Currency crises in Turkey: Why is it happening and what is next?

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Opinion Article

The tail end of the year 2000 saw Turkey suffer a banking crisis which then caused a significant amount of capital flight and a recession that severely affected the economy. Turkey was able to agree to the terms set by the International Monetary Fund for a loan of 19 billion dollars. The loan required Turkey restructure and overhaul its financial system, in addition to removing economic barriers and opening its economy to the world. The coalition government which was in power at that time, started to implement these structural transformations, however, the economic crisis fashioned a way for the Islamist Justice and Development Party, known by its AKP acronym and Recep Tayyip Erdogan, both of which had resided in the political background of the Turkish secular republic.

Erdogan provided a "candid" substitute to political instability and high economic inflation, and voters at the time where keen for an alternative. Even with doubts from abroad and at home, the AKP swore to keep to the program implemented by the IMF, while also promising to uphold the Turkish Republic's secular founding values. The AKP remained committed to the IMF program and met the conditions set. This was aided by the country's application, which started in 1999 to formally enter as a full member into the European Union. The accession process played a significant role as a signal and anchor of Turkey's modern social and economic path.

As a result of this, the economy grew, helped by robust global growth. It was during this time period that inflation numbers finally fell to a single digit after 30 years. The economy had expanded at a rate of 6.8% annually from 2002-2007 and 2012 saw export numbers more than triple. Conversely, critics who claimed there were deeper problems lurking beneath the economic sheen were pushed out, when Turkey was able to survive the global financial disaster in 2008 with nary an effect. It was able to bounce back rapidly, thanks to the restructuring of its financial system back in 2001.

Whilst Europe and the United States were burdened with debt, Turkey's minimal levels of corporate and household debt made the country an extremely desirable location for foreign capital that desired a relatively stable haven which provided constant revenues. This action then resulted in the Turkish banking system being awash with inexpensive credit that was able to finance spending sprees carried out by corporations and households. in the meantime, 2008 saw the IMF's standby agreement expire and negotiations for a renewed agreement stalled until negotiations were adjourned 2 years later, as a result of Erdogan claiming Turkey graduated from the program. He instead believed he would be able to propel the economy towards unlimited growth and ensure it was seamless for Turkish corporations to access foreign currency denominated loans. This move made companies extremely vulnerable to a reduced value in the lira. Also, Erdogan started to funnel more governmental funds into massive public infrastructure programs such as extensive highway systems, city hospitals and airports via a private-public partnership.

This move, together with credit conditions that were favorable, saw the construction section boom, especially in companies that maintained close links with the government. The housing price index of the Central Bank doubled from the beginning of 2010 to the close of 2016. The result of all this was a thriving economy which then helped Erdogan win elections that enabled him to gain even more power. However, the extravagant spending caused the account deficit to worsen. An example of this was the fact that private sector saw its external debt rise from as little as 16% of GDP back in 2003 to nearly 40% at the end of the previous year. Nevertheless, while economic watchers noticed these proceedings increasing alarm, the authoritarianism and popularity Erdogan exhibited only further increased. He became president in June with considerably increased powers that enabled him to operate the government as he desired.

A lost opportunity

Nevertheless, all of these increases are but the dark side to a rosy picture. Turkey's economy was starting to become progressively dependent on foreign money and on imports to fund the majority of its growth. A current account deficit is created when a nation imports more services and goods than it is able to exports, and then sources finances for the difference by borrowing from abroad. This move made the country vulnerable to the impulses of international investors if a crisis was to unfold.

The Turkish Lira has over less than a single month, lost about one third of its value against the US Dollar and has recently recorded a historical low. This translated to every imported good becoming even more expensive almost overnight. Considering, Turkey is a country that is massively dependent on foreign goods, the majority of goods such as food, gasoline, clothing and furniture were affected. Turks have increasingly become worried that more price increases and probable scarcities of imported medicines might be next. Conversely, Turkey saw its inflation rate increase to almost 18% in August, which was a 15-year record high, powered by the Turkish lira's collapse of over 20%. A currency which rapidly loses value, coupled with rising inflation has caused concerns of Turkey plunging into an economic and financial crisis. Analysts and investors alike state that the central banks have to increase rates by a minimum of 4%, while other quarters claim an increase by10% is required to dodge further depreciation in the lira's value [1,2].

Additionally, the catalyst which spurred the current crisis were sanctions by the US, which were imposed on the 1st of August by the Trump administration after the Turkish government refused request by the US to handover an American pastor who had been detained for about 2 years. Turkey retaliated by increase tariffs on US alcohol, cars and other products. It is yet to be seen if more sanctions by the US are headed Turkey's way. The effective economic woes Turkey faces, however, is much more complex than current diplomatic spat with America and goes back decades. Qatar, meanwhile, has promised to invest US$15 billion into Turkey's economy and to provide more aid, however these promised aids do nothing to sort the actual issue.

