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POLITICAL ECONOMY OF TURKEY: IN SEARCH OF STABILITY AMID DOMESTIC AND GLOBAL CRISES

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INTRODUCTION

The Turkish economy witnessed a boom and bust cycle in the last decade. The "home grown" economic crisis of 2001, which had devastating repercussions for the economy, was followed by a prolonged period of growth and stability. The honeymoon, unfortunately, did not last too long. It appears that the Turkish economy is headed toward another period of slow growth; this time, as a result of the global financial crisis ignited by the mortgage crisis in the US.

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The views expressed in this paper are the author's and do not necessarily represent the opinions of TUSIAD.

This paper deals with the political economy of Turkey from the domestic crisis of 2001 to the global crisis of 2008. It will first focus on the domestic economic crisis of 2001 and explore its roots, its effects on the economy, and finally, the cure that was implemented. The political implications of the crisis will also be highlighted. Then, the period of rapid recovery, characterized by a favorable global environment; structural reforms implemented thanks to the International Monetary Fund (IMF) program; and the ongoing EU process will be analyzed. Finally, the paper will speculate about the current global crisis and its implications for the Turkish economy.

The paper will conclude with an assessment of the likely repercussions of the current crisis on the future of the Turkish economy and the domestic political scene in light of the upcoming local elections. The impact of the economic crisis on Turkish foreign policy, with a special reference to Turkey's "soft power" in its region will also be addressed.

DOMESTIC CRISIS OF 2001

1. The making of the crisis

In December 1999 the Turkish government of the time launched a comprehensive belt – tightening program with the help of an IMF-supported three-year agreement in order to bring down inflation and reduce the already unsustainable level of public debt. The program appeared to be on course until fall 2000 and enjoyed wide public support. However, in November the overall mood rapidly deteriorated with the emergence of a serious crisis. In a matter of days interest rates soared, billions of dollars fled the country and Turkey was faced with exceptionally high costs to borrow from abroad. Following a few months of relative calm, another crisis erupted in February 2001 in the immediate aftermath of a harsh political quarrel between PM Ecevit and President Sezer.

The factors that contributed to the making of 2001 crisis, at first sight, appear to be related to the poor macroeconomic performance. The public debt to GNP ratio, the current account deficit (mostly trade deficit), the inflation rate, the interest rates and the ratio of the financial sector's debt (relative to official reserves) were all significantly high and therefore worrisome for most market participants. However, this would be a mistaken judgment as many of these macroeconomic imbalances had been addressed by the IMF program that was put into effect in December 1999.

The primary cause of the crisis was in fact the weakness in the banking system and its heavy exposure to government debt. Because the government needed to finance its debt, private banks were heavily borrowing short-term and lending to the government long-term. The circumstances were also highly complicated for state banks, which were chronically in the red and were thus heavily dependent on short-term borrowed funds to keep the flow of payments. Finally, one should note that the banking system's fragility was essentially driven by the high public sector debt. This debt, in turn, created a massive public sector borrowing requirement. The budget deficits were therefore primarily financed through issuance of debt securities, mainly in the form of treasury bonds.

2. The impact of the crisis and the revision of the IMF program

The crisis came in two installments. The first episode began in November 2000 and the second in February 2001. The latter ended the peg of the Turkish lira to the US dollars and a regime of free floating exchange rates was established. As in most other episodes of financial crisis, the now fluctuating Turkish lira witnessed a free-fall, interest rates rose sharply and the economy contracted at an unprecedented rate.

Kemal Dervis, a vice president of the World Bank and a well known figure in international financial circles, was given the helm of the economy as a non-political/technocratic minister in charge of the economy. The existing three-year IMF agreement was immediately revised and further supported by generous additional funding within a few months following the February incident. The revised program aimed at addressing the root causes of the crisis by placing government debt management at its core. Also, a comprehensive reform agenda was designed for the banking sector.

One of the major consequences of the twin crises was the rapid erosion in credibility for the governing coalition parties, which held a clear majority in the parliament and were already troubled by deteriorating support caused by their perceived inability to govern as well as corrupt practices. In the summer of 2002, at a time when the program had yielded some positive results, the coalition government risked calling for early elections. Kemal Dervis, who soon after taking office became the rising star of Turkish politics, failed to lead a political movement despite the strong winds behind him. He decided to join the opposition Republican People's Party (CHP). Subsequently, the Justice and Development Party (AKP), a party established just a year earlier and led by Recep Tayyip Erdogan, a former mayor of Istanbul, won the elections in November 2002, yielding AKP an overwhelming majority in the parliament.

