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THE TURKISH ECONOMY AND THE GLOBAL CRISIS

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The Turkish economy has faced periodic economic crises since the 1990s, including three major crises between 1990 and 2001. The causes of these crises were based on domestic and international macroeconomic instabilities. In the aftermath of the 2001 crisis Turkey implemented the Transition to the Strong Economy Program within the framework of an agreement with the IMF and stabilized macroeconomic indicators through tight monetary and fiscal policies. Nonetheless, the turmoil in the United States' financial markets in 2007 evolved into a global crisis which significantly affected Turkey. The fact that Turkey had a better growth trend compared to many other countries in 2010 points to the success of its reforms after the 2001 crisis, although chronic unemployment and current deficit issues indicate the necessity of addressing structural problems with respect to this economic growth. In the next few years Turkey needs to rapidly implement reforms, particularly in its industrial sector, to cope with these issues.

INTRODUCTION

The Turkish economy has faced numerous economic crises since the 1990s, including three major crises between 1990 and 2001. After the 2001 crisis, Turkey implemented the Transition to the Strong Economy Program within an agreement it reached with the IMF and moved into a period of macroeconomic stability supported by following strict monetary and fiscal policies. Furthermore, the government proceeded to privatize several state companies and to reform the banking system into a more transparent one. Between 2002 and 2007, Turkey's GDP grew at an annual average rate of 6.8% and the government exhibited important improvements in public deficits and control of inflation. Nonetheless, unemployment increased substantially and contrasted with the good performance of their macroeconomic indicators. In this context, the international financial crisis hit Turkey's economy in 2008-2009 very hard. Nonetheless, this paper shows that, differently from other countries, Turkey could move through the crisis with a strong rebound in its economy.

This paper analyzes the evolution of the Turkish economy since the early 1990s, emphasizing the efforts by the Turkish government in overcoming the crisis of 2001 and creating a much more solid macroeconomic foundation. These policies allowed Turkey to manage a strong recovery after the financial crisis in 2010 and 2011. However, the lack of deep structural reforms, especially in the labor market, opens questions regarding the need for further reform and the sustainability of the current economic growth.

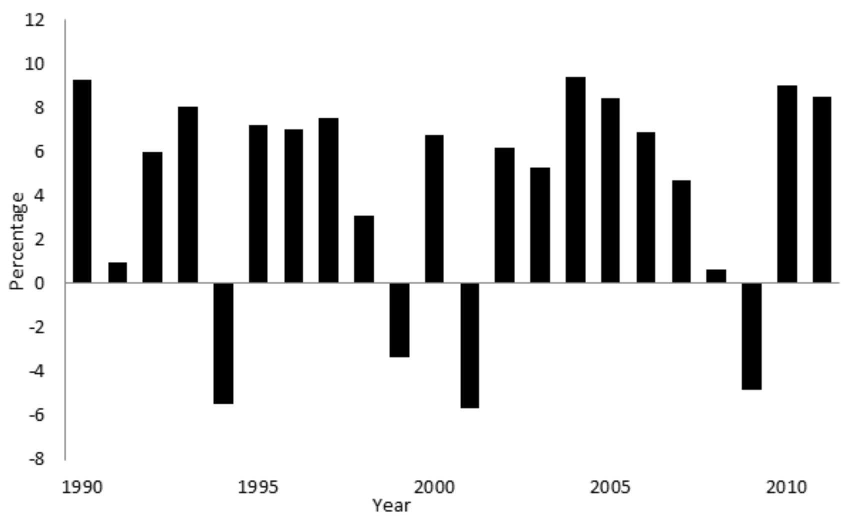
The second section of this paper briefly describes the different types of crises and the instability during the period 1990-2001. The third section describes the implementation of the economic program in the aftermath of the 2001 crisis and the economic performance of the Turkish economy afterwards. The fourth section addresses the impact of the recent financial crisis in Turkey. Finally, the concluding section presents the lessons from this crisis and the challenges ahead for Turkey.

