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Economic Crises in Turkey and Pathways to the Future

Kursat Cinar and Tekin Kose

This paper investigates the Turkish economy within a comparative historical framework. In light of a thorough discussion of Turkish economic crises in the post-1980 period, the paper explores Turkey's contemporary strengths and weaknesses in the global economic arena by comparing it with its peers and developed nations. The paper also highlights Turkey's extant economic vulnerabilities, especially its current account deficit, volatile international capital flows and ongoing banking sector problems. Along with other policy recommendations regarding these vulnerabilities, the paper proposes the introduction of capital controls to enhance economic institutions and cope with future hardships.

Introduction

The current state of the Turkish economy can be understood through an approach that is both comparative and historical. To this end, we need to evaluate the Turkish economy vis-à-vis its place among other countries at the same time being attentive to continuities and changes over time within Turkey. In what follows, we examine Turkey's economic strengths and weaknesses in comparative perspective. We assess Turkey's strengths, such as its young population, trade capacity, price stability and Turkey's weaknesses such as its gross domestic product (GDP) volatility, unemployment levels and regional disparities by examining the domestic conditions and putting these conditions side by side with other comparable cases such as Europe, the Organization for Economic Co-operation and Development (OECD) and developing countries. This analysis leaves us with a better understanding of Turkey's economic vulnerabilities, especially its current account deficit, volatile international capital flows and ongoing banking sector problems. Benefiting from our prior discussion on the flaws and merits of Turkey's economic policies, as well as the successes and failures of comparable cases, we suggest various policy recommendations for the Turkish economy. These specifically include the introduction of capital controls and their potential impact. In providing our policy recommendations, we are also informed by the lessons provided by the past. As such, in the next section we first explore the past economic crises and current characteristics of the Turkish economy.

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A Brief History of Economic Crises in Turkey

The history of financial crises in Turkey provides us important insights about Turkey's power and mechanisms to cope with global crises, past and future. An in-depth analysis of Turkey's past economic crises will not only enhance our understanding about the structural problems preceding and, in most cases, leading to these crises, but it will also draw lessons to cope with future economic hardships. Specifically, we delve into the most recent crises in Turkey, namely, the 1994 and 2001 crises, and the international crises of 2007–2008, with their antecedents and ramifications.

After 1980, liberalization efforts ensued in the Turkish economy to enhance export-led growth. The changes in the exchange rate regime and liberalization of the capital account made the economy vulnerable to shocks in international markets, specifically capital movements. In this regard, Akyüz and Boratav state that the errors in timing and sequencing of the liberalization policies of the 1980s are among the reasons of the macroeconomic imbalances in the Turkish economy during the 1990s.[1] Accumulated macroeconomic imbalances led to the 1994 financial crisis. The lack of fiscal policy discipline and increasing levels of domestic debt were followed by the policy of monetizing the debt. The continuous budget and external deficits, complemented by a change in the way of debt financing, reduced the credibility of the Turkish economy in the world markets leading to capital outflows. Moreover, the banking sector had currency mismatches in their balance sheets, which made the sector sensitive to exchange rate fluctuations. The Central Bank of the Republic of Turkey's (CBRT) policy actions to manage the exchange rate and to prevent depreciation of the Turkish lira led to large losses of international reserves of the country. During the 1994 crisis, the interest rates rapidly increased and the Turkish lira depreciated significantly. Overall, the Turkish economy experienced a contraction period, in which it experienced a drop of 4.66 per cent of GDP in 1994 (see Figure 1).[2]

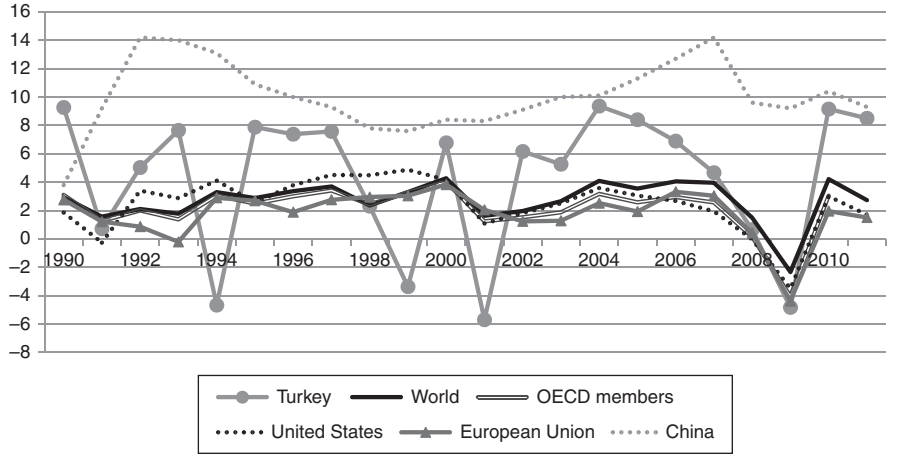


Figure 1 Annual GDP Growth Rates (Per Cent). Source: Trend data are compiled by the authors based on World Bank data (World Bank, 'World development indicators', <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed February 2013)).

After the recovery period, interest rates on public debt still remained high and short-term capital inflows were attracted in. However, this recovery period was impeded by the Asian crisis of 1997 and Russian crisis of 1999. During 1997–99, the Turkish economy struggled with these external shocks. To counter the ongoing macroeconomic imbalances and lingering economic problems such as high inflation rates, unsustainable levels of public debt, financial fragilities, external deficits and lack of fiscal discipline, Turkey started to implement the Exchange Rate Based Stabilization (ERBS) programme promoted by the International Monetary Fund (IMF) in 1999.[3] Growing public sector debt and economic contraction caused by the Asian crisis heavily affected the already fragile banking system. This situation was due to the enactment of new regulations and the introduction of full deposit insurance without effective auditing and supervision.[4] As Öniş aptly suggests, 'deposit insurance program with its 100% guarantee has been one of the reasons behind excessive risk-taking and moral hazard problems prior to the 2000–01 crises'.[5]

The ERBS programme aimed to disinflate the economy using a pegged exchange rate regime and fiscal contraction under the supervision of the IMF.[6] The programme had a preannounced 'exit strategy' such that the exchange rate would be allowed to fluctuate in a wider band.[7] The ERBS also functioned as a 'quasi-currency board' since the growth of the monetary base was tied to the values of net domestic assets and net international reserves. Moreover, the sterilization of foreign exchange market interventions was prevented so that interest rate adjustments and capital movements would achieve the macroeconomic equilibrium.[8]

