

Financial Turmoil in Argentina and Turkey and Implications

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Severe financial turmoil is engulfing Argentina and Turkey as their domestic currency has been devalued to half of its initial value since the beginning of this year. Combined with chronic current account deficits and fiscal deficits, political uncertainty over their policy response to the crisis amplifies the recent financial instability. The current global financial environment, which brings tighter funding conditions to emerging market countries, is expected to continue for some time. Unless policy changes to carry out economic reforms become apparent, the financial turmoil is projected to linger over the two countries. However, such financial market turmoil is less likely to spread to the rest of emerging markets or to evolve into an economic recession. This is because emerging economies have improved their external positions since the global financial crisis, and developed economies are expected to enjoy robust economic growth, unlike the past in which global economic slowdown contributed to the financial contagion. For Korea that possesses characteristics of both emerging and developed market economies, it is necessary to carefully monitor how the financial turmoil in emerging markets is unfolding in light of changes in foreign currency funding and foreign investment conditions. That is, it is time for Korea to prepare itself for possible financial contagion from the emerging markets by maintaining its solid external position, and at the same time, to change its perspective to see the recent financial turmoil as the opportunity to increase returns on foreign investment.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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Argentina and Turkey are currently facing financial crises. Recently highlighted political uncertainty coupled with accumulated internal and external vulnerabilities places further capital flight pressure on the two countries with weaker economic fundamentals. This year's changes in the external environment, such as the strengthening of the US dollar and the Federal Reserve's interest rate hikes, exacerbate external funding conditions for emerging market countries. Further, the likelihood of a prolonged trade dispute between the United States and China increases gradually. Taken together, the financial woes of Argentina and Turkey are highly likely to continue for some time. Moreover, fears are mounting over the spread of financial turmoil from Argentina and Turkey to other emerging economies. This article outlines the current economic situation in Argentina and Turkey sinking deeper into the financial crisis, and examines the causes of their financial crises. In addition, it presents projections of the chance the crises spread to other emerging markets, and draws out implications of the findings for Korea.

Latest developments and projections

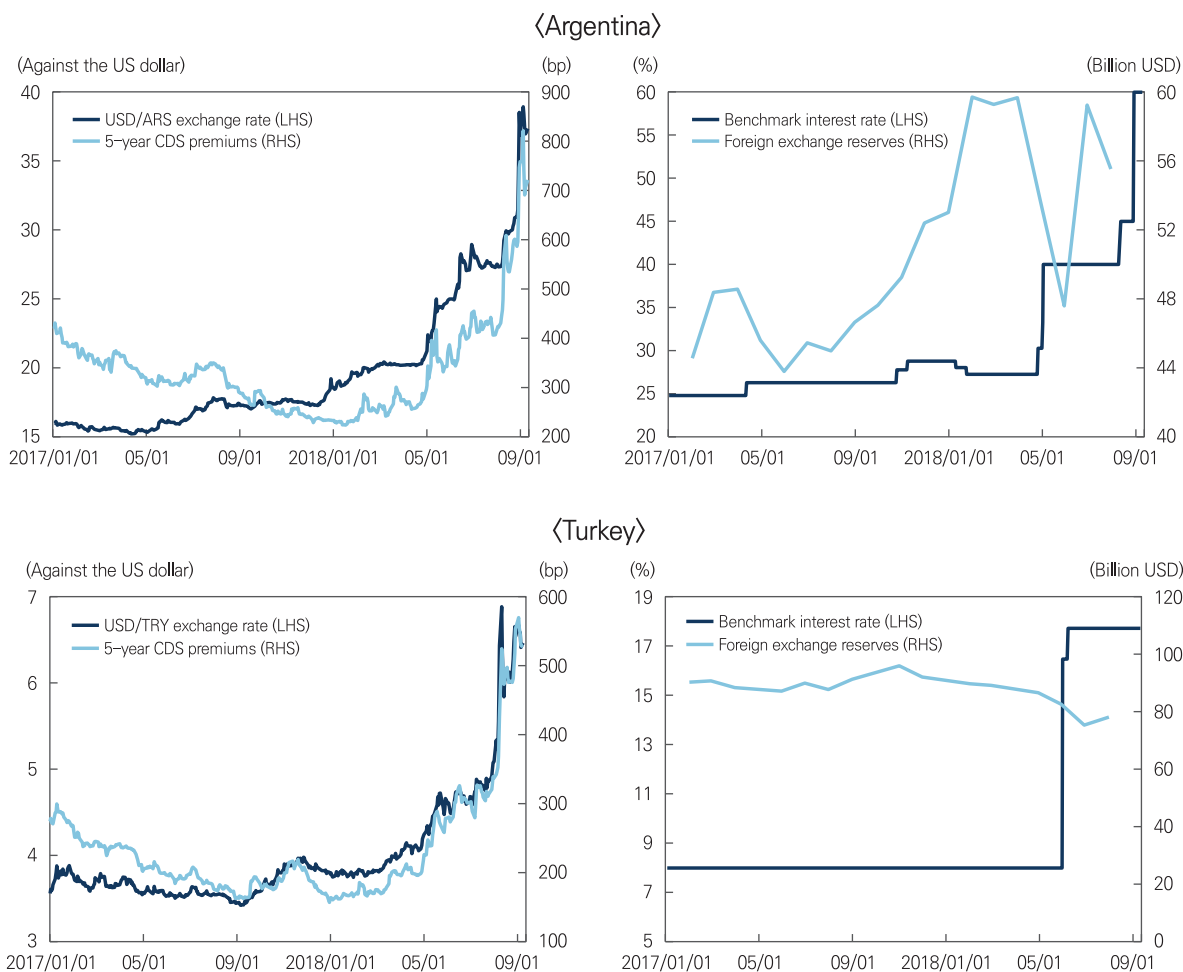
The financial turmoil in Turkey and Argentina has been intensifying rapidly since the dollar gained strength again in mid-April. As of September 10, 2018, Turkish lira and Argentine peso have fallen 41.7% and 50.7% against the dollar, respectively, since the start of this year. CDS premiums on 5-year treasury notes for Argentina and Turkey were 751 basis points and 527 basis points, respectively, indicating that the two countries have already fallen into a financial crisis.¹⁾ Rising uncertainty over the US-China trade conflict, combined with the US interest rate hikes and dollar strength, prompts the spread of capital flight pressure to some emerging markets vulnerable to external shocks. Among major emerging markets, Argentina and Turkey, both of which have persistent twin deficits, have the lowest levels of foreign exchange reserves that cover less than 40% of gross external financing requirements.²⁾

