Turkey headed for debt default

Erdo an to blame for swooning lira

by Desmond Lachman in Washington

Tue 14 May 2019

President Recep Tayyip Erdo an's mishandling of his country's currency crisis heightens substantially the probability that Turkey will soon default on its external debt. That could jeopardise the rest of the emerging market economies' prospects as well European banks, particularly in Spain, with high Turkish debt exposure.

Behind Argentina, Turkey has the dubious distinction of having the world's second worst performing currency. After plunging by 30% in 2018, since the start of this year the currency has lost a further 14% in value and shows no signs of stabilising.

At the heart of the swooning Turkish lira has been the loss of domestic and foreign investor confidence in the government's ability and willingness to correct the large economic imbalances built up by years of overly easy monetary and fiscal policies. It has hardly helped investor confidence that inflation has been allowed to rise to 20%, or four times the Central Bank Of The Republic Of Turkey's official inflation target. Nor has it helped that Erdo an has leant heavily on the central bank to refrain from raising interest rates to stem the currency's slide and to curb inflation.

There are many other ways in which the president seems to have gone out of his way to undermine confidence in the currency. These include getting rid of competent economic officials in favour of yes-men, like the appointment of his son-in-law as minister of finance, to run the economy. They also have included his success in overturning the Istanbul local election and his further souring relations with the US by his close co-operation with Russia on defence issues.

Turkey has an exceedingly high level of short-term external debt and its corporate sector has borrowed excessively in dollar terms. It is estimated that over the next year the country must make $180bn in external debt service payments. This comes at a time when its international reserves have already dwindled to around three months of import payment. It is also estimated that its corporate sector has borrowed $300bn in dollar terms, with a servicing burden becoming more onerous as the lira falls and the economy contracts.

Erdo an is showing no signs of urgency in addressing the currency crisis. He is in fact adding to political uncertainty by forcing a rerun of the Istanbul local election. This risks having the currency succumb to another round of its vicious cycle. A weakening currency could very well lead to corporate bankruptcies that further erode investor confidence and deepen currency weakness. That could add to political instability which would be yet another factor contributing to currency weakness and to a draining of investor confidence.

Erdo an must soon recognise that, once lost, investor confidence is difficult to restore. That might induce him to do something radical, like call in the International Monetary Fund or fire his finance minister. This would show that he has become serious about breaking the downward economic spiral in which the country finds itself. Otherwise, the rest of the emerging market economies and the Spanish banking system should brace themselves for economic shock waves coming from a Turkish debt default.

Desmond Lachman is a Resident Fellow at the American Enterprise Institute. He was formerly a Deputy Director in the International Monetary Fund's Policy Development and Review Department and the Chief Emerging Market Economic Strategist at Salomon Smith Barney.