The initial effects of the ERBS programme were disinflation, increased capital inflows, appreciation of the Turkish lira and low interest rates. All of these factors led to domestic demand-based economic growth. However, improving domestic demand induced larger trade deficits. Although there was a rise in international reserves, these were not enough to sustain the current account deficit and the exchange rate regime. Moreover, the banking sector accumulated foreign currency denominated liabilities whereas they held domestic public sector debt instruments creating currency mismatches in their balance sheets.[9] As Özatay and Sak emphasize, 'the root cause of the banking system fragility was the high public sector borrowing requirement and the way it was financed …, [in which] budget deficits were primarily financed through government securities'.[10]

The problems underlined above accumulated until 2001 when another economic crisis broke out during the early months of that year. According to expert reports, 'this crisis was triggered by the rumoured withdrawal of external credit lines to Turkish banks'.[11] Evoked as a banking sector crisis, the turmoil spread quickly to other sectors of the Turkish economy. The severe effects of the 2001 financial crisis considerably affected the country socially, politically and economically.

On the bright side, Turkey witnessed some positive economic outcomes during the post-2001 crisis period. Macroeconomic indicators of the Turkish economy significantly improved after 2002 thanks to macroeconomic policies guided by the IMF-directed stabilization programme and the European Union (EU) membership

requirements. Inflation targeting (owing to central bank independence) and strict fiscal policies (including privatization) helped reduce inflation rates. What is more, regulatory reforms, such as the diffusion of Independent Regulatory Agencies (IRAs), especially in the banking sector, enhanced corporate governance.[12] For instance, although the Banking Regulation and Supervision Agency (BRSA) faced many challenges, it played an important role in restructuring and rehabilitating the Turkish banking system after the 2001 economic crisis.[13] Regulations on deposits, capital adequacy requirements and auditing also crucially helped with improving the banking system.[14]

On the other hand, the global financial crisis of 2007–2008 revealed that the Turkish economy is still highly dependent on international capital movements. Furthermore, the vulnerabilities of different sectors have not been resolved. The mortgage crisis of the USA triggered a global turmoil in financial markets and crucially affected the emerging economies that rely on external financing. This external shock led to a contraction period in the Turkish economy during 2007 and 2008. The economic slowdown reduced the government and corporate sector revenues, as well as the ability of households to pay back their loans. Moreover, exchange rate volatility increased the risks and fragilities for all sectors due to liability dollarization. The CBRT's Financial Stability Report emphasized the fragility of different sectors:

> ... the global contraction in credit volume leads to difficulties in access to credits and repayment of credits for firms and households. The increased rate of unemployment, collapse of global demand driven by households that defer their demand as they suffer a decline in income and wealth linked to decreasing asset prices, further deteriorates the financial position of firms.[15]

In this section, we have elaborated on Turkey's experience with recent economic crises. We believe that a thorough analysis of the Turkish economic crises, accompanied by the ramifications of international financial crises on the Turkish economy will provide us with a complete portrayal of Turkey's power and mechanisms to cope with its past and future global crises. Thus, we proceed with discussing the strengths and weaknesses of the Turkish economy.

Turkish Economy: Strengths and Weaknesses

In this section, we determine Turkey's place in the global economy via a comparative analysis. We highlight the strengths and weaknesses of the Turkish economy, as well as the opportunities and threats it faces. In brief, increasing GDP, relatively low inflation rates, young population and geographical location for trade are highlighted as major strengths. On the other hand, GDP volatility, high unemployment rates, Turkey's exposure to the fragilities in Europe and the Middle East, and regional disparities are considered as its weaknesses.

Production Capacity and Volatility

Turkey ranks among the largest 20 economies of the world. As of 2012, Turkey had the 17th largest GDP in the world and the sixth largest in Europe, following Germany, the UK, France, Italy and Spain.[16] The most crucial component of Turkish GDP is generated by the manufacturing sector. According to Turkish Ministry of Development reports, the major driver of the Turkish economy is manufacturing, which corresponded to 15.5 per cent of Turkish GDP in 2010.[17] As the *Economist*'s Turkey report also notes, 'these days Turkish firms are leading lights in many manufacturing industries, notably in construction, furniture, textiles, food-processing and car making'.[18]

On the other hand, according to Figure 1 on GDP growth, the Turkish economy experiences larger fluctuations of income growth compared to other countries and country groups.

The 2008 global economic crisis caused a sharp decline in GDP growth rates in all countries. Figure 1 indicates that the Turkish economy has been severely affected from this external shock. There was a 4.82 per cent decline in Turkish GDP in 2009 whereas the GDP of the world decreased by 2 per cent. Despite a decline in GDP growth rates, China maintained positive growth rates in 2008–2009. Similar to Turkey, the EU had a decline in GDP of 4.3 per cent in 2009. Moreover, the domestic crises explained in the first section affected the Turkish economy deeply. Namely, the Turkish economy shrank by 4.66 per cent in 1994 and 5.69 per cent in 2001. In sum, we observe that economic activities in Turkey are crucially affected by both domestic and external factors. More importantly, Turkish GDP follows a more volatile pattern compared to other countries. Specifically, Figure 1 shows the comparison of Turkish annual GDP growth rates with the global trends and trends of the OECD, the USA, the EU and China. In light of the data, Turkish economic policies should focus firstly on stabilization of production and then on the maintenance of positive growth rates.

Price Stability

Another growing strength of Turkey in recent years is price stabilization, which has been achieved by the inflation targeting policy of the CBRT after 2001. World Bank data[19] on GDP deflators indicate that inflation rates of the Turkish economy were significantly higher than several reference groups of countries such as the OECD and the EU during the 1990s. For instance, in 1997, Turkey had 137 per cent growth in the GDP deflator whereas that of the world was around 4 per cent. However, starting with the 2000s, Turkey started to experience much lower inflation rates, which almost match the global trends and the trends of developed countries. Most recently, the world's GDP deflator growth in 2010 was 4.38 per cent whereas that of Turkey was 6.29 per cent. During the same year, the EU had 1.36 per cent and the OECD countries had 1.33 per cent of inflation. In sum, Turkey successfully achieved price stability and should maintain it to have a better economic environment in the future.