1) Although there is no uniform definition of a 'crisis threshold' for emerging markets, a 20 to 25% annual decline in the exchange rate and 500 bp or higher CDS premium are commonly used as crisis thresholds.

2) Gross external financing requirements refer to the sum of current account deficits, liquid external debt and portfolio investment inflows.



Figure 1. Recent developments in the crises of Argentina and Turkey



Source: Bloomberg

Argentina and Turkey share structural weaknesses in the economy and heightening political uncertainty as contributors to the deepening financial turmoil. As for Argentina that is susceptible to recurring financial crises, uncertainty is high over whether the country could implement economic reforms to restore its fiscal soundness. Argentina’s fiscal performance continuously deteriorated due to excessive spending to finance populist policies whose history dates back to the 1940s. The incumbent government that took office in 2015, albeit the pursuit of fiscal policy aimed at reducing the fiscal deficit, expanded government debt in an environment of ample global liquidity. This is regarded as the root cause of the present crisis. Argentina ended up receiving a bailout from the International Monetary Fund (IMF) last May and the financial crisis appeared to be abating. More recently, following the announcement that Argentina asked



the IMF to speed up bailout payments, the peso has nosedived again.³⁾ Argentina's repeated return to the IMF causes investors to lose market confidence and rekindles painful memories for Argentines. An obstacle to overcoming the crisis is uncertainty over the actual implementation of reform policies to rebuild fiscal soundness. Moreover, a recession will be unavoidable due to a sharp rise in inflation and an increase in the cost of funding as a result of the country's response to the crisis. The probability of default on short-term debt is rising as well.

Turkey is the country which runs a chronic deficit in balance of payments as it has continued to post current account deficits over the past 15 years. In 2017, its current account deficit was the fifth largest in the world. Despite its heavy reliance on external funding to finance the large current account deficit, Turkey took policy measures in response to funding pressure that began early this year. The policy uncertainty becomes the main driver of the deepening financial woes. In Turkey, one of the world's largest energy importers, recent oil price hikes drove up inflation pressure considerably. However, the independence and autonomy of the central bank to conduct monetary policy have been greatly constrained by the current government's intervention in monetary policy.⁴⁾ Not only that, a diplomatic dispute with the US has been further exacerbating the turmoil in the financial market.⁵⁾ With tougher capital controls,⁶⁾ Turkey continues to have talks about financial aid with countries like Germany, except for the US. The ongoing diplomatic dispute with the US makes it hard for Turkey to find a solution to the crisis, such as a bailout from the IMF.

