The drop of the Turkish lira and the role of currency speculation

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I presented a detailed analysis of Turkey's economic problems some time ago. The situation is now deteriorating dramatically because the Turkish lira continues to be under enormous pressure and has lost more than a third of its value against Western currencies since the beginning of the year. Last Friday alone, the value of the lira slipped by more than ten percent.

In view of the economic situation, the president's current policy, the country's increasing political tensions with the United States, and a significantly weakening global economic environment, such speculation against a currency of an emerging economy is not surprising, but the dynamics are still very dangerous.

Turkey must try to put a swift stop to speculation that goes far beyond all fundamental data, particularly in order to avoid the ever increasing and serious difficulties for Turkish companies, which have borrowed large amounts in foreign currency. According to the *Financial Times*, this is a sum of over 300 billion US dollars, which corresponds to more than a third of nominal GDP.

What happened?

Turkey is suffering a copybook currency crisis, as has occurred in developing nations many times in the world over the past 30 years, including Turkey. It is also perfectly normal for other emerging markets, which have nothing to do with Turkey, to be infected. This is simply because global "investors", who are rightly called speculators, classify "emerging markets" as an asset class, and hear alarm bells whenever an "emerging" country´s economy is "on fire". So they bet on the fall of currencies in all emerging markets: meaning that they review all their "exposures" to these markets at once and, when in doubt, withdraw their funds in a flash.

Currency speculation and its consequences

A situation like the one in Turkey arises time and again because emerging markets offer high interest rates compared with the industrialized countries, because of their relatively high inflation rates. This invites a carry trade (a strategy in which traders borrow a currency that has a low interest rate and use the funds to buy a different currency that is paying a higher interest rate). Western speculators enter such a market because interest rates are fixed by central banks and are therefore relatively stable and predictable on both sides, so that one can make "good" and secure profits. Since many carry trade speculators also drive up the value of the emerging market currency (i.e. bring it to a higher value or prevent sufficient devaluation measured against the inflation differential), speculators practically always make a profit – as long as no crisis breaks out.

On the other hand, and this has probably also happened on a large scale in Turkey, citizens and companies in the emerging market have foreign currency debt, because loans in euros or dollars are available at wonderfully low interest rates and, moreover, their own currency is still appreciating: that greatly facilitates debt servicing and even the purchase of assets abroad. This is exactly what happened on a large scale at the beginning of the 2000s in Iceland, Hungary and Austria, where many citizens took out their mortgages in Swiss francs.

All this is extremely dangerous for the country that is the target of the carry trade, because the currency appreciates in real terms, the country loses competitiveness, the current account

balance slides deeply into deficit, and sooner or later international speculators get nervous. They worry, either about President Erdogan, or the independence of the central bank, or US President Trump's customs duties: this is important only because a sudden trigger is always needed to reverse the speculative capital flows.

What to do?

There is no need to be concerned about the carry trade speculators: they will withdraw their money in time and if they make a loss it's no disaster, just business. However, the foreign debt of the country's own citizens can become a worry. As a rule this debt is contracted over the longer term, so there is no quick exit. The devaluation of the domestic currency hugely increases the cost of these loans. This in turn threatens the banks that have made the loans, as the volume of bad loans increases sharply and threatens new lending for important investments by many companies and private households. These potential borrowers have to try to absorb the increased cost of credit by means of cutting their expenditures.

Here, as happened far too late in Hungary, the state has to intervene in the public interest and cushion the worst consequences by providing a bridge, partly by converting foreign currency loans into lira credits at the state´s expense. Of course, this can only be achieved by increasing public debt, which is very low in Turkey (at 30 percent of GDP). This crisis also shows that it is by no means the state whose debt is at the centre of a crisis, but rather stupid speculation by private individuals, which has to be regarded under the popular European rubric "freedom of capital movement above all else".

Experience in other nations has shown that a reasonably enlightened state should never have allowed these foreign currency loans. In Austria, incidentally, following the experience with Swiss franc loans, foreign currency loans for private households have been banned completely, despite the "free movement of capital".

Traditional solutions are problematic

Usually, in these circumstances, a country is advised to increase interest rates, introduce capital controls, or contact the International Monetary Fund for assistance. The latter means obtaining dollar loans that are used directly to stabilise the currency or at least send a signal to the "markets" that the global community is prepared not to stand idly by and watch a further slide in the exchange rate.

All three avenues in the case of Turkey, are blocked in one way or another. President Erdogan seems to have ruled out further interest rate hikes at the moment, because he rightly fears that they will stall the economy if they have to be sustained for a long time.

Whether Turkey would be able to establish effective capital controls to stop speculation with the lira cannot be judged at this stage. It should be borne in mind, however, that the current account deficit remains high and that in one way or another foreign inflows are needed to finance imports. This is a goal which cannot be achieved with capital controls in a really serious lira crisis.

Although the devaluation will reduce dependence on imports in the consumer goods sector in the medium term, this will not help in the short term. In addition, a country like Turkey, which is in the middle of building up an industrial infrastructure, needs a considerable volume of Western imports to achieve this.

It is very unlikely that Turkey will make a pilgrimage to the IMF under the current political conditions and ask for an aid programme. President Erdogan has been proud that no IMF programmes have been necessary under his presidency and Washington is not only the seat of the IMF, but also the seat of the American administration, with which Turkey currently has rather bad relations. This article

was written before Qatar announced it would offer $15 billion to bolster the Turkish economy.

Unconventional measures are necessary

In order to find its own way out of this crisis, Turkey would have to employ unconventional measures. Inflation is the biggest problem among the factors that have led to the crisis and it could even increase because of the devaluation. However, the president refuses to fight inflation with the traditional means of monetary policy, i.e. with high interest rates, because he rightly fears a deep economic slump.

In order to combat inflation without interest rate hikes, nominal wage agreements are indispensable for the coming years. The Turkish government must therefore, in its own approach to combating the crisis without raising interest rates, make it clear how inflation can be prevented from accelerating. This can only be achieved with an agreement between the government and key negotiating partners on a medium-term wage framework that assumes a moderate inflation target. This framework must be so firmly agreed that it is credible for all parties involved. The decisive factor here is that the inflation target is strictly included in all future wage negotiations, but not the current inflation rate, which is likely to rise again.

On this basis, one must try to stop the slide of the lira by raising interest rates as little as possible and limiting speculative opportunities for domestic and foreign speculators as broadly as possible. But even if it becomes necessary to stop the total sell-off of the lira with massive interest rate hikes, the damage will be less if the goals of the strategy are clear in the medium term. Using extremely high interest rates, provided they are in force for only a few days, would not damage the domestic economy because most transactions would be stalled temporarily.

Ultimately, as I stated in my contribution on Turkey in June, it is only by means of international co-operation that this kind of currency speculation can be prevented from the outset. But the industrialised countries are blocking any initiative in this direction. And unfortunately, most emerging market governments, blinded by mainstream economics, have not understood how much this would be in their interest.