Turkish Population: High Potential vs. Challenges

A major potential of Turkey lies in its young and growing population. The United Nations (UN) data indicate that Turkey has a younger population than Europe. Predicted population trends imply that the Turkish labour force will be growing whereas the European labour force will be dwindling.[20] According to population data, 26.4 per cent of the Turkish population is under the age of 14 and only 9 per cent is over the age of 60.[21] In contrast, 21.8 per cent of the European population is over the age of 60. Turkey is estimated to have a younger population than EU countries. The EU is estimated to have 29 per cent of its population aged over 60 in 2030 whereas the same estimate for Turkey is only 16.5 per cent.[22] Turkey and Asia have and will have younger populations whereas the USA and Europe have and will have older populations in the future. Thus, Turkey and Asian countries have the potential to be the major drivers of the labour force of the world.

Although having a young population is an advantage for the Turkish economy, the country is not very successful in creating jobs for its rising working-age population. The unemployment rate in Turkey has been on the rise in recent years. The data reveal that unemployment rates in Turkey were lower than the EU and close to the OECD rates during the 1990s (see Figure 2).

However, despite recent economic growth, the 2000s are associated with higher unemployment rates. According to Figure 2, Turkey has recently surpassed all of its reference groups after 2001. As the figure suggests, Turkey's unemployment rates have stayed over 10 per cent throughout the 2000s. Moreover, Figure 2 clearly reveals that the gap between the Turkish unemployment rates and those of the reference groups has either increased or remained constant. Thus, Turkey needs to increase its capacity to cope with unemployment by creating new job opportunities and diversifying the

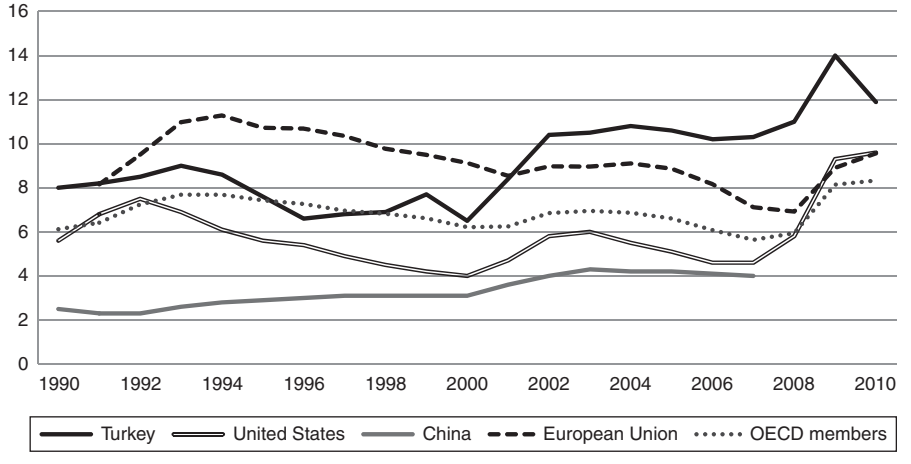


Figure 2 Unemployment Rates (Percentage of Total Labour Force). Source: Trend data are compiled by the authors based on World Bank data (World Bank, 'World development indicators', <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed February 2013)).

extant ones. We are cognizant of the fact that the most recent global recession has increased unemployment rates across the globe. However, this does not refute our claim regarding the severity of the unemployment problem in Turkey. High unemployment rates (coupled with underemployment and underground employment) and low female labour force participation are extant problems for the Turkish economy waiting to be addressed by policymakers. Low levels of female labour force participation rate are indeed a great challenge for the Turkish economy. According to the Turkish Statistical Institute, the female labour force participation rate is 30.2 per cent as of November 2012.[23] This rate is far below the OECD average of 63.2 per cent and the EU-27 average of 65.3 per cent in 2009.[24] Integration of women into the economy would have significant effects on equity and efficiency in the Turkish economy. Using Turkish data, Tansel provides evidence for the U-shaped relationship between female labour force participation and economic development. The author also indicates that 'urban female unemployment rate is underestimated and the discouraged-worker effect for women is substantial'.[25] Thus, policies should be addressing the encouragement of Turkish women to participate in the labour market.

Trade Capacity

Another important strength of the Turkish economy derives from the country's geographical location. Located at the crossroads of Asia, Europe and the Middle East, Turkey has access to trade and shipping routes for a variety of products. Especially, the transportation of energy products from Central Asia and the Middle East to Europe relies heavily on Turkish territories. Thus, Turkey is a key economy of the region, setting up a bridge between Europe and the energy exporting countries.[26]

Europe is the most crucial trade partner of Turkey. The value of Turkish trade with the five biggest countries of Europe (Germany, Italy, France, UK, Spain) corresponds to more than 20 per cent of its total trade.[27] Thus, the recent budget deficit problems of European countries and doubts on the future of European Monetary Union will have crucial repercussions for the Turkish economy.

According to the Turkish Statistical Institute (TSI) data, Russia ranks second in Turkey's trade figures with an 8.5 per cent trade share.[28] The USA and China have relatively lower shares in Turkish trade volumes. Finally, the Middle Eastern neighbours of Turkey have close trade links with the country. The total trade volume of Turkey with Iran, Iraq and United Emirates (11.4 per cent) is higher than Turkey's trade with the USA or China. Given this fact, Turkey faces both opportunities and threats in the region. Many of Turkey's Middle Eastern neighbours, especially Iraq (and specifically the Kurdish administration in Northern Iraq), offer new markets for Turkish firms. On the other hand, current turmoil in various Middle Eastern countries (including the civil war in neighbouring Syria and the ensuing deadlock) and further volatilities in the region will surely threaten the economic development of both Turkey and other neighbouring countries.[29]

Regional Disparities

A weakness of the Turkish economy is regional disparities in economic development; there are substantial differences between the eastern and the western portions of the country. Industrial production is usually located in the western cities whereas the eastern portion of the country is stuck with agricultural production and animal husbandry. Eastern provinces of Turkey show the lowest levels of socio-economic development.[30] Thirty per cent of Turkish GDP is derived from the economic activity in two major cities, Istanbul and Ankara, followed by other metropolitan areas in the west such as Bursa, Izmir and Kocaeli.[31] In their analysis of the determinants of regional disparities in the Turkish economy, Çelebioğlu and Dall'erba note the effect of the PKK (Kurdistan Workers' Party) terrorist organization on the political and economic instability of the eastern and south-eastern portions of the country.[32] Terrorism negatively affects economic growth in Turkey. The researchers show that terrorism's 'provincial effects are more pronounced for the Eastern and South Eastern provinces compared to the Western provinces'.[33] The depth of smuggling activities on the eastern borders of the country further exacerbate the problem since the underground economy is estimated to be as big as 30 per cent of the official GDP in Turkey.[34] Black market transactions are specifically evident in politically unstable areas. This creates a vicious circle for the economic problems in these areas and furthers regional disparities.

