the stability of China's shadow banking system, where it is estimated there is around $4.8 trillion worth of debts. The instability and the potential for a serious crisis is being fuelled by moves by government financial authorities to tighten credit and deflate the debt bubble that has developed over the past five years.

According to the latest Global Data Watch issued by J P Morgan: "Rising interbank rates, as long as liquidity is kept tight, continue to push up borrowing costs and along with slower grow, risks amplifying financial stress."

A significant slowdown in China or a financial crisis will have an immediate impact on those economies that supply it with raw materials, including Brazil, South Africa and Australia, as well as the South East Asian countries that function as suppliers of parts and components to Chinese industry.

While most financial commentators maintain that the current instability is not a repeat of the Asian crisis of 1997–98, the present currency turmoil has many of the same ingredients, including dollar-denominated loans that become increasingly difficult to repay as the value of the domestic currency falls. Moreover, the further complex integration of financial markets over the past 17 years means that a crisis in any region of the world can have swift global effects.