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Because of the role of the U.S. dollar as the world's reserve currency, Americans can be very insulated from the ebbs and flows of global currency values and their effects on global investment and trade markets. While the dollar has reigned supreme for nearly a hundred years in the role of global trade currency, it was not always the case. Until World War 1, London was the capital of world finance, and the British Pound Sterling was the world's reserve currency and had been for a very long time. Only due to the destruction that two world wars took on Great Britain and its place in the world as the master of all credit, trade and finance did the U.S. financial system and the dollar rise to power as the world's reserve currency, displacing the influence of the Pound. The disruption of the wars allowed the U.S. to assume the powerful role of world's leading exporter of agriculture and industrial machinery, as a large creditor to finance the war efforts and as lender, insurer and provider of capital to the foreign trade acceptance market.

The foreign trade acceptance market is a little known but very important function in global trade. In 1890, a grain seller in New York may have contracted to sell a shipload of wheat to a European buyer. However, the ship may have taken two months to get to the European port, and the cash payment may have taken two months to get back to the seller. In stepped a New York bank, who with confidence in the credit of the wheat buyer to send back the payment, would advance the full payment to the shipper, to avoid him being short both the wheat and the payment for four months. It was this ability to provide the oil in the global trade machine that most led to the rise of America as the world's financial capital and the dollar as the world's most used currency.

The dollar today remains far and away the most important currency for billing and settling of international transactions. South Korea and Thailand set the prices of more than 80 percent of their trade in dollars, despite only 20 percent of their exports going to American buyers. The dollar is used in 85 percent of all foreign exchange transactions worldwide, and global foreign banks hold more than 60 percent of their foreign currency reserves in dollars.

While we may not directly feel the power of the dollar as the world's reserve currency, we are seeing the effects of that influence and the world's dependence on the dollar this week in Turkey. The crisis began earlier this summer, when a newly re-elected Turkish president named his son-in-law as Finance Minister, so the administration then assumed an outsize influence over the country's monetary policy. The Turkish lira began its slide when a much-expected boost in short-term interest rates, in order to curb its high inflation rate, did not come to pass. Over the past 20 years, Turkey has become very dependent on foreign debt inflows to expand and grow its economy. A measure of Turkey's reliance on money from abroad is the high percentage of foreign-currency-denominated debt owed by companies, the government and households, at 55 percent of all debt, the highest in the emerging market world. U.S. companies transact business and borrow money in dollars, so are immune somewhat from currency fluctuations around the globe. Turkey, and many Turkish companies, however, have borrowed a huge amount of money from global banks and investors, most of that debt denominated in dollars. While denominating loans in dollars protects foreign creditors from fluctuations in Turkey's currency, the lira, it leaves Turkish borrowers very exposed, as it is required to pay back its loans in dollars, no matter how the value of the lira trades against the dollar. This has caused the crisis this week in Turkey, as a weakening lira has caused a death spiral, where decreased confidence in the Turkish economy and its monetary policy causes the lira to lose value, which decreases confidence even more, and so on. While Turkish companies may be able to pay back dollar debt when a dollar costs one lira, they are very strained to pay back debts when a dollar costs six lira, as it did this week.

The widespread use of the dollar can negatively affect emerging market economies in other areas as well. Global oil is priced in dollars, so the cost of energy in Turkey will be much higher now, which will spike inflation even further. More generally, a falling lira will make foreign imported goods more expensive, which will boost inflation in Turkey as well. The cost of borrowing in Turkey has risen materially, as yields on local-currency Turkish bonds have spiked to 23 percent recently. Bond investors are demanding much higher yields to offset the increasingly higher risk of default.

What is the end-game in these localized financial crises? We have seen similar situations over the past 25 years in Indonesia, Argentina, South Korea and Malaysia. The way out is difficult, but not impossible. It involves a combination of short-run pain, as borrowers default on debts, and offer more credible assurances of a longer-run return to thoughtful monetary policies. In the short-run, Turkey could 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 default of some dollar debt — at the same time putting policies in place for a fiscally sustainable regime once the crisis is over. Over time, confidence will gradually return, and the capital controls could be reduced. However, the Turkey financial crisis may remain as a financial market news item for some time, due to fears of contagion to other emerging market countries and the negative effects on global banks of Turkish debt defaults. And the Turkish administration has not shown a knowledge of or desire to enact smart monetary policies to work its way out of this current mess.