

Growing crisis surrounding the Turkish lira

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Between 7 and 14 June, the Turkish lira lost around 9 percent of its total value against the US dollar, with its exchange rate reaching lowest levels since the Justice and Development Party took power in 2002. Over the past two years, the lira has depreciated around 60% against the dollar. On 9 June, Turkey's president Recep Tayyip Erdoğan appointed Hafize Gaye Erkan as the new head of Turkey's central bank; in the past, she worked as the managing director for the American investment bank Goldman Sachs.

Commentary

- Many factors have contributed to the depreciation of the Turkish currency in recent years. One of them was Erdoğan's desire to sustain economic growth by means of an expansive monetary policy, which involved the commitment to low interest rates by the central bank that is held under the governments direct political control. However, these moves triggered a surge in inflation and a gradual weakening of the lira. The situation was further aggravated due to the shrinking inflow of foreign investments to the country as Turkey continued to lose its credibility among international investors, as well as citizens growing pessimism regarding the stability of the Turkish financial system. To slow the depreciation of the lira, the central bank sold off its foreign currency reserves, hoping that this measure would curb inflation in the pre-election period. By now, these reserves have been almost completely exhausted (according to one method for calculating foreign currency liability, their net value is currently negative and amounts to - \$5.7 billion; this gap is now being filled with further loans from the Gulf states and gold reserves), which has further increased the pace of the lira's weakening in recent days.
- Another reason for the rapid decline of the Turkish currency's value are the allegations that the government has recently decided to stop protecting its rate. Economists say that the lira could weaken against the dollar by a further 20% in the coming months as a result. This decision should be linked to the return to a more traditional monetary policy announced by the new finance minister, Mehmet Şimşek. The markets hope that the base interest rate will be raised even up to 25% (it currently stands at 8.5%). Turkey's financial situation will also improve with the stabilisation of the prices of natural resources (gas and oil), on which the country's imports are largely dependent, and thanks to the tourist season, which is one of the country's main sources of foreign currency inflows. An adjustment of the monetary policy, including the rebuilding of foreign exchange reserves, will help stave off the threat of the state becoming insolvent. These moves will be a test of independence for the new president of the central bank, as well as a verification of the new finance minister's autonomy towards President Erdoğan, who

has so far largely influenced the state's monetary policy.

- In the short run, the side effect of the efforts to fix the Turkish economy – with the lira continuing to slump in value – are going to be higher import costs. The state, using for example mechanisms like subsidies, will be less able than previously to control the increase in the prices of imported goods. This may renew inflationary pressure. In the long run, however, rising interest rates will slow down inflation and stabilise the lira's exchange rate, but it will also slow down economic growth, which will have a negative impact on the Turkish labour market and will likely lead to increased social discontent. Nevertheless, a consensus is beginning to emerge at the political level that this strategy is necessary to start bringing Turkey out of its long-lasting financial crisis. Given the fact that the government camp has won the parliamentary and presidential elections, this is politically the most convenient moment to take such measures. President Erdoğan initially approved of the need to change Turkey's monetary policy in an interview with the media on 14 June.