To briefly reiterate, the strengths of the Turkish economy include Turkey's production capacity, (relative) price stability in recent years, huge population potential and trade capacity of the country. These positive characteristics are counteracted by problems such as production volatility, unemployment, low female labour force participation and regional economic disparities.

Turkish Economy: Vulnerabilities

In this section, we emphasize the vulnerabilities of the Turkish economy, namely, the current account deficit, volatile international capital flows and banking sector problems.

Current Account Deficit

The current account deficit (CAD) is a widely noticed problem for the Turkish economy. The export-led growth strategy of the 1980s and trade liberalization enhanced by the Customs Union Agreement (CUA) were the milestones for the current account measures of the country. Figure 3 shows that Turkey experienced a current account surplus only during crisis (contraction) periods.

According to Figure 3, before the 1994 and 2001 crises, the CAD was around 3.5 per cent of GDP in Turkey. After both crises, the country generated a current account surplus close to 2 per cent of GDP. While Turkey experienced economic growth during 2006, the CAD worsened to 6 per cent of GDP. The foreign demand shock of 2008 led to an improvement in the current account and the deficit decreased

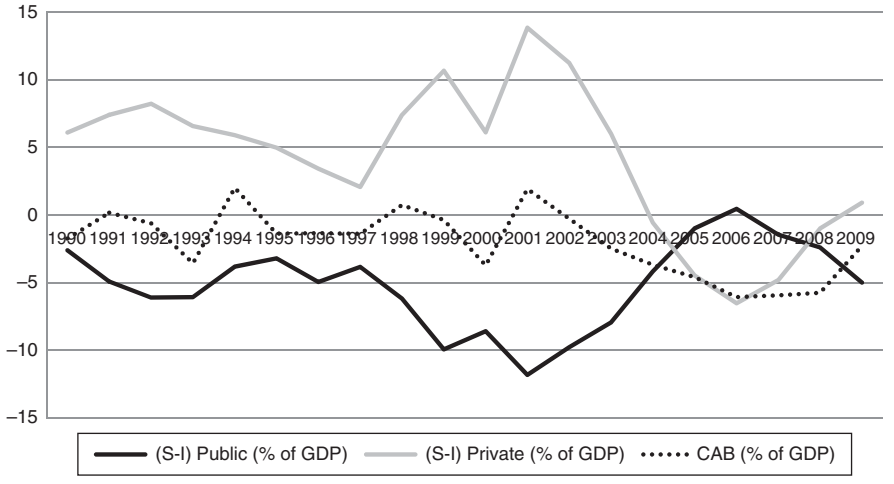


Figure 3 Public and Private Savings–Investment Gaps and CAB for Turkey (as Percentage of GDP). Source: Derived by the authors from Republic of Turkey Ministry of Development (RTMD) data and World Bank data (World Bank, 'World development indicators', <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed February 2013); RTMD, 'Economic and social indicators', <http://www.mod.gov.tr/en/SitePages/mod_easi.aspx> (accessed February 2013)).

to 2 per cent of GDP in 2009. In 2010, during the recovery period, the CAD stood at 6 per cent of GDP. In 2011, the CAD corresponded to 70 per cent of net international reserves and it improved to 36 per cent in 2012.[35]

Savings–investment gap. The savings–investment gaps of both private and public sector are the driving forces of CADs in Turkey. We consider the following representation of the CAD.[36] The CAD at any time period may be written as the difference between investment (I) and savings (S) of an open economy:

$$\mathrm{CAD} = \mathrm{S} - \mathrm{I} = \mathrm{S}_{\mathrm{private}} - \mathrm{I}_{\mathrm{private}} + \mathrm{S}_{\mathrm{public}} - \mathrm{I}_{\mathrm{public}}.$$

The CAD is a structural problem of the Turkish economy. Production heavily depends on imported energy products and imported intermediate goods. In order to export, the Turkish corporate sector has to import inputs. Moreover, household consumption includes a variety of imported durable and non-durable goods. As Őzmen and Yalçın aptly point out, the CAD was driven by the public sector before the 2001 crisis whereas it is caused by the private sector afterwards.[37] This hypothesis is also supported by the data represented in Figure 3.

In the 1990s, the public sector continuously experienced S–I deficits whereas the private sector generated S–I deficits after the 2001 crisis. After 2004, both the private and public sectors experienced S–I gaps. The effect of strict fiscal policy is reflected in the public sector S–I balance after 2001. However, the gap in the public sector started to increase again after 2006 whereas the private sector gap experienced improvements.

According to Figure 3, the public S–I deficit was 10 per cent of GDP in 2001 whereas the corresponding figure for the private sector was a surplus of 14 per cent. During 2006, the private S–I deficit was 6 per cent of GDP whereas the corresponding figure for the public sector this time was a surplus of 0.5 per cent. In sum, although the driving force of the CAD is different across two financial crises of Turkey, the CAD continues to be a source of fragility and risk for the Turkish economy.

The pattern seen in the S–I gap of the Turkish economy is also observed in the comparison between savings and consumption rates. The gross domestic savings (as percentage of GDP) have been decreasing in Turkey for the last two decades. According to World Bank data, during the 1990s, gross savings were around 20 per cent of GDP whereas they were below 17 per cent in the 2000s. Recently, the world's saving rate was 19.2 per cent of GDP in 2010 whereas that of Turkey was 13.6 per cent. China maintains saving rates over 50 per cent of its GDP. The saving rate was around 30 per cent in East Asia whereas the EU and the OECD rates were around 20 per cent.[38] Improvement in current account balance (CAB) cannot be realized with such low saving rates. The Turkish economy needs to increase its savings in all sectors to decrease risks associated with total debt, CAB and capital movements.

We can provide further evidence of the vulnerability of the Turkish economy with another economic indicator. The data on credit card usage reveal the rapid rise in the number of credit card users in Turkey.[39] There were 20 million credit card users in 2003 as compared to 47 million people in 2010. In general, the per capita credit card number is rapidly rising in the Turkish economy. In 2003, the number of per adult capita credit cards was 0.24 whereas this number reached 0.95 in 2010. In other words, almost every adult person (age above 15) holds a credit card nowadays. The anecdotal evidence in Turkey suggests that there is an increasing number of households engaging in Ponzi financing their credit card debt.

