Crisis in Turkey and Lessons for Italy
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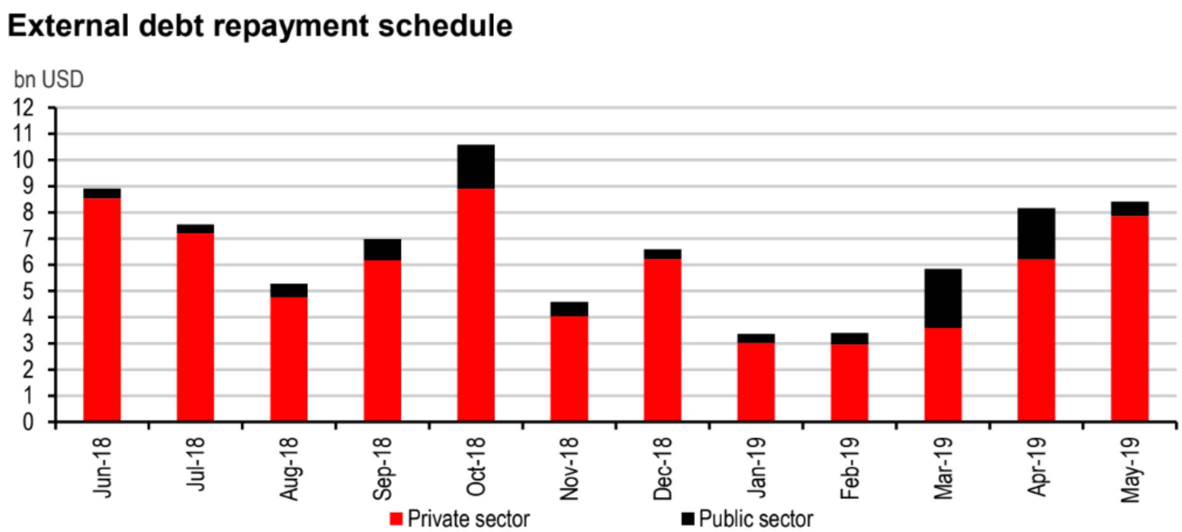
August 16, 2018

The ongoing Turkish crisis is a textbook case. The strongest predictors of financial crises in any country are domestic credit booms and external debts. In emerging markets, credit booms are generally go hand-in-hand with large capital inflows. Turkey had a huge credit boom in the last decade financed with capital inflows. Private sector---corporates and banks---borrowed in foreign currency from foreign investors and now these investors do not want to invest in Turkish private sector anymore since they think what is already owed to them will not be paid back given the mismanaged Turkish economy. As a result, they started fleeing and hence Turkish lira is in free fall.

How did this boom-bust cycle work and does it unique to Turkey? Many high growth emerging markets have been receiving capital inflows since 2008 Global Financial Crisis as the developed economies undertook unconventional monetary policies to ramp up their recessionary economies that led to record low interest rates in those countries. Searching for higher yields, foreign investors from those developed economies poured money into emerging market assets. Turkey is not unique in this sense. Now the tide is turning: Both the US and Europe are doing better and FED started to increase the interest rates in the US. Higher interest rates in developed countries reduce the interest rate differential between developed countries and emerging markets, which might mean capital outflows from emerging markets. Turkey may not be also unique here but is definitely the first country in a series of future similar emerging market debt crises. The reason for this is the fact that Turkey has the maximum number of economic imbalances and vulnerabilities. It is normal in such a scenario that foreign investors want to leave the most vulnerable emerging market first. Given the high levels of inflation at 16 percent and interest rates offered to foreigners being at 19 percent, the real rate is only 3 percent, a return that is barely higher than the developed economies' rates. To calm the markets at this point Turkish Central Bank needs to hike the rates at least 700-800 basis points to give foreigners a real return of 10 percent. Of course, since now the crisis turned into a confidence crisis, this may not be enough and it might be the case that no matter how high the interest rates go, foreigners will leave and Turkish lira will keep losing value. This would not be the case if Turkey did not waste the boom years where there were lots of opportunities and cheap financing to undertake structural reforms. Instead, everyone partied with foreign money until the music stopped. The music has definitely stopped.

Boom-bust cycles in emerging markets are not new and many believed that emerging countries have learned their lessons from the similar cycles ending in financial crises of 1980s and 1990s. It was argued that emerging markets do not have problems of high sovereign debt, inflexible exchange rates, and fiscal deficits anymore. It is indeed true that macroeconomic policies have been much better in emerging markets in 2000s and they all moved to a more flexible exchange rate system and cut down their governments' external foreign currency debt. But, as Turkish crisis clearly showed, even under floating exchange rates and low government debt, you can have a full blown currency crisis if your private sector borrowed heavily in foreign currencies and monetary policy have been so loose that it did not keep inflation in check.

The key vulnerability in Turkey's case is high levels of liability dollarization in the corporate sector. It is well known that in emerging markets, firms tend to borrow in dollars, mostly short-term, and leaving themselves vulnerable to exchange rate fluctuations and a roll-over crisis. The Turkish Central Bank's financial stability reports from last 5 years state that 60 percent of the corporate sector's debt is in foreign currency. For construction sector, this number is 70 percent and for manufacturing, it is 50 percent. What is alarming is that in the case of construction sector most of this will be presumably unhedged by the sector's nature since this sector is not a tradable sector like manufacturing, that is, this sectors' earnings are not in foreign currency. Some companies might be buying currency hedges but in general only big companies can afford to do this given the fact that hedging is very costly. The figure below shows the external USD debt payment schedule where private sector, comprised of banks and corporates, is heavily indebted in foreign currency.



