Managing a currency crisis – External vulnerability and Turkey in 2018.

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Currency crises put public authorities in a bind. Whatever its cause, remedies are painful. Such crises are more plentiful when interest rates are rising around the world. Such was the case in 2018, when in May the US dollar strengthened sharply against currencies in emerging markets due to expected hikes in the federal funds rate by the Fed.

In Turkey, the effect was more profound than in other developing nations, with the lira losing more than 25% in 90 days (from March to May 2018). Public authorities faced the classical action/inaction dilemma: should they intervene to halt the currency's slide or wait it out for the foreign currency market to reach a new equilibrium, knowing that this might spillover into inflation and other macroeconomic outcomes?

Currency crises may even happen in countries that are growing strongly. Before we analyze the possible policy alternatives, we need an overview of the world and the Turkish economies just before the crisis hit. In 2018 there were no signs of a worldwide crisis. Growth was picking up around the world and the resiliency of the American economy was the main reason why interest rates were expected to rise in the US. In Turkey, growth was robust in 2017, even as unemployment remained high. Table 1 summarizes Turkish economic outcomes for the 2013-2017 period, with projections for 2018 as of May 2018.

Looking at the evolution of economic data in a country over time illustrates how difficult it is to identify the path of the economy over the business cycle. On the bright side, growth has been robust, topping at 7.4% in 2017 and expected to be over 4% in 2018. Industrial production and aggregate investment go up by more than 10% at some point in the period. Profligacy was not an issue. The public deficit was expected to be over 2% in 2018, but it was well under control from 2013-2017. By emerging market standards, public debt was low throughout the period, falling from more than 36% of GDP in 2013 to a projected 28% by 2018.

The main macroeconomic problem that the country faced during this period was a combination of persistent high inflation, unemployment and a current account deficit. Unemployment rose above 10% in 2014 and never came down to single-digits. Inflation broke the two-digit barrier in 2017. And the current account deficit averaged 5% throughout the period.

Remember that the steps for a complete analysis of an economy involves: determining the context of the economy; establishing the trajectory of the public debt and with it the possibility of crowding out; making assumptions about the links between the real and monetary sides; forming expectations; and estimating the reaction of consumers and businesses in the global context.

Table 1 – Turkey's economic indicators – 2013-2018.

	2013	2014	2015	2016	2017	2018*
Population (million)	76.5	77.3	78.7	79.8	80.3	80.8
GDP per capita (USD)	12,415	12,084	10,893	10,731	10,592	8,663
GDP (USD bn)	950	934	858	856	851	700
Economic Growth (GDP, ann var in %)	8.5	5.2	6.1	2.9	7.4	4.1
Consumption (annual variation in %)	7.9	3	5.5	2.3	6.7	4
Investment (annual variation in %)	13.8	5.1	9.2	3	6	3
Industrial Production (annual var in %)	3.5	3.5	2.9	1.8	11	4.1
Unemployment Rate	9.1	10	10.3	10.9	10.3	10.6
Public deficit (% of GDP)	-1	-1.1	-1	-1.1	-1.7	-2.2
Public Debt (% of GDP)	36.1	33.5	27.5	28.3	28.5	27.8
Inflation Rate (CPI, ann var in %, eop)	7.4	8.2	8.8	8.5	11	10.4
Policy Interest Rate (%)	4.5	8.25	7.5	8	12.75	16.5
Government expenditure (% of GDP)	34.2	33.3	33.4	35.1	33.8	33.6
Exchange Rate (vs USD)	2.15	2.33	2.92	3.53	3.79	4.8
Current Account (% of GDP)	-6.7	-4.7	-3.7	-3.8	-5.5	-5.7
Current Account Balance (USD bn)	-63.6	-43.6	-32.1	-32.6	-47.1	-49.1
Trade Balance (USD billion)	-79.9	-63.6	-48.1	-40.9	-76.9	-63.9
Exports (USD billion)	152	157	144	143	157	170
Imports (USD billion)	242	233	200	191	234	234
Exports (annual variation in %)	-0.1	4.4	-10	-1.2	9.8	8.2
Imports (annual variation in %)	6.3	-3.8	-14	-4.5	22.5	0
International Reserves (USD)	111	107	92.9	92.2	82.7	85.3
External Debt (% of GDP)	41.1	43	46.2	47.3	53.3	52.6

In the market for goods and services, the country seems to be experiencing a robust aggregate demand, but soft aggregate supply. That can explain why economic growth has been strong, but unemployment and inflation remain persistently high. "Chronic inflation is seen as one of the most vexing problems for Turkey's economy." (Reuters, 2018).

We are mostly interested in the developments in the foreign currency market, given the currency crisis that Turkey went through in the first half of 2018. Mainly, the risks described by the World Bank (2018) came to fruition: "Turkey's external vulnerability remains high. Further tapering of U.S. monetary policy in 2018 could negatively affect capital flows, raising interest and exchange rate risks for Turkey's external debt." It is exactly what happened. Countries with persistently high current account deficits are subject to capital reversals that trigger currency crises. In fact, the rapid depreciation of the lira is a combination of raising interest rates abroad and low confidence in public authorities at home. In 2018 public authorities openly diverged in terms of policy prescription. President Erdogan is a self-described "enemy of interest rates" who wanted the central bank to lower interest rates, fueling concerns that monetary policy is less than independent (Reuters, 2018).

When institutions are less credible and there is an external shock, financial markets respond strongly. That is what happened in Turkey. Under that environment, public authorities had the following options:

- Let the currency depreciate until it reached a new equilibrium;
- Enact capital controls to thwart foreign currency outflows;
- Sell foreign reserves to halt the depreciation;
- Increase the target interest rate to incentivize short-capital in Turkish government bonds;
- Ask for loans from multilateral institutions such as the IMF, as to signal a willingness to intervene in the foreign currency market

The government tried to ride out the devaluation at first, since the President was adamant against increasing interest rates. Then the government started selling reserves. But the damage was done. Finally, on May 24, the Turkish Central Bank hiked the target interest rate by 300 base points (3%), to 16.5%.

The devaluation and interest rate hike should reduce aggregate demand and limit the inflationary effects of the devaluation. If, of course, it was not too little too late.

Questions for discussion:

1) Establish the conditions of the main macroeconomic markets in Turkey at the end of 2017. Starting from the foreign currency market, establishing the economic effects from the sudden capital reversal through the loanable funds, money and goods and services markets. Once the central bank decides to raise the target interest rate, what should be the ramifications in the macroeconomic markets?
2) Assume that the central bank's reaction is met by signals from the President that he disapproves of the higher interest rates? Could further devaluation happen with interest rates above 16% a year?
3) What should be the effects of the currency crises on local banks and non-financial companies? Under which conditions could the country face a financial crisis?
4) Argentina faced a similar predicament in May 2018. On January 10, the Banco Central de la República Argentina (BCRA, the central bank) cut the policy rate from 28.75% to 28%. But as the peso weakened, it sold a significant amount of foreign reserves and successively raised interest rates. On May 4, a week after selling off USD 5 billion of reserves to intervene in the foreign currency market, the BCRA hiked the policy rate to 40%. The currency continued to weaken. Authorities then announced that they were pursuing a rescue package by the IMF. Establish the tradeoffs of Argentinian policymakers regarding IMF loans. What would you recommend that Argentina do, in the long run, to stave off currency crises?

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