PERFORMANCE OF THE ECONOMY IN THE POST-CRISIS PERIOD

The economy has achieved an impressive performance starting in 2002. A number of factors contributed to this process. One of them was the favorable global environment with low global interest rates and the availability of abundant and cheap funding. The key domestic component was the successful implementation of the IMF program not only by Kemal Dervis, its principal architect, but also by the AKP Government. Finally, the high morale and stability that came with the progress made toward EU membership was also instrumental in achieving a remarkable success in some specific areas such as attracting foreign direct investments.

1. The global framework

The global economic environment remained highly favorable throughout the period 2002-2007. The key characteristic of this period was the very low level of interest rates in most industrial countries. Real interest rates also remained low in this period because inflation rates were kept under control to a great extent. One of the implications of low interest rates was that borrowing costs for emerging markets were slashed considerably, and this led to a substantial surge in the financial flows to emerging markets. This ease in external funding led Turkish borrowers, mainly corporations, to borrow from international markets. The Turkish lira also appreciated considerably during this period, making external borrowing even more attractive. Total external borrowing surged three fold, from $33 billion in 2002 to $97 billion in 2007. The other implication of low interest rates over such a long period in industrialized economies was the constant rise in equities and real estate, which eventually created the bubble that led to the mortgage crisis in the US.

Moreover, high global growth rates, rapidly increasing international trade and investments, the emergence of China and India as the new engines of world growth, declining inflation rates, and commodity price hikes in Brazil and Russia created a rosy economic environment, leading many policy makers around the globe to believe that the good times would never come to an end.

2. Domestic developments

Turkey heavily benefited from this favorable global climate while also addressing many of its structural weaknesses as part of the ongoing IMF backed program. The program has led to some significant progress in terms of undertaking major reforms to address structural issues, reducing inflation while maintaining fiscal discipline. These steps led to major improvements in the macro economic situation.

Turkey took major strides to combat high, chronic inflation and brought it down from 70% to a single digit level within a short time span. This was possible with the implementation of sound economic policies such as tight monetary and fiscal policies. Also, the new independence of the Central Bank helped that institution break the inflationary cycles of the past, and brought credibility to the overall policy framework. These new dynamics played a crucial role in bringing Turkish inflation down to historically low levels.

The economy grew strongly out of the slump. The average growth rate was 6.8% from 2002 and 2007, well above Turkey's long-term average of 4.5%. Recovery and growth processes were driven mainly by the flexibility and dynamism of the Turkish economy, as well as the tangible improvement in confidence and expectations. Export growth, in particular, responded well to this realignment process. Over just five years, Turkey's exports grew from $36 billion in 2002 to $107 billion in 2007, an average annual growth of 15%.

Fiscal balances improved visibly over the same period. Fiscal discipline helped bring the budget deficit to 1.6% in 2007 from 17% in 2001. This was achieved by bringing the budget balance to a surplus of 5.3% of GNP by the end of 2003, and by maintaining a relatively high surplus throughout the period. Turkey's debt dynamics reacted favorably to the visible improvement in macroeconomic and financial fundamentals. Real interest rates halved and Turkey began to qualify for long-term borrowing. As is commonly known, Turkey incurred heavy financial losses during the 2000-2001 financial crises. The subsequent rehabilitation of the banking sector (both public and private) cost roughly 30% of GNP. Consequently, Turkey's net public debt to GNP ratio went up from 50% in 2000 to 92% in 2001. Since then, however, debt ratios have improved steadily. Owing much to solid primary surplus generation, the stability of the local currency and strong growth, Turkey managed to pull the public debt to GNP ratio to 74% in 2002 and further down to 39% in 2007.

