Turkey - Is repudiation the new normal? (14/08/18)

Regular readers of the Fortnightly will know that The Solid Ground has long forecast a major debt default in Turkey. More specifically, the forecast remains that the country will impose capital controls enforcing a near total loss of US$500bn of credit assets held by the global financial system. That is a large financial hole in a still highly leveraged system. That scale of loss will surpass the scale of loss suffered by the creditors of Bear Stearns and while Lehman’s did have liabilities of US$619bn, it has paid more than US$100bn to its unsecured creditors alone since its bankruptcy.

It is the nature of EM lending that there is little in the way of liquid assets to realise; they are predominantly denominated in a currency different from the liability, and also title has to be pursued through the local legal system. Turkey will almost certainly be the largest EM default of all time, should it resort to capital controls as your analyst expects, but it could also be the largest bankruptcy of all time given the difficulty of its creditors in recovering any assets. So the events of last Friday represent only the end of the beginning for Turkey. The true nature of the scale of its default and the global impacts of that default are very much still to come.

[Subscribers can read about the impact of the mass default in Turkey in The New Debt Crisis and What it Means, 4Q 2017 and When Monetary Systems Fail - A Guide for the Cautious, 2Q 2018. Please request new copies if you need them. There will be a conference call on the global implications of the default for subscribers at 16:00 on August 13th and for Asian clients a call at 08:00 on August 14th (both UK time). You should receive dial-in details by email and, if not, please contact me directly.]

Strong form capital controls produce a de facto debt moratorium, and very rapidly investors realise just how little their credit assets are worth. A de jure debt moratorium at the outbreak of The Great War in 1914 bankrupted almost the entire European banking system - it was saved by mass government intervention. While the imposition of capital controls in recent years has hit selected investors hard, in Iceland, Cyprus, Greece and key emerging markets, there has been nothing of this size and it is to be fully borne by financial institutions who believe they hold not just valuable credit assets but actually liquid credit assets! The loss of hundreds of billions of assets recently considered liquid by global financial institutions, through the de facto debt moratorium of capital controls, will be a huge shock to the global financial system. This is a different type of default and its nature, as well as its magnitude, will blindside financial institutions.

Be in no doubt that President Erdogan has more than something of the Chavez about him. Surely we have learned, through bitter experience, that relying on discounted cash flow calculations in Excel spreadsheets is a meaningless form of analysis when a Chavez stalks the land. It really is time to put aside the spreadsheet and start thinking. To those still clinging to the security blanket of the spreadsheet, I say yet again that there is more in heaven and earth than is thought of in such binary sophistry.

History is full of those whose ability to pay is well measured, even to more than one decimal place, but who chose not to repay their obligations. To steal once again from Hamlet, ‘one may smile, and smile, and be a villain’, and you can’t capture that in a spreadsheet. Shakespeare understood and dramatized more
about human behaviour than perhaps anyone who has ever lived and it is likely he did so without even realising that the decimal point existed. (John Napier had only recently introduced it to the British Isles).

For many years your analyst has discussed the ability of Turkey and other emerging markets to service their debt obligations. In almost all cases I have simply agreed to differ with emerging market debt teams on this issue of the ability to pay. The scale of the foreign currency debt burdens and the history of default at such high levels indicates likely defaults while the spreadsheet for each individual issuer, apparently, indicates that risks of default are minimal.

I see the wood and EM debt investors see the trees and time will tell which type of arboreal scrutiny is the correct approach on establishing the ability to pay. Then, after that full and frank exchange of views, I have sought to raise the issue of the willingness to pay. Few, if any, have been prepared to engage in such a discussion. In a world of discount rates and cash-flows, the ability to pay and the willingness to pay are the same thing and they are enshrined in the spreadsheet. These numbers gain a sanctity that flows naturally for those with a business school education. Yet history is littered with numerous examples of those who could pay but have chosen not to pay, and a historian who points out these facts commits apostasy in the eyes of the keepers of the spreadsheets.

Historically many have chosen not to pay because the socio-economic pain of paying has been considered too great. For a country with large foreign currency debt, in particular, a mass sale of local assets to foreigners or a crushing recession delivering a major current account surplus are the only ways to repay excessive levels of such debt. These two options are rarely compatible with re-election for politicians and are seen by the populace as sacrificing local livelihoods for the benefit of foreign financial predators. There is a blind and not touching faith from analysts educated in a stable political regime with a long history of a strong rule of law to believe that the ability to pay and the willingness to pay are the same thing. This monoculture amongst professional investors is about to cost their clients dear.

Throughout history default is often chosen as the least bad option, and indeed just such an option is recommended by Paul Krugman in the New York Times this Saturday. It’s not just a Noble Prize winning economist who is recommending the capital control/default option as the IMF followed a similar path in their Greek bailout programme. The Solid Ground has regularly drawn attention to a paper put before the board of the IMF in early 2016 recommending a return to ‘capital flow management’ as a legitimate policy tool for governments.

One wonders why investors expect President Erdogan, a man who has referred to them as like the loan sharks who enslaved the Ottoman Empire, to choose to repay the foreigner and accept the crushing socio-political cost on the local population of doing so? Even if Turkish institutions have the ability to pay, something your analyst has long doubted, the President will forbid them from doing so. This is a large default and it will prove to be almost a total default.

It matters and, of course, it may be politically expedient for others to follow the advice of Paul Krugman and the IMF and choose not to repay their debt obligations to foreigners. This is the new normal. In a world where ten years of extreme monetary policy has failed to inflate away debts, it will become increasingly common to repudiate those debts. Those under the most pressure will be those with the highest levels of foreign currency debt where inflation can play no role in reducing increasingly crushing debt burdens - almost exclusively emerging markets.