Source: CBRT, Treasury. External loan repayments to be made over the next 12 months regardless of the original maturity of the loan. Financial sector includes banks and non-bank financials. Trade credits are excluded. Public sector is central government only

During Asian and Latin American crises, such levels of liability dollarization played a significant role even under flexible exchange rates due to balance sheet effects. In the event of a sudden loss in the value of domestic currency, a debt that is in foreign currency on the liability side of the balance sheet cannot be paid or rolled over when the asset side of the same balance sheet is in domestic currency, resulting in a decline in firm's net worth. So far, this is the main reason behind the investor panic and more than 40 percent loss in Turkish Lira's value against the USD. The first line of defense in these situations are a) interest rate hike, b) IMF, c) capital controls. Turkey made it clear that options b and c are not on the table. They cannot do option c anyway since Turkey is an OECD country and have a customs union with the EU so cannot put capital controls. The only solution remaining is tight monetary policy that is the interest rate hike. Turkey made it clear that they do not want to do this since this will raise the borrowing cost for Turkish firms and hence will have recessionary effects. Well, they should have taught of this before borrowing huge amounts from foreigners who demand a high return, especially in situations like this where they think they take default risk by investing in Turkey so they demand a risk premium. Foreign investors are still hoping that Turkish Central Bank is an independent institution and will increase the interest rates delivering this high return and stopping the panic in the markets. Maybe this will happen but all we have seen so far in terms of the political environment in Turkey suggests the contrary.

Since 2003, when current president Erdogan came to power as the prime minister with the AKP (AK Party) government, Turkey has enjoyed resilient growth that averaged 5 percent annually. It has earned praise from financial markets and economists alike. However, during this period, a political bubble formed in the sense that no major structural, institutional and legal reform had been done. Political bubbles are likely to form during periods of stability and strong government support, especially under so-called ``strongmen'' rule that is associated with populist policies. Research has shown that, in the past, emerging economy crises are preceded by a strong increase in government support. On average, in emerging markets, government stability increases by more than 50 percent in the five years prior to major crisis events. AKP's previous five year support is also around 50 percent. One explanation for such a pattern is that in emerging economies, people assign a larger importance to the government in driving economic performance. This increases the incentives of governments to delay reforms since reforms will reduce popularity and with less popularity the chances of being re-elected is lower. Hence, political bubbles and financial bubbles can go together during periods of stability and growth, where domestic credit growth helps to stimulate the economy during the short run, but can also lead to a bubble in asset prices, mostly likely in the real estate sector, especially in the absence of any domestic structural reform. This scenario can happen in any country and happened in Turkey but in Turkey's case, there is also an additional element: that element is institutional decay. Such decay makes the country vulnerable to a confidence crisis where any political trigger (as the disagreement between Trump and Erdogan showed) can easily turn into a financial crisis as happened during the last week. The reason why in Turkish case there is institutional decay is the fact that strong institutions cannot survive under populist governments. These governments of strongmen never see institutions as partners but rather as threats. For strongmen, loyalty is more important than competence and this brings economic mismanagement, which will worsen the crisis.

There is an important lesson for Italy here, given Italy's new populist government. In democracies, if elected leaders mismanage the economy, for example, if they let credit boom and inflation go rampant, they will be replaced and new comers will fix the situation. In countries governed by populist strongmen, on the other hand, this will not work. The reason is simply the fact that these type of populist governments will cause institutional decay so even they lose elections, it will be hard to fix the situation for any new comer. When crisis comes, it becomes impossible to control it and to fix it without strong institutions such as an independent central bank. As a result, strongmen ruled populist governments are responsible for creating the mess at the first place---since they need growth to keep their constituents happy, so they do not rein in credit growth and inflation and over borrowing---and they are responsible for making the crisis worse given the lack of institutions and economic competence to deal with the crisis. The sad truth is that these type of governments undermine their own economies and well-being of their citizens since at the end of the day the cost is borne out by the people who voted for them.

The current situation in Italy can very well be first signs of such a crisis coming. The populist view in Italy is that Italy can leave the Eurozone and can print money indefinitely to finance its’ debt. One does not need to be an economist to understand that this is a recipe for disaster; just remembering many hyperinflation episodes under dictatorships during the last century will be enough. A country like Italy with high levels of debt needs credibility and transparency in terms of monetary policy. The only institution that can provide this is the European Central Bank. In Italy’s case high levels of public debt makes the economy very fragile as became clear this week when Italian government bonds’ prices dropped sharply due to Turkish crisis. This is not because there is a direct link between Turkish crisis and Italian bonds but rather investors was taking a “risk-off” attitude and dumping risky assets and clearly, they see Italian assets as such. Outside the Eurozone, without an anchor such as European Central Bank, Italy would have been the second debt and credibility crisis this August after Turkey. I hope the Italian populists take notes from these latest events.