Savings–consumption balance is a critical indicator for an economy. To this end, a note should be made about the rapid rise in household credits after 2002. Household credits as a percentage of GDP were 2 per cent in 2002, which increased to 14 per cent as of 2010. In recent years, household consumption corresponds to more than 70 per cent of GDP.[40] Given the decreasing saving rates, increasing credit use and high consumption rates, the household sector as well as other sectors of the Turkish economy should be encouraged to increase their savings in order to avoid possible bankruptcies.

Customs Union Agreement. The CUA with the EU became effective in 1996. Turkey's all trade interactions were to be regulated by EU tariffs and trade policies. The improved trade liberalization led domestic industries to face external competition and operate under new regulations of EU laws. Although the agreement made it easier for exporting industries to trade with EU countries, the imports of Turkey from the EU also increased. Akkoyunlu-Wigley and Mıhçı maintain that increasing imports from EU countries reduced the prices and concentration ratio in the manufacturing sector of Turkey between 1994 and 2000.[41] There is also empirical evidence on the positive effect of the CUA on productivity and competitiveness of the Turkish manufacturing industry.[42] By the same token, Neyaptı *et al.* indicate that the

CUA increased the trade volume of Turkey with the EU and decreased the income elasticity of trade. The authors emphasize that the exports (and *not* the imports) of the country became more responsive to exchange rate movements.[43] Thus, overvaluation of the Turkish lira would induce a larger fall in exports after the agreement. Although the CUA may have positive impacts on the Turkish economy, the evidence suggests that it has contributed to the accumulation of vulnerabilities in exporting sectors. Given the crucial effects of exchange rate movements on competitiveness of Turkish exports, the CBRT and policymakers still have the 'fear of floating' in the Turkish economy.[44]

Trade data[45] identify the trend for types of imported goods in Turkey. The share of consumption goods in total imports was 5.3 per cent in 1995 whereas it increased to 13 per cent in 2011. More interestingly, the share of investment goods in total imports has decreased steadily. The share of investment goods in total imports was 22.7 per cent in 1995 whereas it decreased to 15.5 per cent in 2011. Finally, the structural problem of the Turkish economy is strikingly expressed as the share of intermediate goods in total imports is relatively stable at around 70 per cent for all 16 years. Thus, the primary source of the CAD is the import of intermediate goods. In order to cope with the CAB imbalances, Turkey should consider applying policies to encourage innovation and technology to replace importation of intermediate goods.

Energy imports. Importation of energy products is a significant part of import demand in Turkey. Özlale and Pekkurnaz emphasize that imports satisfy 70 per cent of energy demand in Turkey. The authors find evidence that oil price changes significantly affect the CAB of the Turkish economy.[46] The World Bank data set illustrates that the share of imported energy in Turkish energy consumption has steadily increased.[47] During the 1990s, the share of imported energy was between 50 and 60 per cent whereas this share ranged between 60 and 70 per cent during the 2000s. Although the EU has lower levels of import dependency in energy, it has a similarly increasing pattern. Around 50 per cent of the EU energy consumption was imported in 2010. China has low levels of import dependency in the energy sector. Less than 10 per cent of China's energy consumption is imported. The dependency on imports is a significant risk both for the EU and Turkey. A possible increase in oil prices due to potential political instability in the Middle East would significantly deteriorate the Turkish trade balance and its CAD. Thus, Turkey and the EU should develop policies to decrease import dependency such as considering alternative energy types and sources.

International Capital Flows and Turkey

Another major volatility of the Turkish economy is its dependence on international capital flows. In this subsection, we present the details of this issue.

Foreign direct investment and portfolio flows. The rising integration of world economies leads capital movements to have a more significant impact on economic performance of countries. The composition of capital flows is a crucial determinant for the stability of an economy. Figure 4 reports the foreign direct investment (FDI)

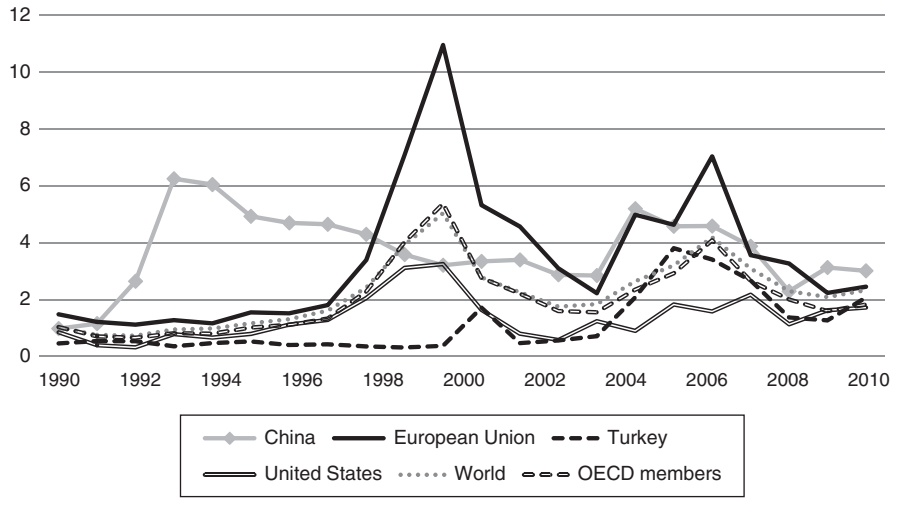


Figure 4 Net FDI Flows (as Percentage of GDP). Source: The trend data are compiled by the authors based on World Bank data (World Bank, 'World development indicators', <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed February 2013)).

flows in Turkey and reference countries/groups. Direct investment flows follow a more stable pattern than portfolio flows, which are shown in Figure 4.

The introduction of the euro and the enlargement of the EU increased FDIs in European countries during the late 1990s and early 2000s. In 1997, the level of the FDI for the EU countries was 1.6 per cent of GDP whereas it reached 10.9 per cent in 2000. During the 20-year period, China maintained an average of 3.7 per cent FDI inflows. Compared to other countries, Turkish FDI inflows have been very low, especially during the 1990s. The EU candidacy position of the country had a positive impact on FDIs, which was driven up to 3.8 per cent of GDP, during 2005–2007. However, recently, FDI flows constitute only 1.2 per cent of GDP in Turkey for 2010. Thus, the performance of the Turkish economy in attracting FDIs is fairly low.