For the past few years professional investors have fretted about the implications of something widely referred to as ‘populism’. This, it seems, is a developed world phenomenon. While others see populism, all your analyst sees are sovereign peoples trying to bring power back to their elected representatives. This is a movement to strip power from multi-national organisations (the EU, WTO), multi-
national corporations, independent central banks and any other body that has stripped sovereignty from elected representatives over the past three decades. That is an exercise in democracy that may well be bad for returns on, and of, capital but it is a constitutional swing within the rule of law.

It is difficult to define this shift back towards a more representative democracy as populism, whatever you many think of the repercussions for your portfolio. I realise that many readers will disagree, but in the developed world the barbarians are really not at the gate. Things are entirely different in emerging markets.

True populism is when political representatives, elected or otherwise, subvert the rule of law. Investors, focused as they are on the sanctity of the spreadsheet, often forget that the sacred numbers have no meaning if there is a breakdown in the rule of law and thus your right to collect your coupons, dividends and ultimately your principal. So while the fretting about so-called ‘populism’ in the developed world continues, investors choose to ignore the retreat of the rule of law and the rise of the rule of man across the emerging markets - Turkey, Romania, Hungary, Poland, China, the Philippines, Mexico - to name just a few of the countries where the laws that protect the cash flows in those spreadsheets are likely waning as rule by man waxes.

The move by Turkey to repudiate de facto its debt obligations will reveal the truth about populism: it is red in tooth and claw in emerging markets because it is there that title to assets and their cash flows have limited constitutional protection. That is the existential risk to capital from true populism while, in the developed world, a much longer less dramatic tussle is fought by democratically elected institutions to reassert their power of influence and control. That will also have profound impacts upon returns for investors (see Capital Management in An Age of Repression, 3Q 2016) but those impacts are entirely different from the populism in emerging markets that will see the rule of law subverted by the strong men. Utilising the authority of the IMF and Paul Krugman to default on their debt obligations is one of the easiest ways in which the strong men defend their own positions, seemingly protect their peoples and show their independence from foreign influence.

No developed country is likely to produce a Hugo Chavez, but investors in selected EMs will be dealing with Hugo’s ghost for many years to come. Events in Turkey in the days and weeks ahead will finally expose the nature of emerging market risks in jurisdictions where there is no strong protection from a constitution to protect either citizens or capital. A major and rapid re-evaluation of EM risk is now on the cards with negative impacts for EM exchange rates and asset prices and ultimately, through a higher cost of capital, global growth.

As subscribers are aware, there are numerous much wider implications from the Turkish default. One of the most important is the pressure on the USD/RMB exchange rate that the Fortnightly has focused on for most of this summer. China has lowered its interest rates and permitted its exchange rate to decline in a way that any central banker would do; that is any central banker without an exchange rate target. If it looks like a duck and quacks like a duck then it is probably a duck, and the declining RMB, as a result of a decline in RMB interest rates, looks and quacks more like the duck of independent monetary policy every day.

This managed exchange rate has been at the very core of global monetary policy for over two decades. It has produced an excessive growth in RMB and a matching excessive purchase of US treasuries by the PBOC. The impact has thus been to boost Chinese nominal GDP growth and also boost US and global growth by depressing the level of the global risk-free rate - the yield on US treasuries. Boosting growth and reducing discount rates is the double nirvana that produces higher equity prices. In the 3Q Quarterly Report, The Solid Ground will focus on the huge ramifications from the end of that relationship being probably the most important breakdown in the structure of the global monetary system.
In the meantime, events in Turkey will send the USD ever higher, as EMs seek to repay their foreign currency debt and scramble to buy the USD to do so. In a very strong USD world the weakness of the RMB will be revealed as not just a temporary, perhaps cyclical, phenomenon but as the structural change that augurs a new global monetary system. As suggested in the last Fortnightly, investors should watch commodity prices in general and copper prices in particular to assess whether the net impact from the untethering of the RMB from the USD is reflationary or deflationary.

Clearly in a world of growing EM default/repudiation and lower EM growth, China will have to pull the monetary levers even more dramatically if it is to reflate the world. China’s move looks increasingly like it has come too late to take the world smoothly to the much higher inflation that is necessary to reduce the world’s excessive debt burdens. For a time at least, repudiation and not inflation will dominate the outlook for investors, particularly those in emerging markets.

For the past few years your analyst has focused on the structural changes to the global monetary system and warned that a focus on cyclical forces alone is an increasingly dangerous sport. As events in Turkey play out at a time of still incredibly low, developed-world interest rates, it is time to ask again how wise it is to pursue the returns of a normal cycle as the foundations of the global monetary system are shifting under your feet.

For the first year of publication of The Solid Ground Fortnightly the prelude to each missive was a quote from the Nobel Laureate Bob Dylan. Finally your author bowed to public pressure and dropped the Dylan deluge, but the time has come again to plunder the great man’s work. Sometimes it’s not a cycle, it’s something more than that; as it was, at least socially, when Bob Dylan explained the consequences of ignoring structural shifts in January 1964:

*Come gather 'round people*
*Wherever you roam*
*And admit that the waters*
*Around you have grown,*
*And accept it that soon*
*You'll be drenched to the bone.*
*If your time to you*
*Is worth savin’;*
*Then you better start swimmin’*
*Or you’ll sink like a stone*
*For the times they are a-changin’.*

*The Times They Are A-Changin’ (Bob Dylan)*
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