# Turkey: The Bounce After the Crisis

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Turkey experienced a severe economic crisis in November 2000 and again in February 2001. The crisis erupted after Turkey adopted an *exchange-rate based disinflation program* led and engineered by the IMF.[1] During the year 2001, GNP fell by 9.5% in real terms, consumer price inflation soared to 54.4%, and the currency fell 51% against the major foreign monies. The rate of unemployment rose by 2 percentage points in 2001 and then by another 3 percentage points in 2002. Real wages fell by 20% in 2001 and have not recovered to this day.

The IMF had also been involved with the macroeconomic management of the Turkish economy prior to the crisis, and provided financial assistance of $20.4 billion between 1999 and 2003. Following the crisis, Turkey implemented an orthodox strategy of raising interest rates and maintaining an "overvalued" exchange rate. The government adopted a contractionary fiscal stance, and promised to initiate further steps towards market friendly reforms. According to the logic of the program, successful achievement of the fiscal and monetary targets would enhance the "credibility" of the Turkish government reducing country risk perceptions. This would reduce the rate of interest which would then stimulate private consumption and investments, paving the way to sustained growth. Thus, it was alleged that the *fiscal contraction* was actually an *expansionary* program.

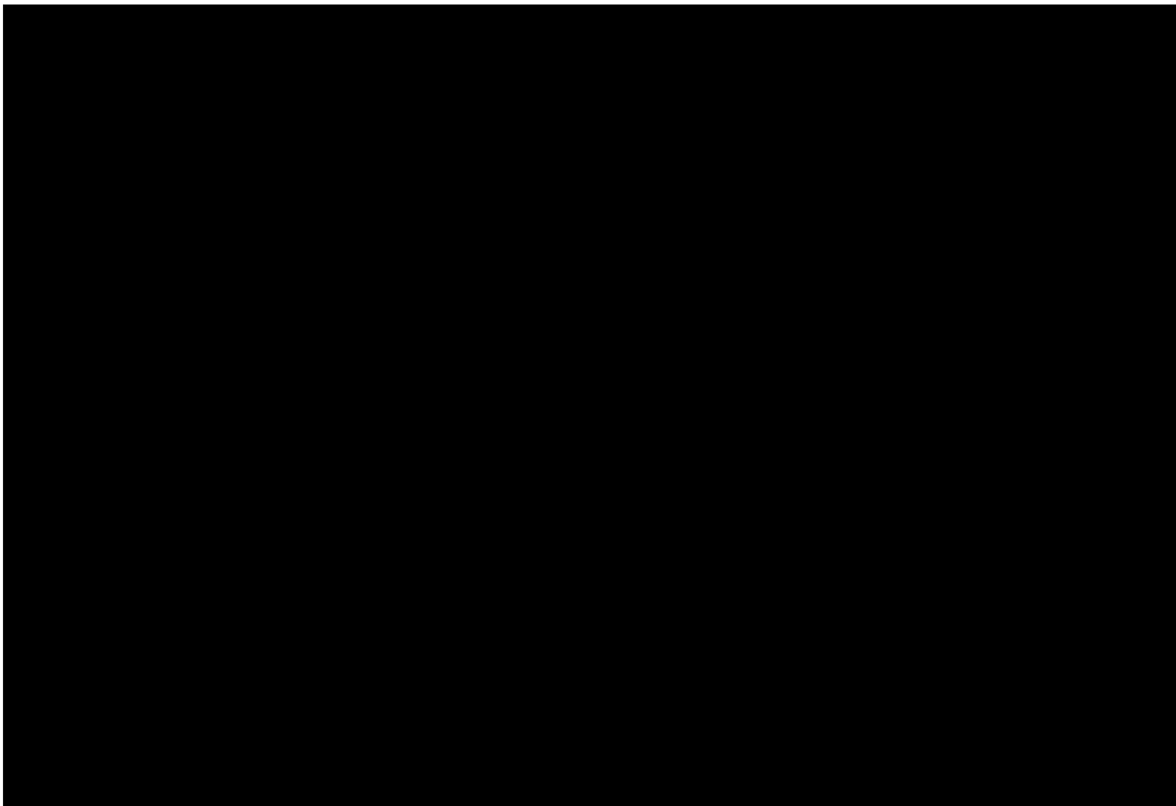
### *Rapid growth, with serious fragilities*