It is highly likely that until policy changes for economic reforms become visible, Argentina and Turkey will remain plagued by financial woes fueled by the political uncertainty on top of the economic fragilities as described earlier. To ride out the crisis, Argentina should point policies in the direction of minimizing short-term shocks through negotiations with the IMF for accelerated

3) The IMF's bailout package for Argentina totals USD 50 billion. The IMF planned to disburse USD 15 billion in advance to Argentina and keep the remainder available only as a precaution. On August 29, 2018, President Macri unveiled that he would ask the IMF to speed up the payments of the remaining bailout funds (FT, August 30, IMF to revise Argentina bailout terms after drop in peso).

4) Despite the surge in the exchange rate and inflation, the central bank in Turkey did not adjust its benchmark interest rate before June. Even after President Erdogan took office again, concerns are mounting over the deterioration of central bank independence including the appointment of the central bank governor.

5) In response to the detention of American pastor Andrew Brunson, the US imposed sanctions on Turkey including the freezing of assets on the US soil held by two Turkish ministers (August 1), and reassessment of tariff exemptions granted to Turkish imports (August 3) (Center for International Finance, August 8, 2018, Increasing Likelihood of Turkey going to the IMF for bailout, Issue Analysis).

6) Turkey's Banking Regulation and Supervision Agency (BDDK) took an action to cut the limit on a Turkish bank's foreign exchange transactions with non-residents to 25% of the bank's shareholder equity (August 15, BDDK's press release).



bailout payments, and forge consensus (both internal and external) for the policy direction. In the case of Turkey, it should resolve the diplomatic conflict with the US. Also, the central bank's bold policy response to the crisis is desperately needed. The most imperative is the restoration of investor confidence in central bank independence. Going forward, setting the direction of monetary policy is expected to have a material impact on whether the financial panic will cool down.

Implications

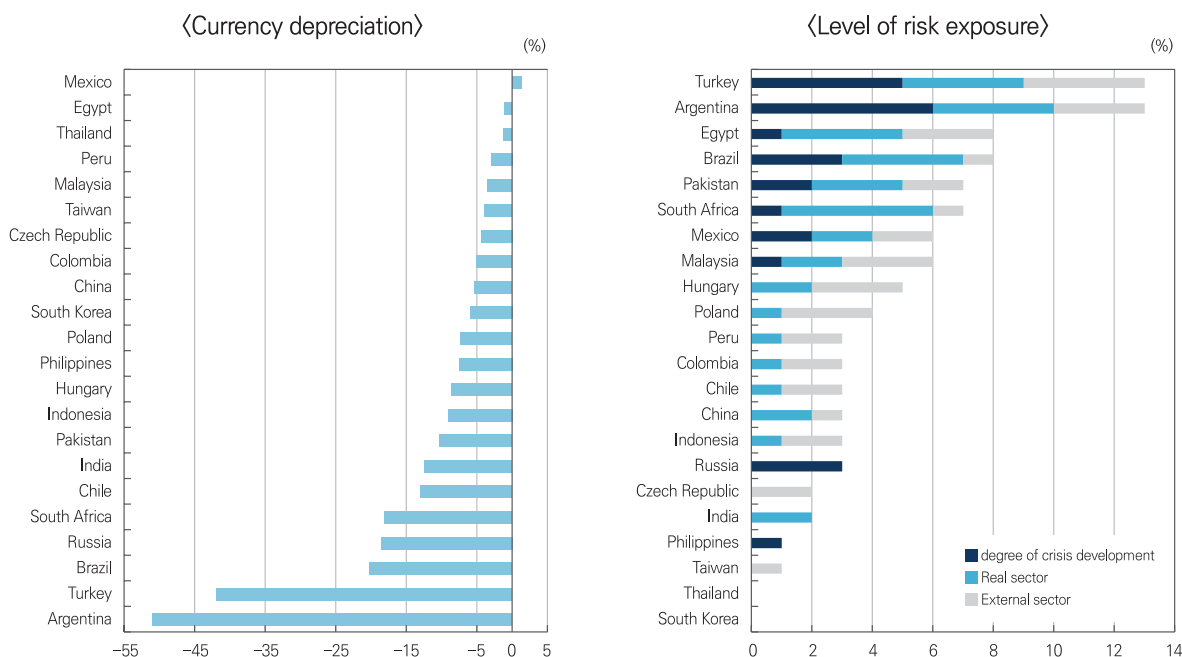
Whether or not the financial crises in Argentina and Turkey will abate is very important, given the ripple effects of their respective crises due to the large size of the economy (ranking 18th and 21st in terms of GDP, respectively) and the likely financial contagion in emerging markets. As the current global environment is expected to continue for the time being, weighing on emerging markets' funding conditions, concerns are growing over the spill-over effects of the financial crisis on the rest of emerging markets, as seen during the previous crisis.⁷⁾ In addition to the currencies of Argentina and Turkey, other vulnerable emerging market currencies, namely Brazil's real, Russia's ruble, and South Africa's rand plummeted 20.2%, 18.5%, and 18%, respectively.⁸⁾ The sharp fall in the value of these emerging currencies has fanned contagion fears. According to a study on the probability of a financial crisis in emerging markets calculated, taking into account each country's economic fundamentals and degree of crisis development, Brazil, Egypt, South Africa, Pakistan, Mexico and Malaysia are now highly exposed to the risk of a financial crisis.⁹⁾