The improvement in Turkey's macro economic and financial fundamentals took place as a result of extensive structural reforms. First and foremost the banking sector was overhauled and strengthened. Second, the Central Bank was granted full independence. Third, important steps were taken to improve public resource management processes. Finally, key structural measures were instituted in a way as to consolidate the market process at large. In this context, independent regulatory authorities were established and agricultural markets were de-regulated. Indirect agricultural subsidies, which distorted the market incentive structure and put pressure on fiscal balances, were largely eliminated. New legislation that would help encourage foreign direct investment (FDI) was introduced. Important steps were taken to further liberalize energy markets. A new bankruptcy bill was enacted to enhance contract enforcement, which was a must for instituting an efficient market economy. Public banks (Ziraat, Halk and Vakıf) have been restructured to pave the way to their ultimate privatization.

3. Unaddressed major issues

Despite the impressive progress achieved through the IMF-backed program, a number of key structural issues remained unresolved. The political and social implications of these colossal issues led the AKP government to postpone addressing their root causes. In other words, AKP fell short of extending and deepening the reform process:

- Even though the stabilization of the economy was essentially achieved, the second stage, micro reforms that should follow such macro reforms were never formulated and put forward.
- The actions to simplify the tax system, to broaden the tax base and improve the tax administration have never fully materialized despite repeated promises.
- Combating the informal economy has not been given any serious attention. The relatively large size of the informal economy keeps hindering competition and discouraging foreign direct investments in addition to reducing tax revenues.
- A comprehensive reform of the judicial system was never implemented.

GLOBAL CRISIS OF 2008

The global crisis surfaced at a time when the Turkish economy was already showing signs of changing direction from its earlier path, as demonstrated by a slowing economic activity since the second half of 2006 and rising unemployment. The lowest quarterly growth since 2002 was recorded in the third quarter of 2008 (0.5%). The non-agricultural unemployment rate surged to 14.0% in 2008 from 12.6% in the previous two years. The fact that the Turkish financial system and banks were immune from the risky derivatives business — in addition to being highly capitalized and closely supervised — saved Turkey from the initial waves of the subprime toxic assets tsunami. This, however, led the AKP government to believe that this was only a "financial" crisis and limited to banks and economies with exposure to such risky derivative instruments. The trade, finance and growth aspects of the global recession, the liquidity crunch and the overall impact of the global financial crisis on the real economy was not properly understood.

1. How does the global crisis affect the Turkish economy?

The crisis, coupled with already declining levels of domestic consumption, has already started taking a toll. More pain is likely to be felt in 2009, a year in which the crisis will increasingly hit non-financial sectors around the world. Even though the Turkish economy is in much better shape than many emerging economies, the crisis will still be felt through three main channels:

First, there is likely to be decline in external funding in the face of growing risk aversion and disruptions in global credit markets. External borrowing at relatively low interest rates at a time when the Turkish lira was continually appreciating had become one of the engines of growth throughout the last five years. Out of nearly $167 billion in private debt, $45 billion in redemptions is expected in 2009. Turkish borrowers are not likely to face lenders as receptive as those they had gotten used to. Therefore, a strain on Central Bank reserves is likely to be seen in 2009. However, the fact that the average maturity of debt is around 3.5 year is a relief since the entire pressure will not be felt in the coming year.

Exports are going to be the most hard-hit area and deterioration will continue even though Turkey's exports are relatively well diversified in terms of composition and destination. Already, the exports from the automotive sector, which had become the engine of Turkish exports over the last few years, and of durable goods were severely hit, and some factories ceased production temporarily. The last important impact is expected to be a major drop in foreign direct investments, which surged to average $18 billion per annum during the period 2005-2007. The FDI estimates for 2009 were revised to $6 billion from $12-15 billion.

While all of the above areas indicate a worsening in the financing of the current account deficit, there is some good news that should be taken into account as well. The first will be a declining oil bill. Thanks to a significant drop in oil prices and decreasing economic activity, the oil costs will be substantially lower in 2009. Also positive will be the waning current account deficit, as imports also will drop as a consequence of slowing exports and lessening domestic demand.

2. How does the AKP cope with the crisis?

Until recently, the AKP government opted to ignore the impact of the global economic crisis on the Turkish economy and severely jeopardized prospects for 2009. While a proactive response to such crises is expected from policy makers, the AKP government first ignored it and then tried to convince market participants that it would have minimal impact on the economy. As a result, the government failed to take the necessary actions to restore confidence and facilitate the proper functioning of the credit markets. Also, the government hesitated for a long time to sign a new standby agreement with the IMF, fearing that it would impose fiscal discipline prior to the local elections. However, considering the dramatic loss of confidence observed among consumers and investors, the government recently decided that the political cost of a non-agreement would be higher than that of an agreement, and it has made a compromise to sign a pact with the IMF.