Recovery of the Turkish economy was vigorous after the crisis of 2000/2001. Under the *first* AKP government (November 2002 – August 2007), gross national product (GNP) grew at an average annual rate of 6.9%. Price inflation was finally brought down to single-digit levels after nearly four decades of high inflation episodes. In the meantime, significant success in fiscal balance has been achieved, and Turkey has successfully further penetrated European markets, raising the significance of full-membership negotiations with the EU.

All this, however, was not free of problems, and came at a very unique conjuncture in the global economy. First, growth, while rapid, had some peculiar characteristics, mainly driven by a massive inflow of foreign finance lured by high rates of interest offered domestically. High rates of interest attracted short term foreign finance, and the relative abundance of foreign exchange led to overvaluation of the *lira*. With a relatively cheaper foreign exchange (overvalued *Lira*) the economy experienced an import boom, both in consumption and investment goods, leading to a sharp rise in the current account deficit. The current account deficit rose to above US$30 billion in mid-2007, or 6.5% of GNP, and contributed to the perception of Turkey's increased external fragility as Turkey had not previously been prone to current account deficits. Over the last two decades, the current account balance has averaged around ±1.5-2.0%, with deficits exceeding 3% precipitating significant currency adjustments, as in 1994 and 2001.

A further characteristic of the post-2001 era has been Turkey's *jobless growth*. Rapid growth rates have been accompanied by high unemployment and low participation rates. The unemployment rate rose to above 10% after the 2001 crisis, and has not come down to pre-crisis levels despite rapid growth. With relatively cheap imports, Turkey has been importing much more foreign products. (See Table 1 for a succinct summary of Turkish macroeconomic performance before and after the 2000/2001 crisis.)

[1] The underlying elements of the disinflation program and the subsequent crisis are discussed in detail in Ertürk, and Ekinci (2007); Akyuz and Boratav (2004); Ertugrul and Yeldan (2003), Yeldan, (2002), Boratav and Yeldan (2006), Alper (2001).



***Rising external debt burden…***

A significant concern with the rising current account deficit relates to its mode of financing. As Table 1 attests, the primary mode of deficit financing entailed a sharp rise in external debt. The external debt stock increased from $130.1 billion at the end of 2002 to $226.5 billion in June 2007. Much of this increase has been by the *private* sector, especially by non-financial (real sector) enterprises, while the public sector has substituted *domestic debt* with external debt. The AKP government further succeeded in attracting $87 billion in "hot money", as well as $30 billion in foreign direct investment, though mostly for mergers and acquisitions of domestic firms and land/real estate purchases by foreigners.

Thus, in the final account the main propeller of growth rests on the availability of external finance. Turkish GNP is expected to rise from $180 billion to $410 billion over the five years from end-of 2002 through the end-of 2007. This $230 billion cumulative increase in GNP has been accompanied by a $127 billion increase in *net* external debt over the same period. Thus, in US dollar terms, the external debt content of the increase in GNP amounted to 55% under the post-crisis era.

Thus, contractionary policy has become expansionary and the "stabilization policy" has involved "managing expectations" and "securing credibility". The international context has been decisive in moving capital flows as Turkey has become an important destination for the carry trade. The low returns in most developed countries and the decline of the US dollar in recent years have increased the attractiveness of emerging markets such as Turkey.

