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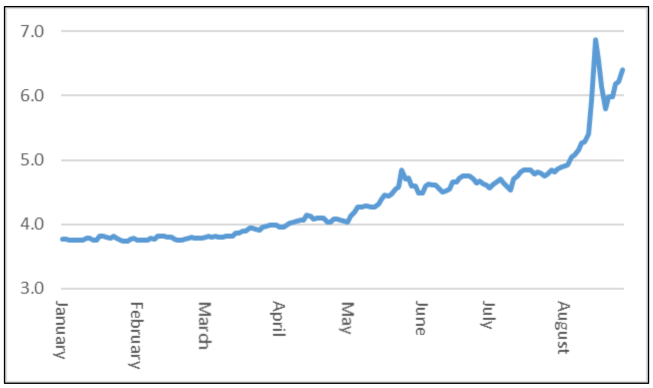
# Turkey's Currency Crisis

Turkey, the 17th largest economy in the world, is facing a significant currency crisis. The value of its currency, the lira, has fallen by about 40% against the U.S. dollar since the start of 2018 (**Figure 1**). The lira lost about 25% of its value in the first two weeks of August.

The collapse in the value of the Turkish lira may pose questions for Congress for foreign policy and economic reasons. On foreign policy, economic instability in Turkey could impact U.S.-Turkey relations, with tensions heightened in recent months between the two NATO allies. On the economic side, U.S. direct economic exposure to Turkey is relatively low. Nevertheless, Turkey's currency crisis risks impacting European banks and spilling over to other emerging markets, which could have implications for the U.S. economy.

**Figure 1. Value of the Turkish Lira: 2018 to date**

Liras per U.S. dollar




**Source:** Central Bank of Turkey.

**Notes:** An increase in lira per U.S. dollar represents a depreciation of the lira relative to the U.S. dollar.

## Currency Crisis in Turkey

### Vulnerabilities and Lira Depreciation

Since the global financial crisis of 2008-2009, interest rates in advanced economies have been at historical lows. International investors increasingly turned to emerging markets to seek higher rates of return on their investments. Turkey was an attractive destination due to economic reforms in the early 2000s, vibrant growth (6.9% annually on average between 2010 and 2017, compared to 3.8% globally), and its large domestic market (it has a population of about 80 million people). Turkish banks and large firms borrowed heavily from foreign investors, typically in U.S. dollars. Easy access to foreign financing supported Turkey's large annual current account deficits (a broad measure of the trade balance), averaging 5.5% of GDP per year between 2010 and 2017 and among the largest in the world.

Turkey's reliance on external financing made it vulnerable to changes in the terms and availability of credit. Turkey's financing costs increased as the U.S. Federal Reserve (Fed) started increasing interest rates. Additionally, investor perceptions of Turkey's creditworthiness started changing. Investors started questioning the sustainability of Turkey's construction boom and expansionary fiscal and monetary policies in the months preceding the June 2018 presidential and parliamentary elections. Increased political tensions between Turkey and the United States also eroded investor confidence. In August 2018, the Trump Administration levied sanctions on two Turkish cabinet ministers deemed responsible for detaining and prosecuting an American pastor whose full release President Trump has demanded.

As investors became more reluctant to invest in Turkey, demand for the lira started to fall and the currency depreciated. Then the nominal value of Turkey's debt (the value of the debt in lira) rose, exacerbating investor concerns about debt sustainability in Turkey, making investors even more reluctant to invest and further pushing down the value of the lira, creating a vicious cycle.

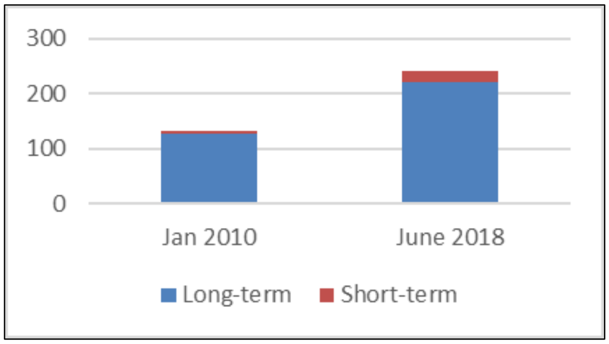
On August 10, 2018, President Trump alluded to concerns about the lira's depreciation when he announced on Twitter a doubling of the steel and aluminum tariffs on Turkish imports invoked under Section 232 for national security concerns. Rapid depreciation of the lira generally makes it harder for U.S. products to compete with Turkish products, although U.S.-Turkish trade flows overall are low. Almost immediately after the President's tweet, the lira markedly dropped even further.

