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Partying like it's 1998

Turkey has an old-fashioned currency and debt crisis - demanding old-fashioned solutions

Read this article in German.

And now for something completely similar.

For a while, those of us who devoted a lot of time to understanding the Asian financial crisis two decades ago were wondering whether Turkey was going to stage a re-enactment. Sure enough, that's what seems to be happening.

Here's the script: start with a country that, for whatever reason, became a favorite of foreign lenders, and experienced a large inflow of foreign capital over a number of years. Crucially, the debt thus incurred is denominated in foreign currency, not domestic (which is why the US, also a recipient of large inflows in the past, isn't similarly vulnerable — we borrow in dollars).

At some point, however, the party comes to an end. It doesn't matter much what causes a 'sudden stop' in foreign lending: it could be domestic events, like appointing your son-in-law to oversee economic policy, it could be a rise in US interest rates, it could be a crisis in another country investors see as being similar to you.

Whatever the shock, the crucial thing is that foreign debt has made your economy vulnerable to a death spiral. Loss of confidence causes your currency to drop; this makes it harder to repay debts in foreign currency; this hurts the real economy and further reduces confidence, leading to a further decline in your currency; and so on.

The result is that foreign debt explodes as a share of GDP. Indonesia came into the '90s financial crisis with foreign debt less than 60 percent of GDP, roughly comparable to Turkey early this year. By 1998 a plunging rupiah had sent that debt to almost 170 percent of GDP.

Averting the downward spiral

How does such a crisis end? If there is no effective policy response, what happens is that the currency drops and debt measured in domestic currency balloons until everyone who can go bankrupt, does. At that point the weak currency fuels an export boom, and the economy starts a recovery built around huge trade surpluses. (This may come as a surprise to Donald Trump, who appears to be levying punitive tariffs on Turkey as punishment for its weak currency.)

Is there any way to short-circuit this doom loop? Yes, but it's tricky. What you need to reduce the costs of crisis is a combination of short-run heterodoxy and credible assurances of a longer-run return to orthodoxy.

You need a government that is both flexible and responsible, not to mention technically competent enough to implement special measures and honest enough to carry out that implementation without massive corruption.

How it works: stop the explosion of the debt ratio with some combination of temporary capital controls, to place a curfew on panicked capital flight, and possibly the repudiation of some foreign-currency debt. Meanwhile, get things in place for a fiscally sustainable regime once the crisis is over. If all goes well, confidence will gradually return, and you'll eventually be able to remove the capital controls.

Can Erdogan pull it off?

Malaysia did this in 1998; South Korea, with US aid, effectively did something like it at the same time, by pressuring banks into maintaining their short-term credit lines. A decade later, Iceland did very well with a combination of capital controls and debt repudiation (strictly speaking, refusing to take public responsibility for the debts run up by private bankers).

Argentina also did quite well with heterodox policies in 2002 and for a few years after, effectively repudiating two-thirds of its debt. But the Kirchner regime didn't know when to stop and turn orthodox again, setting the stage for the country's return to crisis.

And maybe that example shows how hard dealing with this kind of crisis is. You need a government that is both flexible and responsible, not to mention technically competent enough to implement special measures and honest enough to carry out that implementation without massive

corruption.

That, unfortunately, doesn't sound like Erdogan's Turkey. Of course, it doesn't sound like Trump's America, either. So it's a good thing our debts are in dollars.

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