Global Macro Views – Rebalancing in Turkey and Argentina

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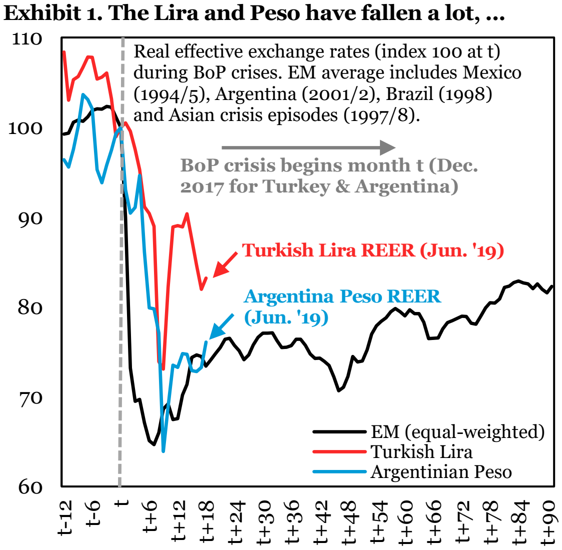
Robin Brooks, Managing Director & Chief Economist, rbrooks@iif.com, @RobinBrooksIIF
Martín Castellano, Head of LatAm Research, mcastellano@iif.com, @mcastellano44
Ugras Ulku, Head of Eastern Europe & Turkey Research, uulku@iif.com, @UgrasUlkuIIF

INSTITUTE OF INTERNATIONAL FINANCE

- Since the height of the Lira and Peso sell-off in August 2018, ...
- we have been tracking the rebalancing of Turkey and Argentina.
- Both currencies have weakened sharply in real effective terms, ...
- with the scale of depreciation in line with historical "sudden stops."
- While both have seen their current account deficits narrow sharply, ...
- this is mostly due to cyclical weakness and not genuine rebalancing.
- This is the reason why our current account-based FX fair value model, ...
- signals that both the Lira and Peso are only fair and not undervalued.

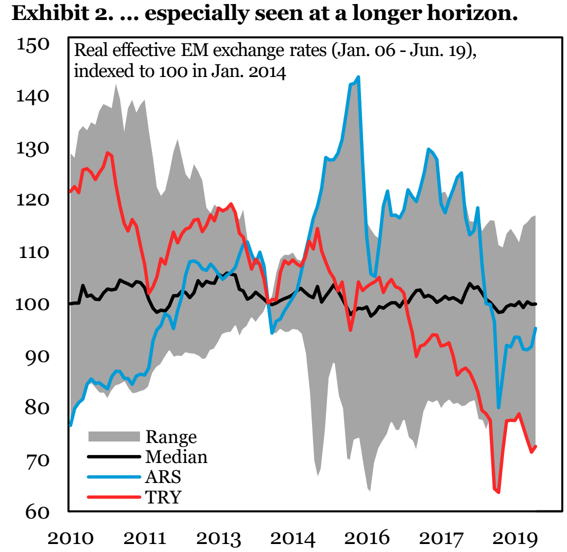
Since the BoP sudden stops in Turkey and Argentina last August, we have closely tracked progress towards rebalancing in both economies. The Lira and Peso have fallen sharply in real effective terms, an important pre-condition for rebalancing. Current account deficits that widened out sharply in 2017 and early 2018 have narrowed. Taken together, this combination could signal currency undervaluation, but our fair value model says no, putting both currencies merely around fair value. Why is this? At the present stage, much of the current account adjustment is cyclical, i.e. reflects growing output gaps, not genuine rebalancing. When we cyclically adjust these current accounts and feed through the effects from lagged depreciation, the underlying current account position in both places still registers a deficit of 1.0 percent of GDP, which is our estimate for equilibrium at the current juncture. Large real devaluations – 36 percent for the Lira and 12 percent for the Peso since 2013 (the approximate lag structure in our fair value model) – are thus enough to offset past imbalances, but not enough to put either currency in outright undervalued territory.

Exhibit 1. The Lira and Peso have fallen a lot, ...



Source: Haver, IIF

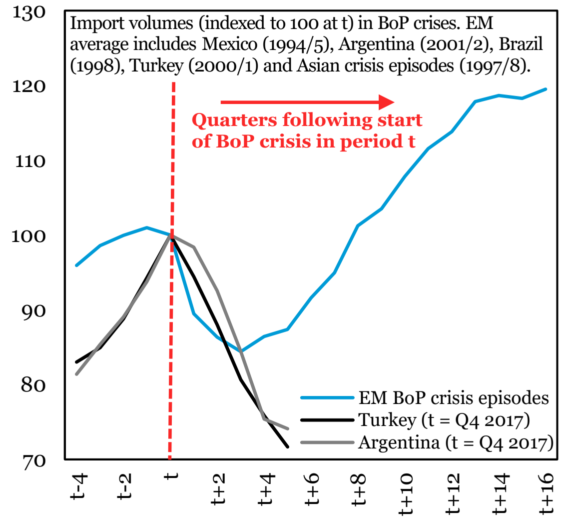
Exhibit 2. ... especially seen at a longer horizon.