CONCLUDING REMARKS

With a GNP of $655 billion (2007), per capita income of $9,500 (2007), a population of over 70 million, high growth rates, and a substantially improved political and economic climate in the wake of the 2001 crisis, Turkey stands as a central player in a troubled region. The market-driven and highly diversified Turkish economy has become over time a fundamental component of a maturing democracy in a region characterized by former Soviet countries, monarchies and/or single-product (oil) based economies trying to survive in an increasingly global, open and competitive world. The economic aspects of Turkey's growing soft power in the region is often unnoticed or underestimated. Exponentially increasing trade volumes between Turkey and its neighbors, significant Turkish investments and huge construction projects undertaken by Turkish companies in surrounding countries, and the development of some neighboring countries into de facto hinterlands of the Turkish economy, are evidence of the role the Turkish economy plays in its region.

However, this rather bright picture might be blurred as a result of the ongoing global crisis, which is likely to produce some undesired consequences for the country's economic and political stability. The global crisis initially was not felt in Turkey given the robust state of the financial sector. But, it has added new and tricky uncertainties to the already troubled growth prospects. Consequently, negative trends in the growth and unemployment rates are already being felt and with it a deterioration in the overall mood. Shrinking external funding and decreasing exports are going to be the most immediate effects felt by Turkish companies. Abundant external funding and rising exports have been crucial in stimulating high growth rates in the last five years. Also, foreign direct investments that were one of the main sources of hard currency in the last three years are likely to dip in the near future.

Depending on the pace of deterioration in the economy, local elections in March 2009 might lead to a relatively unfavorable political outcome for the governing AKP, despite the lack of a credible party in the opposition ranks. AKP's rising popularity over the last six years has been strongly supported by the impressive economic growth, increase in per capita income and improvements in income distribution. A reversal, however limited, in this trend will definitely have political implications for the governing party. One has to recall that this remarkable performance has been achieved not only by AKP's own competence but also the favorable global environment and the positive climate created by twin anchors of the EU and IMF. It seems that, this time around, the picture looks entirely different. One of these favorable elements, global environment, has been the main driver of the events that sparked the crisis in Turkey. The other two external factors, EU and IMF, are not currently in the picture in a forceful way. But, an agreement with the IMF may bring one of them back in a positive fashion.

However, the fact that, in the Turkish context, the crisis is unfolding primarily in the real sector, might minimize the immediate damage since elections are only one month away, and a severe deterioration in economic indicators by then is highly unlikely. Nevertheles, even if we assume that an agreement will be reached with the IMF shortly, the persistence of the crisis, especially a possible acceleration, will surely provide a suitable climate for the opposition to exploit. The AKP government's skillfulness in handling the crisis and the extent to which global efforts will reverse the trend remain to be seen. One thing, though, is clear: that AKP, which owes its election victory in 2002 to the collapse of the economy under the previous coalition government and was tested politically on several occasions over the last six years, is going to confront its first major economic crisis test. Unfortunately, their performance so far in dealing with the early signs of the crisis has not been promising for their future actions.

This crisis might have ramifications for Turkey's international relations as well. Turkey's relations with the EU might become even more complicated at a time when European economies are going through a recession. Also, dealing with the crisis will likely consume much of the energies of both European and Turkish governments in the near term. Another difficulty may arise with Russia, which is one of Turkey's most important trading partners. The political understanding and cooperation that were facilitated by the enhanced economic activity might not be acheivable in the foreseable future. The crisis, though, should have no significant bearing upon the regional power role Turkey has been enjoying for some time. As the crisis is going to hit nearly all economies of the region, including oil and raw material exporters such as Russia, Iran and others, Turkey's relative economic strength might not be jeopardized. Moreover, the diversified nature of the economy may even lead to a faster recovery and secure Turkey a relatively better position in the aftermath of the crisis provided that the AKP government acts swiftly and wisely.

ABOUT CUSE:

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