INSTABILITY PERIOD, 1990 TO 2001 – A BRIEF ASSESSMENT

Economic crises can be divided into two categories: real sector crises and financial sector crises. While real sector crises can emerge in the form of strong reductions in the level of production and/or employment in goods-services and labor markets, financial crises can be broadly defined as the disruption of payment systems as a result of problems that emerge in financial markets and could potentially spread throughout the entire economy. Financial crises are divided into two categories: currency crises and banking crises; and currency crises are categorized as either first, second or third generation crises.

Within this framework, the crisis that the Turkish economy faced in 1994 can be explained within the scope of macroeconomic instabilities resulting from the First Generation Currency Crisis model that was developed by Krugman (1979); and the 2001 crisis can be explained within the scope of Third Generation Crisis Models (Krugman, 1997; Sachs & Radelet, 1998) that result from an interaction among First Generation Currency Crises, banking and finance sectors, and the ethical risk problem in the sector in question. While the 2008 global crisis can be examined within the framework of Third Generation Crisis Models, the impact on the Turkish economy was through a contraction in goods and services markets due to a reduction in the short term capital volatility.

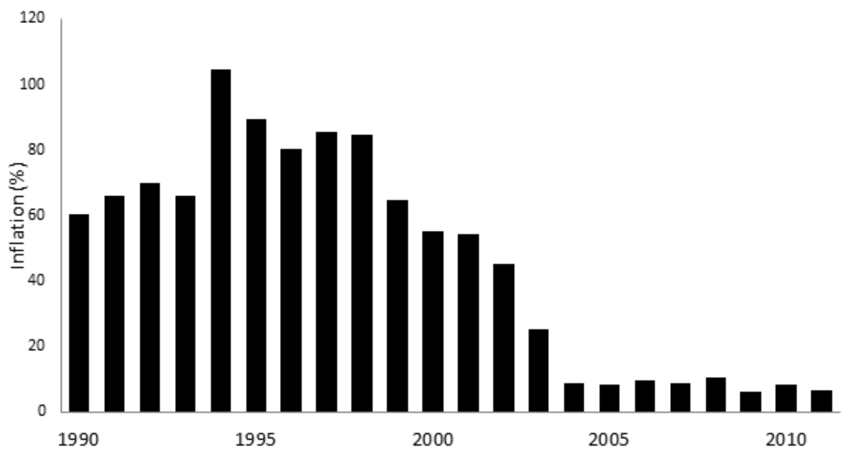
Figure 1. Real economic growth rate 1990-2011.



Source: IMF, World Economic Outlook Database

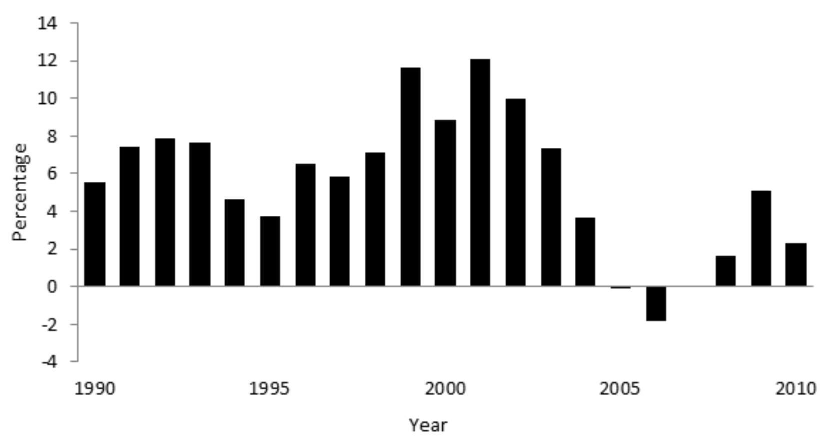
The Turkish economy faced very volatile economic conditions in the 1990s. The hallmark of this period was the unstable macroeconomic environment. Periods of high economic growth were followed by strong declines in production (Figure 1). At the same time, inflation was in high in double digits and was a reflection of the monetization of high fiscal deficits (Figures 2 and 3).