The economic crisis is exacerbated by two extra factors. Firstly, Recep Tayyip Erdogan, Turkey's president is against increasing interest rates in a bit to cool the economy down and prop the currency and has been using his election victory to enforce his unorthodox views onto the central bank of Turkey. The dearth of action concerning interest rate coincided with a noticeable worsening of the country's diplomatic relation with the US. Furthermore, the decision to place Andrew Brunson, an American pastor, on house arrest by Turkey on dubious terrorism charges, prompted Donald Trump to double tariffs on Turkish aluminum and steel imports while also imposing sanctions.

What does this imply to the global economy?

The direct influence of what appears to be an unavoidable Turkish recession might be comparatively modest, as in spite of having 80 million people and a stable growth over the years, Turkey only accounts for 1% of the world's GDP. Countries in the Eurozone ran a small trade surplus with Turkey. The two most prior financial crises in Turkey saw European exporters switched their businesses to newer markets. The ECB European Central Bank recently expressed angst over potential contagion via the banking system of the Eurozone, with Spain and the Italy, being the countries that are most exposed. A larger danger, however, is that the Turkish crisis could spill into other emerging markets and signs that some countries viewed as vulnerable were being speculatively attacked. The problems Turkey faces are principally acute, as it holds over $300 billion in dollar denominated business debt, which only becomes even more expensive to finance as the days go by. Nevertheless, countries such as South Africa and Mexico [3] also enjoyed the low interest rates handed out by the US after the global financial recession to heavily source for dollar denominated credit and their currencies came under pressure. Critics have feared a full-blown crisis in emerging markets could arise.

High rising inflation rate

Turkey was unable to create a concrete economic policy strategy which had to include a reduction in government spending and restricting the supply of money to respond to the currency crisis. Instead, the government has firmly blamed the crisis on foreign powers, with the US president as the major suspect. Rather than rolling out economic policies that could help stabilize the Lira, the devaluation of the Turkish currency was decried as an attack on the country. This action caused further eroding of the lira's value.

The lira's devaluation meant that the debt burdens the country was under had doubled in regards of the country's domestic currency. Turkey's foreign debt was measured at $466.7 Billion at the beginning of the 2018's second quarter. This amount was 55% of Turkey's GDP. Whilst the country's general ratio of public debt to its gross domestic product is comparatively low, foreign currency debt is nearly 50% of the country's public debt, and this means the budget is susceptible to currency devaluations and reduced availability of international capital [4,5].

The reduction in the rate of public debt was mostly down to strong growth over the last decade. Once Turkey was able to recover quickly from 2008's global debt crisis, the effective annual growth rate of its GDP was about 7% on average. 2018's first quarter saw the country's yearly growth rate reach 7.4%, an increase from 7.3% recorded the prior quarter [1].

In the event that Turkey is able to avoid a total default, the impact of steep currency devaluations coupled with consistent interest rate rises is sure to restrict investments into the economy and lower profit margins. Consequently, unemployment rates is sure to rise. Consumers in Turkey are sure to experience higher prices and increased unemployment. At this moment, inflation has been recorded at 18% and is forecasted to hit 20.8% once the year ends. This figure is twice the average recorded over the past ten years [1].

So what should the Turkish government do next?

At the moment, the response of the government has been to put out strict and tough rhetoric but actually doing very little. The Turkish president, Erdogan has consistently accused the United States of America of betraying Turkey and has directed the government to announce a crackdown on individuals who use social media to spread fake news concerning the crisis. Meanwhile the central bank has moved to ease the financing requirements Turkish banks had to meet. Neither of this moves appear sufficient enough to deal with a crisis on a scale like this, especially considering the dearth of Turkey's gold and foreign currency reserves.

To combat this, the Turkish government has a couple probable solutions

The first and the most unlikely, is to return to the IMF plan that was swiftly jettisoned by Erdogan, as it would put restrictions on the cheap credit Erdogan views as paramount to economic and financial growth. Considering Erdogan publicly states that there had never been a structural issue in Turkey's economy, this method is most likely a nonstarter.

The second possibility is for Turkey to create and put into place its very own stabilization plan, with some support perhaps coming from the EU, by helping Turkey alleviate its short term issues. However, for a host of reasons which include prior tensions and minimal to no financial ties, this option is one that appears dead on arrival.

Another option would be to create an economic management plan that could better help Turkey achieve its aim of becoming a wealthy nation. The plan has to have an economic structure that is diversified. It also includes a domestic financial structure that is both resilient and flexible. Turkey has over prior decades experienced significant economic stability and progress, with the economy registering increased growth rates coupled with stable inflation rates.

It is imperative to not that lessons from the crisis in Turkey do not only have to be learnt by Turkey. It is just another crisis that shows the need for reform in countries that have fragile economies.

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