Source: Haver, IIF

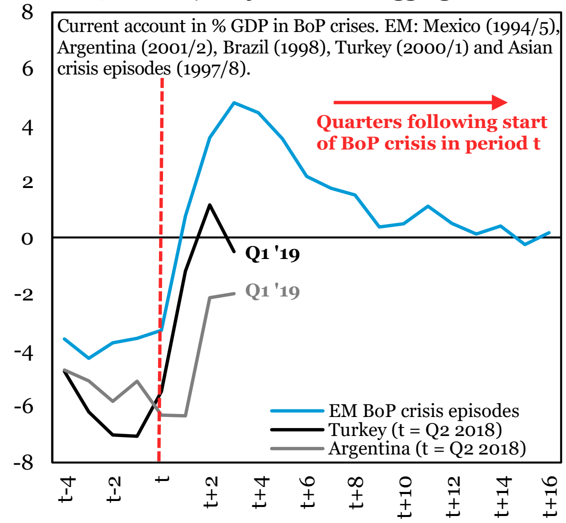
Countries that experience BoP sudden stops see their real exchange rates fall sharply. Across key historical episodes, the magnitude of this devaluation averages out to around 30 percent (Exhibit 1), which both the Lira and the Peso come close to having done, especially factoring in the trend depreciation of the Lira over the past 10 years (Exhibit 2). Relative to history, the degree of import compression exceeds the norm for sudden stop episodes. Import volumes tend to bottom out after a 15 percent fall, but in the case of Turkey and Argentina we are already seeing drops twice that size (Exhibit 3). This decline, which we see as largely cyclical, has however not yet generated the kind of current account adjustment that is the norm for these episodes (Exhibit 4). Partly this is because global growth is weaker than in past sudden stops. Partly it reflects domestic policy decisions, like Turkey's large credit expansion in Q1 of this year. In other words, despite substantial real depreciations and very large import compression, there is still work that needs to be done in rebalancing the two economies.

Exhibit 3. Import compression has been large, ...



Source: Haver, IIF

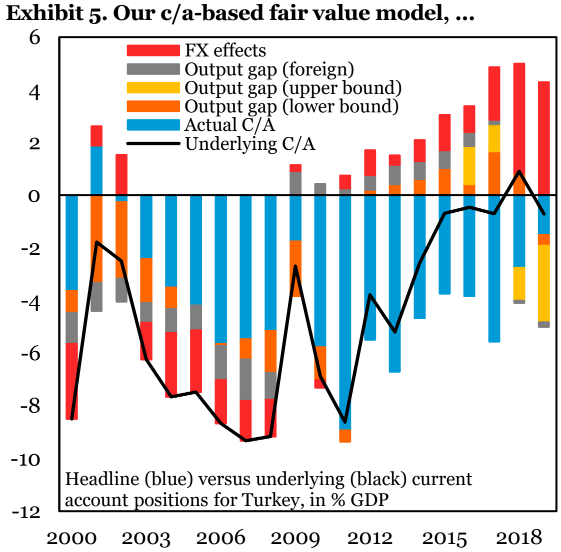
Exhibit 4. ... but c/a adjustment is lagging.



Source: Haver, IIF

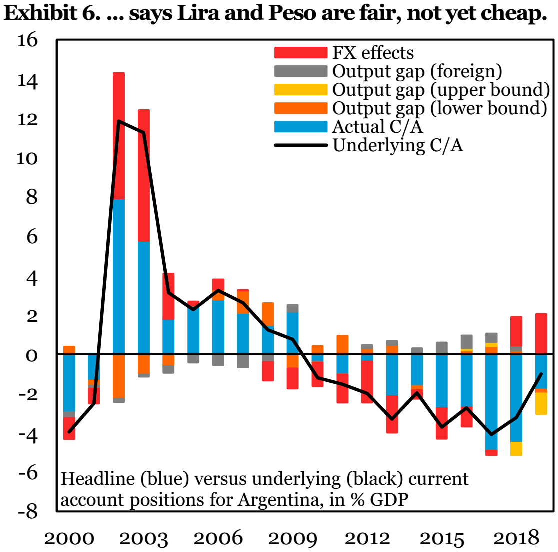
Our FX valuation model delivers the same message. Our framework adjusts observed current accounts for output gaps and lagged depreciation effects to yield an underlying current account estimate. Exhibit 5 shows this underlying current account for Turkey (black line), which is -1.0 percent of GDP. The emergence of a potentially large output gap (yellow) says that much of the adjustment in the headline current account is cyclical. But there are also lagged depreciation effects still in the pipeline (red), which are large. Both effects are roughly offsetting, which puts our underlying current account roughly in line with our estimate of equilibrium. The Lira – in other words – is near fair value. The same method puts Argentina's underlying current account at -1.0 percent of GDP as well, again suggesting that the Peso is close to fair. All this means that the large depreciations both Turkey and Argentina have seen are not yet sufficient to push either currency into undervaluation territory, but have so far merely offset large structural deficits.

Exhibit 5. Our c/a-based fair value model, ...



Source: Haver, IIF

Exhibit 6. ... says Lira and Peso are fair, not yet cheap.



Source: Haver, IIF