COMMENTARY

Erdogan Can Save the Turkish Lira

He should form a currency board—a monetary-reform measure that's been tried 70 times and never failed.

Turkey's President Recep Tayyip Erdogan addresses his supporters in his Black Sea hometown, Rize, Turkey, Aug. 11. PHOTO: ASSOCIATED PRESS

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The Turkish lira floats, but not on a sea of tranquillity. Since Recep Tayyip Erdogan became president in August 2014, the lira has shed 66% of its value against the U.S. dollar. Since May 14, when Mr. Erdogan announced he was taking Turkey's monetary reins into his own hands, the lira has plunged 31%.

Turkey's annual inflation rate reached 85% last Friday by my measurements, which use high-frequency data and account for price changes in all commodities, services and assets. This is nothing new. Inflation has ravaged Turkey for decades. The average annual inflation rates for the 1970s, 1980s, 1990s and 2000s were 22.4%, 49.6%, 76.7%, and 22.3%, respectively.

Those horrendous numbers mask the periodic lira routs. In 1994, 2000-01 and the past few months, the lira has been torn to shreds. On May 28, when the lira traded at 4.58 to the dollar, I predicted a collapse to 7. Friday's close was 6.43.

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As fantastic as it may sound, particularly for Turks, there is a way to save the lira from its death spiral and crush inflation immediately. Turkey should adopt a currency board. A currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. It is required to hold anchor-currency reserves equal to 100% of its monetary liabilities, and it generates profits from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities.

By design, a currency board has no discretionary monetary powers and cannot issue money on its own credit. It has an exchange-rate policy—the exchange rate is fixed—but no monetary policy. Its operations are passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Consequently, the quantity of domestic currency in circulation is determined entirely by market forces, namely the demand for domestic currency. Since the domestic money is a clone of its anchor, a currency-board country is part of an anchor country's unified currency area.

A currency board requires no preconditions and can be installed rapidly. Government finances, state-owned enterprises and trade need not be reformed before a currency board can issue money.

Currency boards have existed in some 70 countries. The first was installed in the British Indian Ocean colony of Mauritius in 1849. No currency board has failed. This perfect record includes the National Emission Caisse, established in northern Russia in 1918 during Russia's civil war. The Caisse issued "British ruble" notes, backed by pounds sterling and convertible into pounds at a fixed rate. The father of the British ruble was John Maynard Keynes, a British Treasury official at the time.

Despite the civil war, the British ruble never deviated from its fixed exchange rate with the pound. In contrast to other Russian rubles, the British ruble was a reliable store of value. Naturally, the British ruble drove other rubles out of circulation. Unfortunately, its life was brief: The National Emission Caisse ceased operation in 1920 after allied troops withdrew from Russia.

Contrary to popular belief, Argentina's monetary regime—which was installed in April 1991 and collapsed in December 2001—was not a currency board but an unusual arrangement called a "convertibility system." Like a currency board, convertibility maintained a fixed exchange rate between the peso and its anchor currency, the U.S. dollar. That nominal anchor smothered hyperinflation.

But the convertibility system's deviations from currency-board orthodoxy allowed it to behave more like a central bank than a true currency board. These deviations were significant and allowed it to engage in discretionary monetary policies. In an October 1991 article for these pages, I argued that Argentina should abolish its "central bank" and replace it with a currency board.

Turkey can look to an immediate neighbor for a currency-board success story. In 1997, Bulgaria was gripped by hyperinflation. The lev had collapsed, and the monthly inflation rate had soared to 242%. As the president's adviser, I designed a currency board that was installed on July 1. With that, the lev became a clone of the deutsche mark. Inflation was crushed immediately, lev interest rates plunged, a hard budget constraint was put on Bulgaria's fisc, and the economy boomed. Since the installation of the currency board, fiscal deficits have been tightly controlled.

Bulgaria's fiscal discipline and debt reduction have made it a star performer in the European Union.

To make the Turkish lira as good as gold—or some other anchor currency of choice, meaning the euro or U.S. dollar—Mr. Erdogan should announce today that Turkey will install a currency board in 30 days. As part of that announcement, he should state that until the currency board is installed, the lira monetary base will be frozen and the lira will be permitted to freely float. At the end of the 30-day period, a fair exchange rate will be chosen to lock in the lira to its new anchor. That is the procedure we employed in Bulgaria, and it worked like a charm.

The effect of such an announcement would be dramatic. In 1998 President Suharto appointed me his special counselor and announced that he was considering a currency board for Indonesia. That day the rupiah appreciated 28% against the greenback. An announcement by Mr. Erdogan would similarly send the lira soaring and inflation plunging.

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