The lira reversed earlier gains after a doubling of interest rates failed to assuage concern that Turkey’s economy will be left exposed by a slowdown in China and a reduction in U.S. monetary stimulus. Stocks fell.

The Turkish currency depreciated as much as 2.4 percent after strengthening more than 4 percent following the central bank’s midnight rates decision and traded at 2.2597 per dollar at 5:19 p.m. in Istanbul. Yields on two-year benchmark notes decreased 18 basis points to 10.88 percent and the Borsa Istanbul 100 Index (XU100) of shares slumped 2.3 percent.

Governor Erdem Basci is fighting to restore credibility eroded by a currency run that gained speed amid domestic upheaval and a global rout of emerging markets. Prime Minister Recep Tayyip Erdogan, who said yesterday he’s always opposed higher rates, is embroiled in a graft scandal that has ensnared several ministers and the chief executive officer of a state-owned bank. It spooked investors just as the reduction of U.S. monetary stimulus began sucking money out of riskier assets.

“Turkey would appear to have received the worst of both worlds,” Michael Shaoul, the New York-based chairman and chief executive officer of Marketfield Asset Management LLC, which oversees $21 billion, said in e-mailed comments. “Local economic activity can be expected to be constrained by massive monetary tightening, while foreign investors are hardly likely to be enticed by increased yields given the volatility and downside potential of the currency.”

Rand Drop

The Lira Reacts to Turkey’s Continental Divide
South Africa’s currency also slumped today following an unexpected interest-rate increase. The rand dropped 1.8 percent to 11.24 per dollar after the Monetary Policy Committee lifted the repurchase rate to 5.5 percent from 5 percent, the first rise since June 2008. The tender lost 6.4 percent this year, the third-worst performer among 24 emerging-market currencies tracked by Bloomberg.

Emerging-market assets are losing their luster on concern that Chinese growth is slowing as the government implements the biggest policy shifts since the 1990s and tackles debt-fueled investment in a bid to generate more manageable growth. A Jan. 23 report from Markit Economics and HSBC Holdings Plc showed manufacturing in the world’s second-biggest economy may unexpectedly contract for the first time in six months.

Turkey’s central bank raised all its main interest rates at an emergency late-night meeting in an effort to shore up the lira, resisting government pressure and reversing years of policy aimed at stoking growth. Interest rates had been on hold since August.

**Graft Probe**

The Ankara-based bank increased the one-week repo rate to 10 percent from 4.5 percent, the overnight lending rate to 12 percent from 7.75 percent and the overnight borrowing rate to 8 percent from 3.5 percent.

The central bank said the one-week repo rate, now at 10 percent, should be treated as the benchmark policy tool. Since it had previously been encouraging investors to use the overnight lending rate as the main guideline, the move amounts to an effective tightening of between 200 and 400 basis points, Neil Shearing, the chief emerging-markets economist at Capital Economics Ltd. in London.

Turkey’s financial markets have plunged since news of the corruption scandal broke last month, leading to the departure of three cabinet members whose sons were detained in the probe. That coincided with a flow of money out of emerging economies that weakened currencies from Brazil to South Africa.

**Basci Constrained**

“Let’s not forget that the trigger for the selloff was political and that very much
remains in place,” Abbas Ameli-Renani, a London-based strategist at Royal Bank of Scotland Group Plc, wrote in an e-mailed report. “Political noise” is expected to rise significantly as Turkey approaches March 30 local elections, he said.

Erdogan’s response to the graft investigation has been to accuse a “gang” within the police and judiciary loyal to U.S.-based Islamic cleric Fethullah Gulen of attempted treason.

Basci has been constrained by political opposition to raising borrowing costs as growth slows. While economists and investors advocated higher rates to bolster the lira, Erdogan has repeatedly railed against an “interest-rate lobby,” blaming it for last year’s wave of protests and the graft probe implicating members of his government.

At the last regular policy meeting on Jan. 21, Basci left the three main interest rates unchanged, even after the lira had declined almost 7 percent in the previous month. He opted instead to introduce a fourth rate of 9 percent, to be used only days when the bank decides extra tightening is needed.

**Currency Intervention**

As the currency’s slide picked up pace last week, Basci intervened unannounced in markets for the first time in more than two years, selling about $3 billion. That only accelerated the slump, leading the bank to reassemble last night.

It was a currency crisis that laid the foundations for Erdogan’s 11-year rule. The collapse of an International Monetary Fund program in 2001 led to a devaluation of more than 50 percent. In elections a year later, the parties that presided over the slump were swept away, clearing a route for Erdogan’s Islamist-rooted movement to win a majority.

Erdogan says growth of 5 percent a year under his government has left Turkey’s economy less vulnerable to such shocks. The premier reiterated yesterday that he’s always been opposed to rate increases. Speaking in Ankara before leaving for Iran, he said he hoped the bank would make the right decision and usher in a “new era” for the Turkish currency.

Before today, Basci accommodated the political pressures by developing a system
of multiple benchmarks that allowed him to tighten policy without raising headline rates and vary monetary conditions day-to-day within an interest-rate corridor.

**Simpler Policy**

The bank said today it would seek “to simplify the operational framework” in an effort to achieve price stability. It took another step to that end today, announcing an immediate end to “extra tightening days,” on which it did not lend at the one-week repo rate.

As well as Turkey and South Africa, India unexpectedly increased rates yesterday, and Brazil has pushed its benchmark higher for six straight meetings.

“Real rates aren’t high enough to guarantee de-dollarization,” Manik Narain, a currency strategist at UBS AG in London, said in an e-mail. “Local demand for dollars won’t reverse at this level.”

To contact the reporters on this story: Onur Ant in Ankara at oant@bloomberg.net; Taylan Bilgic in Istanbul at tbilgic2@bloomberg.net; Selcuk Gokoluk in Istanbul at sgokoluk@bloomberg.net

To contact the editors responsible for this story: Andrew J. Barden at barden@bloomberg.net; Samuel Potter at spotter33@bloomberg.net