Figure 2. Annual inflation rate 1990-2011.



Source: IMF, World Economic Outlook Database

Figure 3. Fiscal deficit as a percentage of GDP, 1990-2010.

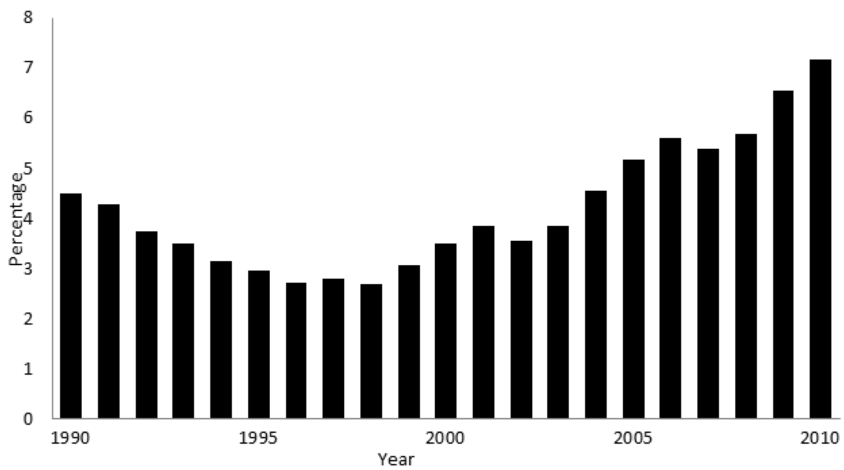


Source: IMF, World Economic Outlook Database

In this period, short term capital movements also have an impact on the expansion and contraction of the economy due to the high dependence of investment in the inflow of foreign financing.

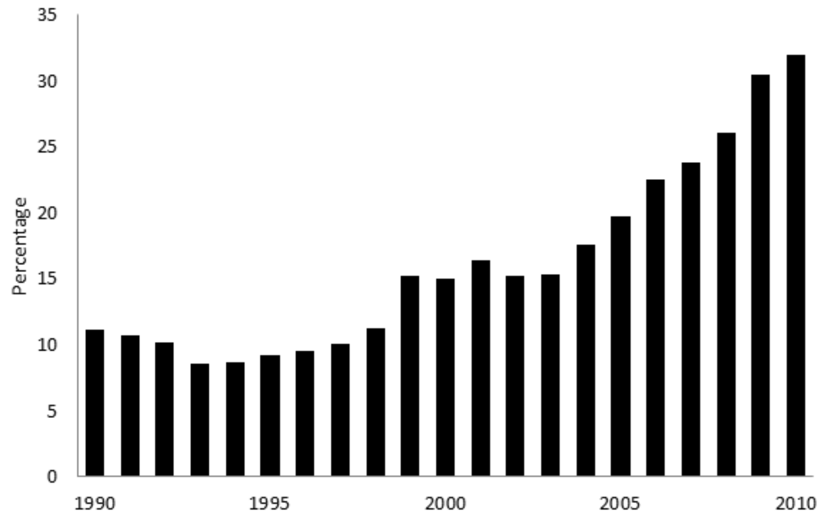
The monetization of these deficits and the lax monetary policy are seen in the low levels of the Monetary Base and M2 (as a percentage of GDP), an indication that people were running away from the local currency due to the loss in value due to the high inflation rates (Figures 4 and 5). At the same time, these high fiscal deficits produced a sharp increase in the level of the government debt, creating more pressure over the fiscal accounts and producing more pressure to monetize the deficits and to continue fueling the inflationary process (Figure 6). While the ratio of the public sector's net debt stock to the gross national product was 44% in 1995, it became 76% by the end of 1999. The rise resulted from the high public non-interest deficit in the first half of the period, but during the second half of the period, high real interest rates were the factor (Transition to Strong Economy Program, 2001).

Figure 4. Monetary base as a percentage of GDP, 1990-2010.



