FOREX FOCUS: Cooling Hot Money In A Turkish Bath

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LONDON (Dow Jones)--Like many other popular emerging markets, Turkey has a problem with 'hot money'.

But unlike the central banks in other emerging markets, the Central Bank of Turkey is dealing with the problem in a novel fashion.

It is cutting, rather then hiking, interest rates and hoping that an increase in bank minimum reserve requirements will cool the domestic economy instead.

There is nothing new in raising bank reserve requirements.

China has employed this method of curbing credit several times over the last year or two in an effort to stop its economy from overheating.

And, in the wake of Turkey's decision, the deputy chairman of Russia's central bank, Alexei Ulyukayev, has already suggested that Russia could also use higher bank reserve requirements to tackle its hot money and inflation problems.

However, the problem for Turkey is that, unlike China, it has a floating exchange rate regime. And, if 'hot money' inflows persist, the country could well find that inflation gets out of hand.

'Hot money' flows have become an issue as international investors have turned their back on the more traditional but lower-yielding markets in developed countries in favor of the higher-yielding markets of the emerging nations that weren't hit by the global financial crisis.

Not only have the inflows contributed to stronger economic growth, and increased the risk of inflation, but they have pushed the currencies of these countries sharply higher in recent months, making their exports more expensive.

Other emerging markets, such as Brazil, have tackled the inflation problem by hiking interest rates and warning that they will introduce capital controls to slow the inflows that are pushing their currencies higher.

Turkey, however, surprised financial markets by doing the opposite. It cut its one-week repo rate by 25 basis points to 6.25% Thursday in an effort to make the lira less attractive to international investors.

The Turkish currency is already heading down towards a six-month low against the dollar as a result.

See how the dollar has bounced back against the lira:
http://www.dowjoneswebservices.com/chart/view/5321

On Monday, the central bank is scheduled to announce an increase in bank reserve requirements designed to curb credit growth, keep a lid on domestic demand and, with any luck, stop inflation from rising.

On paper, the plan for cooling 'hot money' looks promising.

So much so that some economists suggest that Brazil and other emerging markets should take note of the Turkish experiment. So far, Brazil's own policy has only stabilized the level of its currency, the real.

However, there are risks to the Turkish route. If hot-money flows persist, the central bank may have to lower rates even further, leaving scope for sharp rises in inflation if the curbs on domestic credit haven't been successful.

The country's current-account deficit could also become a problem if a continued rise in import demand is no longer being offset by inward investment flows.

So, given the risks, it might take some time before other emerging markets jump into the bath with Turkey.

Bloomberg	TNI FRX POV
Reuters	USD/DJ
Thomson	P/1066 or P/1074

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