7) In general, a financial crisis in an emerging market possesses the nature of systemic risk arising from change in the risk appetite of foreign investors.

8) The currency depreciation here refers to the percentage of a decline in the value of local currency against the US dollar from the beginning of the year to September 10, 2018.

9) See Hansoo Kim, 2018, Background and Risk Factors of Recent Financial Unrest in Emerging Market Countries, KCM Issue Report 18-07; Emerging market countries covered include 22 countries that make up the MSCI Emerging Markets Index.

Figure 2. Risk exposure and currency depreciation of major emerging economies



Note: Currency depreciation refers to the percentage of a drop in local currency against the US dollar as of September 10, 2018 as compared to the beginning of the year.

Source: Bloomberg, KCM Issue Report (18-07)

At the moment, however, the probability of financial contagion from the Turkish or Argentine crisis to the rest of emerging markets is limited. First of all, the overall external positions of emerging economies are better than those during the previous financial turmoil. Lately, emerging market currencies have depreciated considerably against the dollar, but still remain below the 2008 levels during the financial crisis. Overall, emerging market CDS premiums are also lower than the levels during the previous financial crisis. Government debt in emerging market countries has increased slightly owing to the continuously affluent global liquidity environment. Nevertheless, a decline in short-term external debt after the global financial crisis has enabled emerging markets to keep their external positions relatively stable. In addition, IMF statistics show that current account deficits in emerging markets, except for China, were 0.7% of GDP in 2017, lower than 1.6% during the Asian financial crisis. Unlike the past in which global economic slowdown posed larger downside risks to emerging markets, the ongoing economic recovery of developed countries including the US leads to the low likelihood that financial contagion across emerging markets would be spurred by global economic downturn.



Table 1. Key indicators of emerging markets by point in time

	2008	2013	Sept. 10, 2018
Currency depreciation	13%	8%	11%
CDS premiums	591 bp	259 bp	184 bp
Government debt/GDP	40%	45%	48%
Gross external debt/GDP	29%	33%	34%
Short-term external debt/Gross external debt	24%	20%	18%
Short-term external debt/Foreign exchange reserves	48%	48%	47%

Note: Currency depreciation to the date stated above from the beginning of the year; based on the simple average of 22 emerging market economies (the countries concerned are the same as those in Figure 2).

Source: IMF, World Bank, Bloomberg (requoted from KCMI Issue Report (18-07))

Korea’s external position is relatively stable as compared to other emerging markets thanks to its healthy economic fundamentals propped up by tighter prudential control over the foreign exchange market and robust economic growth. If the financial crises in Argentina and Turkey only limitedly spread to some vulnerable countries as expected, their impact on the Korean financial market will be limited. Furthermore, Korea is an external creditor economy in which the value of foreign assets held by residents exceeds the value of domestic assets held by foreigners. It means that the country possesses features of both an emerging market sensitive to foreign currency funding conditions and a developed market as an international investor. Thus, Korea should carefully monitor how the financial turmoil in the emerging market countries affects changes in foreign currency financing conditions and the climate for investing in foreign assets. That is, it is time for Korea to prepare itself for possible financial contagion from the emerging markets by sustaining its solid external position, and at the same time to change its perspective to see the recent financial turmoil as the opportunity to raise returns on foreign investment.