Unlike the FDIs, the Turkish economy experiences large inflows and outflows of short-term portfolio investments, especially during the expansion period of the early 2000s. According to Figure 5, Turkey had 5.6 billion US dollars' worth of portfolio equity flows in 2007. This is a 165 per cent increase compared to 2006 levels. In 2008, however, the portfolio inflows decreased by 86 per cent down to 0.7 billion US dollars. The portfolio flows for other countries have been following similar patterns yet at much higher levels than the Turkish case. Similar to the GDP patterns, the Turkish economy experiences outflows and inflows depending on the domestic conditions as well as external conditions. Turkey should develop policies to substitute FDI flows for portfolio flows to induce long-term foreign investments such as capital control instruments.

Previous research indicated the vicious cycle of the Turkish economy regarding international capital flows. The Turkish economy has started to follow a flow of economic events with capital inflows after the liberalization of the current account.

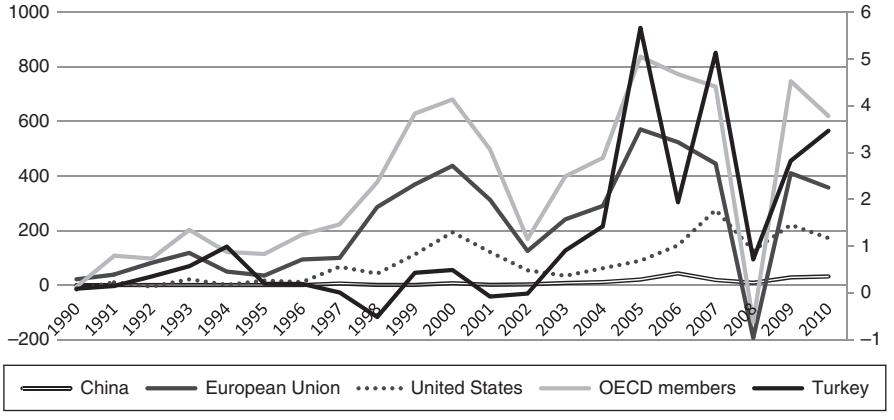


Figure 5 Net Inflows of Portfolio Equity (Current Billion US Dollars). Note: Turkish data are shown on right axis. Source: The trend data are compiled by the authors based on World Bank data (World Bank, 'World development indicators', <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed February 2013)).

Boratav emphasizes that Turkey had the same flow of events in the emergence of the 1994, 2001 and 2008 financial crises:[48]

$$\text{Capital Inflows} \rightarrow \text{Domestic Demand} (+ \text{External Debt}) \rightarrow \text{Real Growth}$$

$$(\text{Unutilized Capacity}) \rightarrow \text{Imports} \rightarrow \text{Current Account Deficit}.$$

Before the financial crises, the capital account balance (or financial account balance with the IMF definition) of Turkey was positive due to capital inflows. The 1994 and 2000–2001 domestic crises have been associated with massive capital outflows from Turkey. Moreover, external shocks such as the Asian crisis in 1997–98 and the recent mortgage crisis originating from the USA generated capital flights, too. Thus, Turkey is subject to both internal and external risks of capital movements. The absolute level of capital movements has been gradually increasing in Turkey. During the 1990s, the financial account balance was less than 5 billion US dollars in each year. After 2004, Turkey has had financial account balances higher than 10 billion US dollars. In the second quarter of 2011, the financial account produced a surplus of 24 billion US dollars. Moreover, data indicate deterioration in the Net International Investment Position (IIP) of Turkey.[49] The Net IIP is defined as 'the difference between Turkey's assets abroad and liabilities to non-residents'.[50] Although, there are slight declines in the IIP of the country in periods of crises, Turkey's IPP is always negative and gradually widening. The IPP of the country was 54 billion US dollars in 1996, 127 billion US dollars in 2004 and 383.5 billion US dollars in 2012. Over eight years, Net IPP of the country worsened by 202 per cent.

International reserves and external debt. The capital inflows help Turkey accumulate international reserves. The level of international reserves and the short term of external debt for Turkey have been steadily increasing as shown in Figure 6.

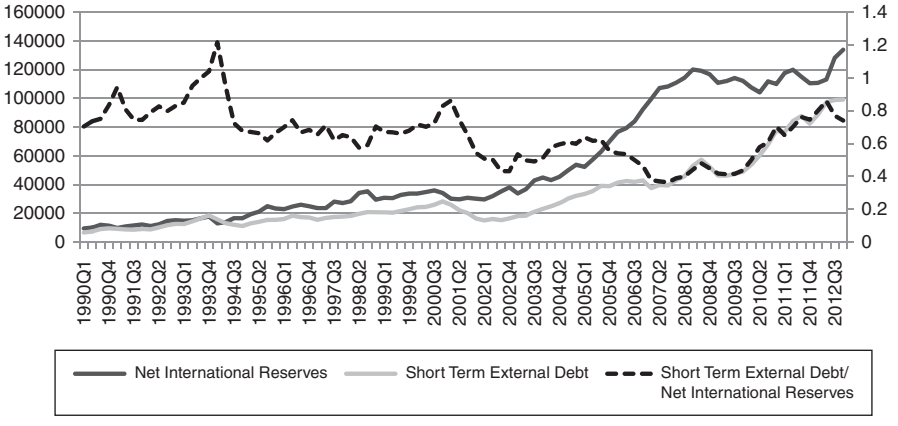


Figure 6 Comparisons of Short-Term External Debt and Net International Reserves for Turkey (Million US Dollars). Note: Right axes show the ratio of short-term external debt to international reserves. Source: Derived by the authors from Central Bank of the Republic of Turkey (CBRT) international investment position and short-term debt statistics; CBRT electronic data delivery system (CBRT, 'International investment position and short-term debt statistics', <http://www.tcmb.gov.tr/uyp/uyp_tr.html>, <http://www.tcmb.gov.tr/uyp/iiptable16.pdf8.5> (accessed February 2013); CBRT, 'Electronic data delivery system', <http://evds.tcmb.gov.tr/yeni/cbt-uk.html> (accessed February 2013)).

During the periods of financial crisis, international reserves of Turkey depleted due to massive capital outflows. However, after recovery periods, portfolio inflows help the CBRT accumulate reserves. The level of international reserves declined by 39 per cent during the 1994 crisis and by 46 per cent in the 2001 crisis. Finally, the external shock of 2008 induced a 10 per cent decrease in net international reserves.