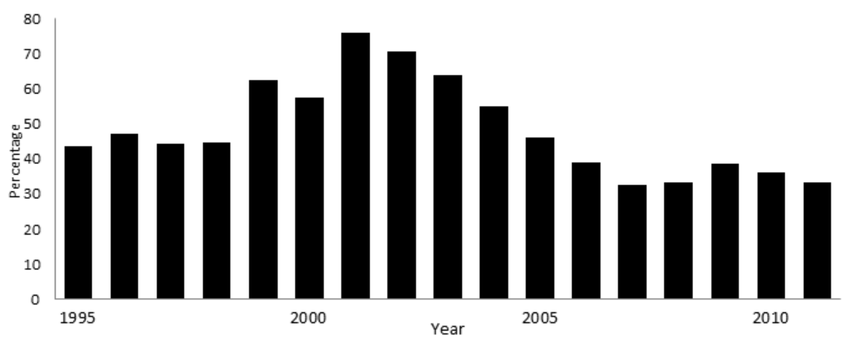
Source: Republic of Turkey Ministry of Development Database

Figure 5. M2 as a percentage of GDP, 1990-2010.



Source: Republic of Turkey Ministry of Development Database

Figure 6. Net government debt as a percentage of GDP, 1990-2011.



Source: Republic of Turkey Ministry of Development Database

After 1994, a high public sector deficit and the fact that the public sector was the net external debt payer created pressure on domestic markets, and real interest rates remained high. High real interest rates increased the public sector's need for loans (Transition to Strong Economy Program, 2001). The strong increase in the public debt stock resulted from different factors including off-budget funds, losses of public banks, excessive expenses of local administrations, budget deficits of social security establishments, inefficient employment policy in the public sector, agricultural subsidy policies that did not meet real needs, and government business enterprises. To make matters worse, the main funding source for these high budget deficits was costly domestic loans with high interest rates that produced an increasing expense in interest in the public budget (Transition to Strong Economy Program, 2001).

Another factor creating additionally instability between 1990 and 2001 was the functional losses of public banks. These losses, resulting from government-mandated support of the agricultural sector and small and medium size enterprises, were not paid on time and undermined the solvency of the public bank system. Furthermore, the high demand of loans from the government was supported by the banking system, which transferred resources from productive investment projects to the government. The share of the state's domestic loans in the total assets of deposit banks was 10% in 1990 but it rose to 23% in 1999. The share of credits given to the private sector dropped to 24% from 36% for the same period (Transition to Strong Economy Program, 2001).

Due to all the reasons mentioned, the trust in Turkish Lira decreased. The share of foreign exchange deposit accounts was 25% in 1990 and it rose to 42% in 1999. The fact that an important part of total deposits of banks consisted of foreign exchange deposits reflected the lack of confidence in the local currency. The lack of transparency and the compatibility of the asset–liability balance level of banks with international standards in this period created a huge risk for the Turkish economy (Transition to Strong Economy Program, 2001).

Within this scope, in order to decrease inflation and create a consistent growth environment, the Disinflation Program was put into effect in 2000 within the scope of the agreement reached with the IMF. Eleven months after the program was implemented, there was a huge outflow of capital abroad and the crisis erupted in 2001, with dire consequences for the real economy. Nonetheless, the government realized that they could not continue with fiscal and monetary policies inconsistent with macroeconomic stability.

CRISIS OF 2001 AND THE TRANSITION TO THE STRONG ECONOMY PROGRAM

In order to achieve a consistent growth environment in the Turkish economy, the Transition to the Strong Economy Program was constituted as a result of the agreement reached with the IMF after the 2001 crisis. The program aimed to fight inflation, establish a healthy relationship between the financial sector and the real sector and to reestablish discipline in the public accounts. The implementation of the regulations regarding the re-establishment of the financial sector and maintaining the public financing balance was successful and helped Turkey to achieve a more stable structure than it had before the 2001 crisis.