### Economic Implications for Turkey

Turkey's currency crisis could create a wave of defaults across Turkey's banks and corporations, whose debts to foreign creditors have nearly doubled since 2010 (**Figure 2**). The currency crisis makes debt payments difficult for two reasons. First, changes in the currency have increased their debt in terms of lira, from about 44% of GDP to almost 80% of GDP over the course of 2018. Second, loss of investor confidence means that banks and corporations may have trouble "rolling over" their debt (paying off old debts by securing new loans), forcing debt payments that they may not have been planning. The government may face pressures to provide assistance to banks and corporations. This could create fiscal problems for the government, even though it entered the crisis with relatively modest levels of debt (28% of GDP in 2017, compared to an average of 49% of GDP for emerging markets and developing economies and 103% of GDP for advanced economies).

**Figure 2. Turkey's Private Sector Debt: Foreign Loans Outstanding**

Billion US$




**Source:** Central Bank of Turkey.

### Possible Policy Responses

It is not clear how the Turkish government plans to strengthen its currency. The central bank's foreign exchange reserve holdings are low (less than 10% of GDP), limiting its ability to support the lira by directly intervening in foreign exchange markets (selling foreign currency in exchange for lira, to increase demand for the lira).

Turkey's central bank could appreciate the lira by rising interest rates, but likely at the cost of curbing economic growth. Turkish President Recep Tayyip Erdogan has prevailed, successfully so far, on the central bank to hold off on raising interest rates. In July, after re-election, Erdogan gave himself the power to appoint central bank rate-setters and appointed his son-in-law Berat Albayrak to serve as treasury and finance minister, exacerbating investor concerns about central bank independence and the politicization of monetary policy.

Finance Minister Albayrak has also ruled out two other possible policy responses: capital controls and financial assistance from the International Monetary Fund (IMF). However, a number of outside observers speculate that Turkey will need an IMF financial assistance package at some point, even though the policy reforms attached to IMF funds have been politically unpopular in Turkey in the past.

Qatar extended a $3 billion currency swap agreement to Turkey in late August as part of a larger $15 billion investment package for Turkey. The currency swap agreement increases the availability of dollars in Turkey but some analysts are skeptical it is sufficient to stabilize the lira. The German government is also reportedly considering providing emergency financial assistance to Turkey. Easing political tensions with the United States could also increase investor confidence in Turkey, but the prospects for doing so are unclear.

## Implications for the U.S. Economy

Overall economic ties between the United States and Turkey are relatively weak. Turkey accounts for less than 1% each of U.S. merchandise exports, U.S. merchandise imports, U.S. direct investment overseas, foreign direct investment in the United States, and the overseas claims of U.S. banks. Turkey has stronger ties with Europe, and the European Central Bank has expressed some concerns about European bank exposure to Turkey. Given strong U.S.-EU economic ties, banking instability in Europe could negatively impact the United States.

An impact on the U.S. economy could also be felt if Turkey's crisis spreads to other emerging markets that are similarly reliant on external financing and negatively impacted by rising U.S. interest rates. Argentina, facing similar pressures, turned to the IMF for financial assistance in June 2018. Rapid depreciation of the lira has caused the value of Brazilian, Indian, Mexican, and South African currencies to fall as well, fueling concerns about contagion effects. If Turkey's crisis spills over to other emerging markets, a broader crisis across several emerging markets could have significant implications for the U.S. economy. However, there are a number of factors specific to Turkey driving the crisis, and some analysts are hopeful that the crisis can be contained if investors focus on the fundamentals specific to each country.

## Questions for Congress

- Are U.S. financial institutions sufficiently capitalized and diversified to withstand potential defaults on outstanding debts by Turkey and/or other emerging markets?
- How does the lira's depreciation affect global steel and aluminum markets, including U.S. production? Are higher steel and aluminum tariffs effectively offsetting changes in exchange rates, or exacerbating exchange rate volatility?
- The United States plays a leadership role in shaping IMF policies. Does Turkey need an IMF program? If so, under what conditions would the United States support such a program? Turkey has been a repeat IMF borrower, with 19 programs, the most recent of which ended in 2008. How would a new program be similar to and different from previous programs?
- Turkey is a major recipient of financial assistance from some multilateral development banks. Should the multilateral development banks adjust funding levels in light of currency instability? Should the European Bank for Reconstruction and Development (EBRD) be heavily invested in Turkey, given its mandate to operate in countries committed to multiparty democracy and pluralism?
- What political issues should affect U.S. considerations regarding Turkey's currency crisis, and what effect is the crisis likely to have on those issues?
- To what extent is the crisis in Turkey driven by factors specific to Turkey or more broadly shared among emerging markets? Are problems in other emerging markets likely to arise if and when the Fed continues to raise interest rates?

For more information on Turkey, see CRS Report R44000, *Turkey: Background and U.S. Relations In Brief*, by Jim Zanotti and Clayton Thomas, and CRS In Focus IF10961, *U.S.-Turkey Trade Relations*, by Shayerah Ilias Akhtar.

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