***The role of high interest rates***

Turkish interest charges have remained significantly higher than in most emerging market economies. The credit interest rate has been constrained by a lower bound of 16% despite the deceleration of price inflation. Interest rates have remained high

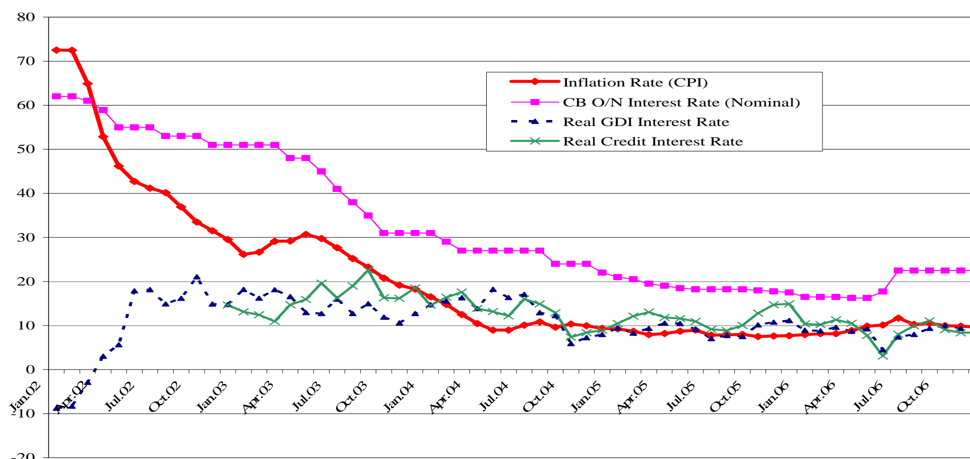
though the inflation rate has not declined much since mid-2004. Figure 1 shows the paths of (CPI) inflation and the central bank's overnight interest rates. Persistently high *real* interest costs affect the costs of credit generally, including government debt instruments (GDIs).

The high interest rate and overvalued lira have increased Turkish firms' access to finance while reducing borrowing costs in foreign currency. So, perversely, the high interest rate appears to have eased large firms' access to credit while squeezing the small fry. Imports of both consumption and investment goods have consequently risen. The steep increase in Turkish exports, despite the overvalued lira, has been facilitated by a significant rise in productivity. While labor shedding has played a role, the lowered cost of investment in new technology has been more important.In conclusion, contrary to the traditional stabilization packages that increase interest rates *to constrain domestic demand*, Turkey's high interest rates became instrumental to *attract speculative foreign capital* from international financial markets. The end results in the Turkish context were significant overvaluation of the *Lira* (relatively cheap foreign exchange) leading to widening current account deficit and an unprecedented rise in external debt. This process was also responsible for distorting the private enterprise sector's incentives to over-invest in capital intensive technologies and venturing into highly risky projects. Furthermore, as the domestic industry intensified its import dependence, it was forced to adapt increasingly capital-intensive and foreign technologies which had adverse consequences on domestic employment.

Turkey should have been ready to *graduate* from the IMF programs given its macroeconomic performance to date. But continued IMF surveillance is regarded by many as a necessary *institutional anchor* to maintain the continued inflow of external finance despite increased external fragility and possible *reform fatigue*. Thus, the "stabilization policy" has meant "managing expectations" and "securing credibility" with continued IMF tutelage.

However, the tacit dilemma is that the main logic of the current IMF-endorsed program itself relies on maintaining the pillars of the *speculative-led growth* environment characterized by high real rates of interest; overvalued domestic currency; and the consequent rise in external indebtedness and external fragility. It is not clear how this tacit circle of fragility-*cum*-creditworthiness game will be resolved in the days ahead.

**Figure 1. Inflation and Interest Rates under the Post-Crisis Era**




Source: TR Central Bank

***What lies ahead?***

Turkey's post-crisis adjustment retraces the path of many emerging markets dependent on foreign

capital conditioned to adopt and maintain high interest rates and deal with their consequences in order to secure "investor confidence" and "international creditworthiness". Such policies include a balanced budget, lower fiscal expenditures, and a relatively contractionary monetary policy with an *ex ante* commitment to high real interest rates.

Turkey is now experiencing increased external debt burdens. The generally favorable global conditions conducive to rapid growth of the economy may no longer be available in the new future. Turkey will face the current turbulence and the consequent decline in liquidity in global financial markets with greater external vulnerability. The needed adjustments ahead for securing economic stability in Turkey in a less favorable external environment may be more costly and difficult.

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