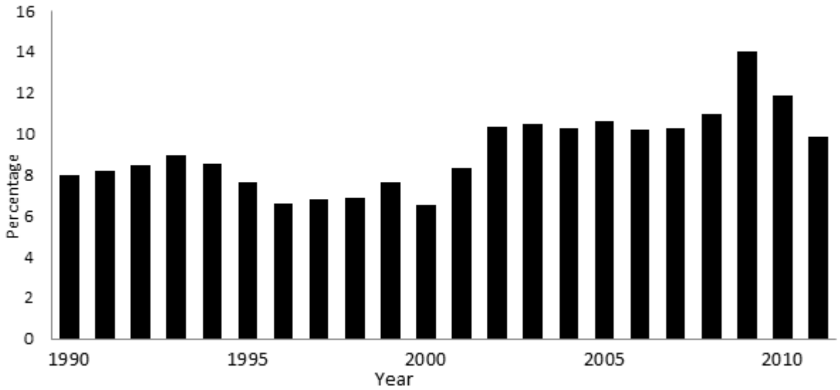
The most important reforms affected the financial system. The main regulation reforms aimed at limiting the operations of public banks that would result in losses and to limit subsidies to the government through public banks. Additionally, capital was raised in order to rehabilitate the financial structure of public banks, and enhanced transparency was introduced in the financial systems. Many regulations were instituted in order to provide a healthy structure for the asset–liability balance of private banks.

Several measures were introduced to reduce the financing of public deficits through diverse financing sources. Regulations regarding loans and public procurements were implemented in order to provide public finance balance. Off–budget funds were closed in order to maintain fiscal discipline. A strict fiscal policy was designed to ensure a healthy public financing balance. There were substantial savings in public expenses, and the non-interest surplus target in terms of fiscal policy was one of the main purposes of the program (Transition to Strong Economy Program, 2001). As a result, we observe a strong decline in the fiscal deficit and the size of the public debt (see Figures 3 and 6).

The program provided a strong success for the Turkish economy. Turkey entered a period of rapid economic growth (see Figure 1). While the average annual growth rate was 3% between 1992 and 2001, it reached 6.8% between 2002 and 2007. The inflation rate decreased at unseen levels from a decade before (see Figure 2). The inflation rate, which was 74.9% between 1992 and 2001, went into a falling trend by 2002 and dropped to a 17.6% annual rate between 2002 and 2007. The fiscal discipline brought by the Transition to a Strong Economy Program had an important contribution to this economic momentum. The ratio of budget deficit to the gross domestic product was 15.7% in 2002, but it dropped to 3.5% in 2007. There was also a significant decrease in the net loan load of the public sector. While the net loan load of the public sector was 70.2% in 2002, it dropped to 32.2% in 2007. In addition, we observe an increase in the level of Monetary Base and M2 as percentage of GDP, reflecting an increasing confidence of the public in the local currency (Figures 4 and 5). On the negative side, the privatization program, the fiscal adjustment and the tight monetary policy induced a high level of unemployment, which reached above 10% (Figure 7). An additional issue in this period was the increase in the current account deficits (Figure 8). The tighter monetary policy and the higher inflation, as compared with other developed countries, especially in the EU, led to a real appreciation of the Lira, which resulted in mounting trade deficits. The combination of high trade deficits and high unemployment point to the lack of export dynamism and the need of structural reforms to make domestic industries more competitive.

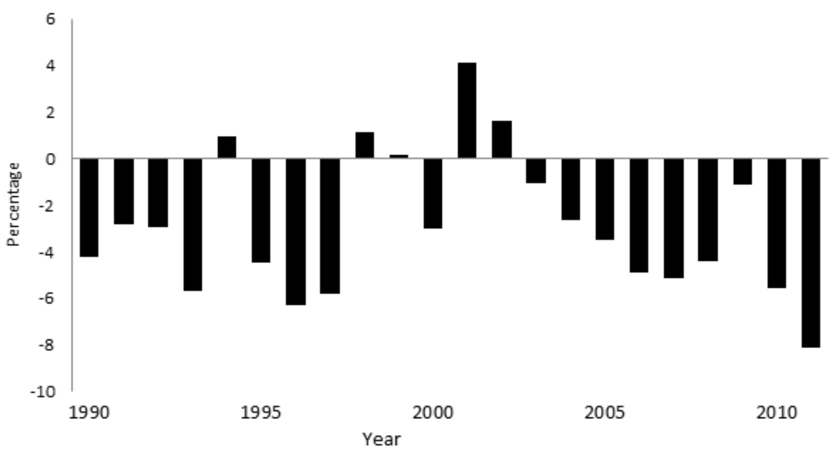
When all of these indicators are considered, at the time of the recent global crisis Turkey presented a consistently high growth rate, controlled inflation, a strict fiscal policy, a decreasing public debt and a rational monetary policy, although it exhibited a high unemployment rate and current account deficit.

