MEMO

To: All CMC Clients

From: Dr. Abdur Chowdhury

Date: 8-18-18

Re: **WILL THE TURKISH CRISIS SPREAD TO OTHER EMERGING MARKETS?**

- **We believe the concern that problems in Turkey will spread to other EMs is overblown.**

- Turkish assets have been hammered recently and **fear of "contagion" has led to selling pressure on other emerging market (EM) assets**. The Turkish lira's plunge has also hit other emerging-market currencies such as Argentine peso, Indonesia's rupiah, Indian rupee, Mexico's peso and South Africa's rand.

- Turkey's central bank has kept interest rates low and inflation has grown as the economy heated up. **Turkey's inflation rate will top 11% this year**, about double the rate of any other major emerging market except Argentina.

- It is true however that **vulnerable countries could experience external debt crises** if their currencies continue to come under downward pressure and/or if the Fed hikes rates further.

- But **the financial issues that Turkey is now facing are not systemic to the entire developing world.** Few markets share Turkey's vulnerabilities, and global banks are relatively insulated from foreign defaults. So, **we do not think that a wave of financial crises will engulf the developing world à la 1997-1998**

- *But why is it more likely that contagion will not spread?*

    1. **Few other countries are troubled by as broad a constellation of economic problems as Turkey**. Its economic woes include one of the largest trade deficits of any emerging-market country, unmatched external debts, exceptionally high inflation, up until recently an exceptionally overvalued currency and unorthodox monetary policy.

    2. Turkey runs an unusually large current account deficit (approx. $49 billion in 2018), making the **economy dependent upon capital flowing into the country and prone to reversals in investor sentiment.**

3. **Turkey has financed this deficit by borrowing extensively in foreign currencies** which have been largely corporate borrowing, in euros and dollars. Turkey's government also has issued debt in foreign currency amounting to 11% of GDP.

4. **Many developing economies are better equipped to deal with their external debt problem than they were two decades ago**. Most developing economies allow their currencies to float. Consequently, central banks can allow their exchange rate to adjust gradually downward, and do not need to raise interest rates to defend their currencies to the same extent as they would under fixed exchange rate regimes. Less monetary tightening means that their economies are more resilient than they would be under fixed exchange rates.

5. Secondly, **the ability of many EM economies to service their external debt is better today than it was two decades ago as these economies have developed in the last generation**. The debt service-to-export ratio of the developing economies is about 20% today compared to 30% in 1997 meaning they are less vulnerable in aggregate to capital flight.

6. Lastly, **EM economies have larger foreign exchange reserves than before, which they can use to counter some of the downward pressure on their currencies.**

In short, the recent financial woes of Turkey are very much a function of how they have managed their financial system overall. The combination of factors that led to their crisis has been largely theirs in the making. While there are other states with weaknesses in the developing world, they are not all like Turkey and keen professional investors should see this as an opportunity to selectively purchase assets from the developing world cheaply as investors punish all Emerging Market assets.

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