The short-term external debt–net international reserves ratio increased up to 1.21 in 1994 whereas it was 0.82 in the last quarter of 2000. However, before the 2008 global turmoil, this ratio decreased to 0.36 in 2007. It is recently around 0.8 for the third quarter of 2012. Turkey still has a short-term external debt level close to its net international reserves. Interest payments on external debt of Turkey were 1.7 billion US dollars in 2009 and 2.9 billion US dollars in 2011.[51] In other words, there has been an increase of 70 per cent in interest payments on external debt in two years. Although, net international reserves of the country have been increasing, the current level of short-term external debt may not be sustainable in the long run and it is still a vulnerability of the Turkish economy to be addressed. Thus, Turkey should develop policies to improve the sustainability of external debt in the short term and reduce the level of external debt in the medium and long term.

Banking Sector Vulnerabilities

The domestic credit has been gradually increasing in the Turkish economy as the banking sector dominates the financial markets of the country. The pre-1994

period witnessed a stable domestic credit/GDP ratio, between 20 and 25 per cent, whereas the domestic credit/total reserves ratio was rapidly increasing. The domestic credit/total reserves ratio was 3.75 in 1990, which increased up to 5.9 in 1993.[52]

The 1994 financial crisis created a sudden decline in both domestic credit and international reserves and the ratio declined to 3.5 per cent during the economic downturn. In 2001, the domestic credit/total reserves ratio was 5.21 and it decreased to 3.66 in 2003. The 2001 financial crisis led to a decline in both domestic credit and international reserves and the ratio increased during the economic recovery. In 2010, the domestic credit/international reserves ratio was 5.9 (pre-crisis level of 1993) whereas the domestic credit corresponds to almost 70 per cent of GDP.[53] The role of credit expansion has been steadily increasing over time. A crucial difference across two financial crises of the Turkish economy is the difference between the ratios of domestic credit over GDP.

The Turkish banking sector is so heavily exposed to exchange rate risks such that the BRSA issues annual reports on the subject matter.[54] According to Figure 7, the foreign exchange open position of the banking sector was 16.8 billion US dollars in 2000. During the contraction period of the 2001 crisis, the open position gradually decreased in the sector. During the recovery period, the banks re-accumulated their foreign exchange open positions. In 2008, the balance sheet open position of the banking sector was 8 billion US dollars whereas it recently reached up to 16.8 billion US dollars in 2011, the same as the pre-2001 period. However, in light of Figure 7, there is a crucial difference between 2000 and 2011. The net open position of the sector was −5.9 billion US dollars in 2000 and it was 0.7 billion US dollars in 2011. Thus, the vulnerability of the banking sector to exchange rate fluctuations is still a problem although the regulatory agency supervision and auditing improved the banking sector performance after 2001.

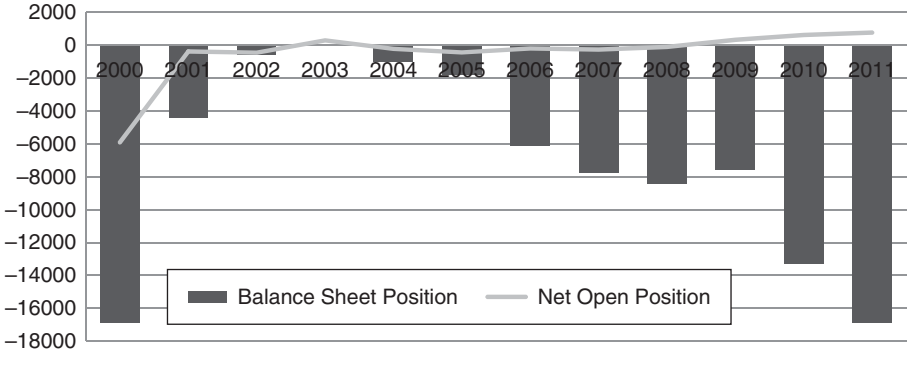


Figure 7 Foreign Exchange Open Position of Banking Sector in Turkey (Yearly Averages in Million US Dollars). Source: Authors' calculations based on Banking Regulation and Supervision Agency (BRSA) of Turkey (BRSA, 'Turkish banking sector evaluation annual reports' and 'Turkish banking sector exchange rate risk evaluation annual reports').

Policy Implications

Our analysis indicates that Turkey has a long way to go to correct for its vulnerabilities in several areas. These include raising levels of savings, encouraging female labour force participation, diminishing dependency on energy imports, managing the structure of capital flows through the utilization of efficient capital control mechanisms and elaborating on the banking sector. In this section, we specifically discuss the role of capital controls for enhancing financial stability of the Turkish economy.

Liberalization of the capital account for Turkey to enhance financial integration and trade was a result of orthodox economic policy recommendations by the IMF. However, prior experiences of many developing countries as well as Turkey raise question marks for the validity of these orthodox neo-liberal policies. As Rodrik aptly suggests, policy recommendations for countries 'should be tailored to local economic and political realities, rather than obeying the dictates of the international globalization establishment'.[55] In other words, one-size-fits-all recipes for developing countries' ailing economies are recipes for further disasters, unless these countries' socio-economic and political idiosyncrasies are taken into consideration.

We provide our policy recommendations for Turkey with this in mind. To start with, the dependence on capital inflows is a crucial vulnerability of the current Turkish economy, which has been cyclically exposed to sudden changes in capital flows. The sudden stops and capital outflows have led to enormous welfare losses in the country.[56] Thus, the management of capital movements is a necessary condition to achieve a stable financial and economic system.

Even recent studies of the IMF Staff consider capital controls as a stabilization policy. Ostry *et al.* discuss the relationship between capital controls and macroeconomic stability. The researchers consider capital controls as necessary tools to achieve different policy goals.[57] They discuss the means of capital controls such as taxes on stock market investments, foreign loans and foreign exchange transactions, and minimum maturity requirements.

By applying controls on capital flows, Turkey may achieve economic growth and change the composition of capital movements, which will help reduce risks associated with open positions of different sectors. As Gallagher notes, Brazil and Taiwan achieved stability and economic growth by managing capital flows.[58] In a similar vein, Montiel and Reinhart maintain that capital management policies affect composition of inflows (not their volume). The authors further provide evidence for the positive impact of capital controls on FDI inflows.[59] For instance, applying capital controls, China achieves high levels of FDI inflows and economic growth.

The capital control measures would affect both composition and maturity of inflows.[60] Moreover, prudential policies on domestic financial institutions may be effective in reducing currency mismatches and the open position of the domestic financial system. For instance, Ostry *et al.* discuss the effects of the unremunerated reserve requirement on composition of capital inflows for the Chilean and Colombian cases.[61] The researchers also analyse country cases for asymmetric position limits (Malaysia, 1994), ceilings on net liability position of banks (Thailand, 1995–96) and prudential marginal reserve requirements (Croatia, 2004–2008).

