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The Return of the 'Vigilante'

Will the one swimming against the current survive? The historic plunge of the Turkish lira (TRY) in recent months against USD (falling as much 55% ytd by end of 17 December 2021) raises a lot of questions about the soundness of the Turkish central bank's unorthodox policies which focus on nothing but growth at a time when inflation and its expectations are obviously beyond targets. Aside from politics and the Turkish central bank's credibility, the Turkish case adds more fuel to risk metrics of emerging markets (EM), especially for countries sharing Turkey's same characteristics, i.e. suffering from a chronic trade deficit, relying on external funding, CAD, and an unfavorable debt structure, which entails substantial exchange rate and interest rate risk. While the export-focused growth formula is not new and has been tested in Asia, Turkey's policymakers face numerous obstacles that will likely stymie their efforts to achieve the same results. On top of all that, even according to economic literature, currency depreciation will not immediately improve the trade deficit but will actually worsen it in the short term. Also, timing is critical for a country grappling with historically-high inflation rates. Lastly, TRY will remain under the pressure of the high prices of imports needed for sticking to President Erdogan's plan and the debt burden that surpasses FX reserves (c.108% of reserves).

The 2018 shadow, even worse: The effect of the financial market vigilante (i.e. the way investors react to unsoundness or futile policies) will only add insult to the injury of TRY and its bond yields. Also, we see the consequences of this situation reverberating through Egypt and the entire region in the following fashion:

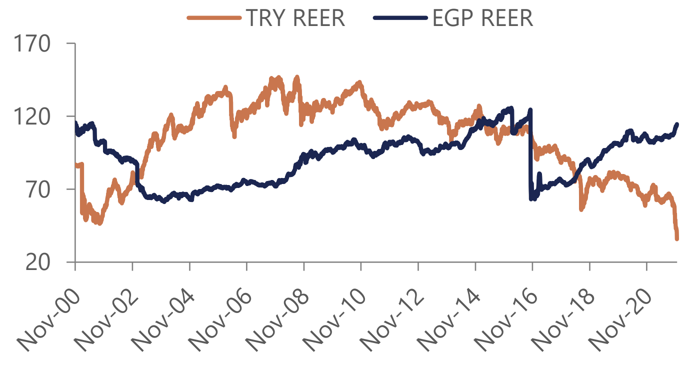
(1) **Capital inflows:** Egypt's reliance on capital inflows to finance its CAD could drive the CBE to tighten its policy as a preemptive measure, though even inflation remains within target. In this respect, we have to remember that Egypt still has the highest real yield among its EM peers (c.4%). Yet, the global tightening has sapped the strength of EM assets in general, not to mention that the broad-based outlook for USD strength in 2022 is a threat.

(2) **Financial stability:** The contagious effect of the current TRY crisis might be limited for now. However, the persistence of the crisis, as well as its potential impact on foreign banks and the stability of regional financial institutions, may blunt foreign investment appetite for EM assets. This comes at a time when EM assets are already facing a number of headwinds, ranging from the Fed tightening to growing Omicron threats.

(3) **Trade linkages:** Turkey is among Egypt's main trade partners, with the trade balance always in favor of Turkey, whose trade volume in FY21 represented 3.7% (USD3.7bn) of Egypt's total trade volume of merchandise goods. According to the CBE, Turkish merchandise accounted for 3.7% (USD2.6bn) of Egypt's total imports in FY21. Machines, electronics, vehicles, and textiles represented 38% of total imports, while iron and steel alone accounted for 20% and around 25% of Egypt's steel imports. Real currency depreciation should provide a competitive edge for Turkish exports. Yet, this could be limited by Turkish exports dependency on intermediate and raw material inputs, especially in the manufacturing sector. On the other hand, Egyptian exports accounted for 3.8% (USD1.1bn) of Egypt's total exports—concentrated in intermediate and raw materials including fuels, chemicals, and cotton (c.34% of Egypt's exports to Turkey)—will likely grow due to higher prices.

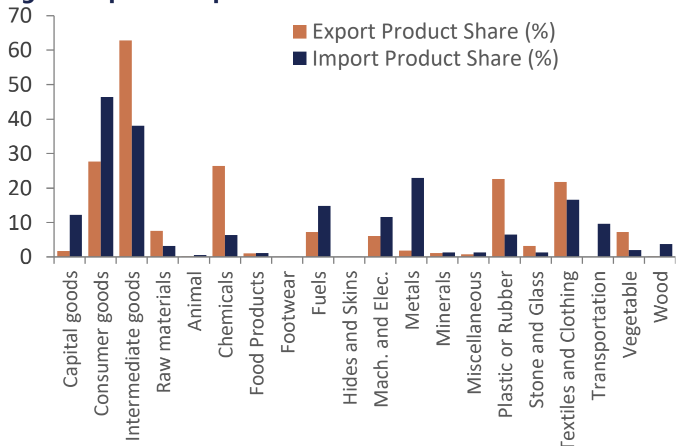
In a nutshell, we believe TRY depreciation might be unfavorable for Egypt's trade deficit, and its financial implications will keep all EMs on alert, given the mounting global headwinds ahead of them in 2022.

Figure 1: Turkey's real effective exchange rate (REER) depreciation boosts TRY's competitiveness vs. EGP



Source: Bloomberg.

Figure 2: Domestic manufacturing is going to face some level of competition if Turkish exporters adapt well with higher imported inputs



Source: Trade Map.

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