Figure 7. Unemployment rate, 1990-2011.



Source: IMF, World Economic Outlook Database

Figure 8. Trade balance deficit as a percentage of GDP, 1990-2010.

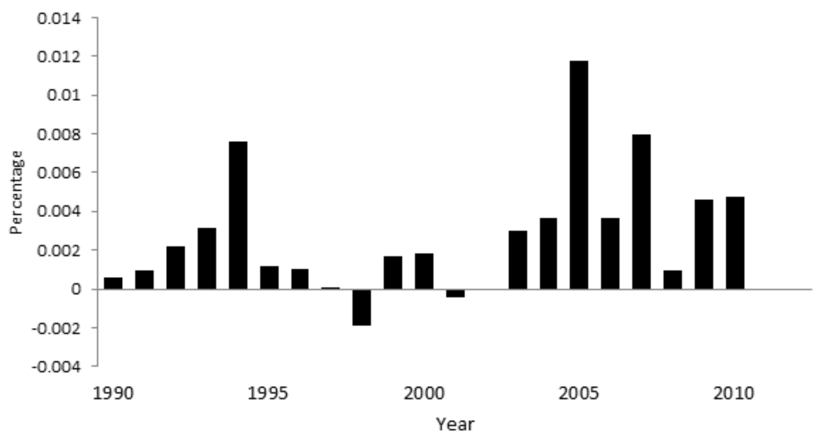


Source: Republic of Turkey Ministry of Development Database

GLOBAL CRISIS AND ITS EFFECT IN THE TURKISH ECONOMY

The financial troubles that started the crisis in the financial markets in the United States in 2007 turned into a full fledged global crisis in 2008 (Krugman, 2009). Turkey was one of the countries which were strongly affected by this global crisis. However, as we show in this paper, due to the reforms made in the banking sector after the 2001 crisis, the Turkish economy was able to quickly bounce back from this crisis. The growth rate of GDP dropped to 0.7% in 2008, when the effects of the crisis started to be felt, and Turkey's economy further declined at a rate of 14.3% in the first quarter of 2009 (Figure 1). In 2009, Turkey's exports decreased by 13.2% and unemployment, which is one of the main structural problems in this economy, rose to 14.3%. Furthermore, the outflow of short term financial capital accelerated, as in the 2001 crisis, further depressing the economy (Figure 9).

Figure 9. Short term capital flow as a percentage of GDP, 1990-2011.



Source: Central Bank of Turkey Database

The slowdown in domestic demand is evident in the strong decline in imports, which in 2009 surpassed the decline in exports, inducing a strong decline in the trade deficit for that year (Figure 7).