Given that volatile capital flows constitute a primary risk, Turkey should consider applying measures of capital controls to improve financial and macroeconomic stability via reducing vulnerabilities for different sectors of the economy. Capital controls can be based on prices, quantities and regulations. We do not favour any specific application of capital control measures since each of them has its own advantages and disadvantages. For instance, Altınkemer discusses the pros and cons of the Tobin tax on international capital flows and suggests a variant of taxing capital flows in the Turkish economy.[62] Rather, we provide a general argument and suggest that the optimal type(s) of capital control tools should be chosen in accordance with policy goals for Turkey.

Introduction of capital controls will impact the Turkish economy via different channels as summarized in Figure 8. First, capital account measures will significantly impact the volatility in foreign exchange markets. A decline in volatility of capital controls will decrease the frequency of speculative attacks, helping the CBRT with maintaining stable exchange rates without excessive use of international reserves. The CBRT would need fewer operations of sterilization and hold fewer international reserves, which will reduce the cost of holding reserves for the society.[63] Furthermore, foreign exchange exposure of the private and government sectors as well as fear of floating in policymaking will be reduced as a result of exchange rate stability. Thus, capital controls will lead to room for more independent monetary policy.

The reliance on foreign capital is a key characteristic of the Turkish economy. Both government and private sectors significantly borrow from abroad driving the external debt of the country. Excessive use of foreign capital leads to vulnerabilities in the balance sheet of economic agents and the financial institutions. The open positions and currency mismatches in balance sheets of economic agents/institutions make the

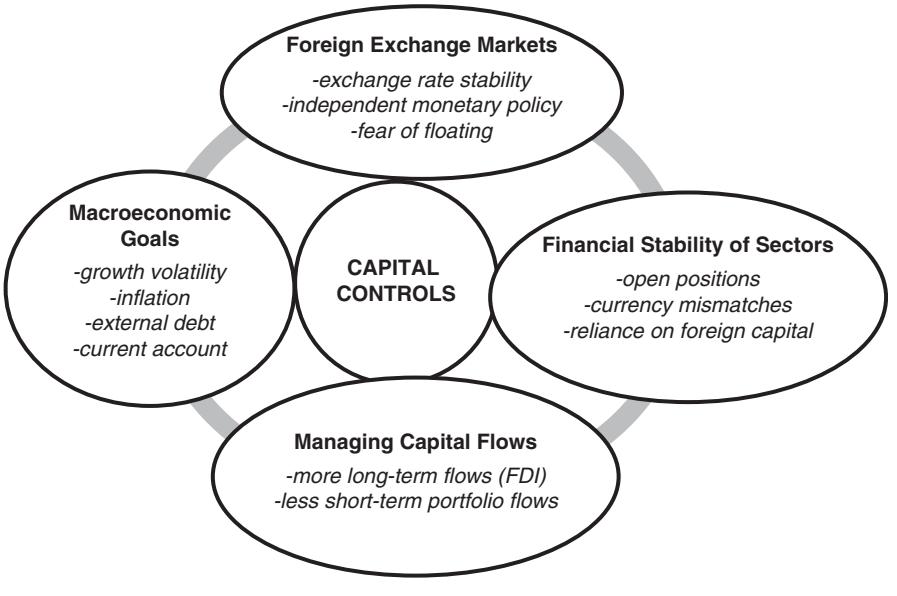


Figure 8 Capital Controls and Transmission Channels

Turkish economy sensitive to exchange rate fluctuations. As discussed above, capital controls have the potential to stabilize the exchange rates and thus reduce the foreign exchange exposure on different sectors. Moreover, capital control tools may be employed to regulate the financial institutions, especially the banking sector, to affect the volume of volatile short-term external borrowing. For instance, introduction of the 'unremunerated reserve requirement' or similar measures by the CBRT would prevent excessive use of external financing in the banking system.

The next impact of capital controls will be on term structure and composition of capital flows. There are two dimensions of capital flows to be affected by control measures: maturity and investment type. Capital controls will mostly drive short-term flows out and encourage long-term investments in. The share of risky short-term portfolio investments will decline whereas the portion of long-term FDI flows will increase for the Turkish economy. The identification of the net impact on total volume of capital flows in the Turkish economy would not be feasible for the time being. However, as Magud and Reinhart underline, 'capital controls on inflows seem not to reduce the volume of net flows'.[64] Thus, capital controls (e.g. a Tobin tax on portfolio movements) have the potential to reduce the volatility of capital flows and the effects of capital flights or sudden stops without decreasing the net inflow of capital for the Turkish economy.

The regulations and controls on capital movements would lead the Turkish economy to achieve macroeconomic goals such as stable growth rates and reduce the vulnerabilities such as CAD and external debt. The capital controls will decrease the volatility of mass capital movements in the Turkish economy and prevent the dramatic fluctuations in the exchange rates which will stabilize the export revenues as well as imported consumption. Regulations on the banking/financial system would impact domestic credit expansion and thus both government and private consumption levels which will decrease the volatility of external debt for the country. In sum, we suggest that capital controls have the potential to stabilize the Turkish economy by decreasing the previously described vulnerabilities. Applying the appropriate form of capital controls may lead to a more sound financial system, less volatile and higher maturity investments, stable exchange rate markets, more independent monetary policy and thus a more stable Turkish economy.

Concluding Remarks

This paper peruses the current state of the Turkish economy by going over its economic history since the 1980s. We present the impact of domestic and international economic crises on Turkey's economic and political arenas in the first section. We provide a discussion of Turkey's place in the global arena, as well as its strengths and weaknesses in the following section. Turkey's strengths revolve around its huge production capacity, price stability in recent years, high population potential and trade advantages of the country thanks to its geographical location. On the other hand, Turkey's weaknesses centre on its GDP volatility, ongoing problem of unemployment, low female labour force participation rate and regional economic disparities. After going over Turkey's strengths and weaknesses in the global economy,

we elaborate on its vulnerabilities in the real and financial sectors in the third section. These include low levels of savings, dependency on energy imports and the import of intermediate goods, lack of efficient capital control mechanisms and vulnerabilities in the banking sector. Finally, we discuss a policy implication to enhance economic institutions, that is, capital controls, which can help Turkey cope with its vulnerabilities. Elaboration on these aspects will be reflected in more sound and efficient economic institutions, which will hopefully pave the way for greater and sustainable economic growth for Turkey in the 21st century.

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Disclosure Statement

No potential conflict of interest was reported by the authors.

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