According to Rodrik (2009), Turkey's case during the global crisis taught important lessons to other countries. Even though a government administers sound economic policy, it can become helpless before developments in financial markets abroad. Nonetheless, the monetary and fiscal policies applied in the previous years were able to protect a country's economy not only against domestic shocks but also against external shocks. In that respect, the Turkish economy has recovered very quickly from the financial crisis and high economic growth returned in 2010. Foreign capital came into the economy, government fiscal deficit did not get out of hand, monetary policy continued its course, and economic growth showed a strong resurgence, in striking contrast to the economic slump of its immediate neighbor, Greece. It is worth mentioning that the confidence built by the Turkish government in the years before the financial crisis provided for the use of fiscal policies during the crisis, as denoted by the increase in public deficit in 2009 (Figure 3). The ability to use its own monetary policy also shows an increase in the Monetary Base and M2 as percentage of GDP, which allowed Turkey to infuse its economy with financial resources during the recent crisis (Figures 4 and 5). These policies resulted in an uptick in net public debt, but without creating the massive crisis of 2001. In addition, the Lira depreciated with respect to the US Dollar and the Euro, helping to mitigate the effects of the international crisis. The effects of these policies are a clear contrast to the Greek experience, where public restraint and tight monetary policies are sinking the country to new lows every month. Nonetheless, the recent economic resurgence of Turkey has produced a new increase in trade deficits, and unemployment, while lower than in 2009, stays at high levels.

Turkey's experience can also be compared to Brazil's. The period of instability that Brazil experienced from 1995 to 2002 originated from its vulnerability to external shocks. A high current account deficit, low public savings in spite of high tax burden, and high consumption levels due to increasing loan volume in the private sector caused Brazil to be substantially affected by the crisis encountered in Latin American countries (Blyde et al., 2010). Prasad et al. (2007) found that there is a positive relationship between current account deficits and economic growth in both Turkey and Brazil. However, even though the ratio of current account deficit to gross domestic product of Brazil shows an increasing trend similar to Turkey, it is at a considerably lower level than Turkey's. Although Brazil's economy shrank by 0.3% in 2009, it grew by 7.5% in 2010. The reason why Brazil was affected by the global crisis less than other countries is the reforms it made in the banking sector prior to the global crisis (Coutinho, 2009). Differently from Turkey, the unemployment rate in Brazil decreased by approximately 3% between 2004 and 2009. Measures (such as making long–term investments in energy, environmental and infrastructure areas) that were required for Brazil to create a steady growth environment, encourage domestic saving, and enhance the innovative capability and competitiveness of both its domestic manufacturing industry and Brazilian companies operating abroad, thus increasing social mobility of individuals by improving educational opportunities are also seen to be feasible for Turkey (Coutinho, 2009).

CONCLUSIONS AND SUGGESTIONS

Even though Turkey was deeply affected by the global crisis, it quickly entered a recovery in 2010. This recovery was the result of the economic program that was applied with discipline during the pre-global crisis period. Before the global crisis, Turkey overcame its chronic inflation problem and went into a macroeconomic stable growth phase. With the introduction of reforms in the banking sector, Turkey did not experience the effects of the global crisis in its financial sector as other countries did. But the real sector was substantially affected by the crisis and some structural problems remain unsolved. The primary structural problem in the Turkish economy is, as it was during the 1990-2001 period, a high dependency on foreign financing. Therefore, fluctuations in foreign capital strongly affect the Turkish economy.

Furthermore, Turkey is very dependent on imports of inputs and intermediate goods, which produces a current account deficit when the economy grows at high rates. When we look at exports, the failure to execute value–added, brand building production with high technology causes the current account deficit problem to grow further. According to the projections of the IMF (2011), Turkey's current account deficit trend will continue. The ratio expected for 2012 is 8.2%. In order to carry on with such a high level of current account deficit, foreign financing needs to continue. This makes the Turkish economy still vulnerable to external shocks. Thus, the predictions made within the medium term program, including the perspective of Turkey's economic status between 2012 and 2014, are based on the assumption that the short–term capital inflow will continue.

According to the OECD (2010) Turkey Report, the post–crisis period is an opportunity for Turkey to undertake the pending structural reforms in order to reduce dependence on foreign financing and reduce the still high unemployment rate. Structural reforms should focus on education, labor market reforms and industrial policies that foster domestic production.

Nonetheless, despite the weaknesses and pending reforms, it is important to highlight the strong performance of the Turkish economy in the aftermath of the crisis and how stable and rational policies before the crisis provided a strong foundation to navigate the turbulent years. This situation is in striking contrast to the problems faced by neighboring European countries.

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