

Observations on Turkey's recent economic performance

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Abstract

We establish that the Turkish economy underwent a remarkable transformation during the last decade. We identify the underpinnings of this successful transformation as well as the inadequate policies that enabled vulnerabilities to accumulate. Despite improvement in the economic fundamentals, volatility and dependence on external finance not only persisted but actually increased during the last decade. We discuss the structural causes of the widening external deficit. Finally, we evaluate Turkey's outstanding economic performance in the aftermath of the global financial crisis and the recent "soft landing" and rebalancing episode.

1. Introduction

Turkey's economic performance has been remarkable in the aftermath of the global financial crisis, even "stellar" according to some economists. The economy grew by 9.1 % in 2010 and 8.5 % in 2011, thus placing Turkey, for the first time in recent history, among the most rapidly growing economies. As a result, at the end of 2011, all indicators had improved substantially compared to their pre-crisis levels: Gross Domestic Product (GDP) and private consumption was up by 13 %, private investment in machinery-equipment by 25 %, and unemployment was down to 9.5 %.

This performance came as a great surprise to many observers both at home and abroad. Turkey had been one of worst casualties of the global financial crisis. At the peak of the turmoil in the winter of 2009, the news media, financial markets and credit-rating agencies were all predicting an immediate implosion of the economy, usually blaming the AKP government for its refusal to appeal to the IMF for assistance. Indeed, GDP contracted by 14.7 % in the first quarter of 2009 over a year ago and unemployment jumped to 15 % in April 2009. Any forecaster who correctly predicted that a rapid recovery was just around the corner would have been the laughing stock of the trade. Yet a rapid recovery did take place and none of the "catastrophe scenarios" materialised; the economy began growing in the second quarter of 2009, at first slowly, and then it gradually picked up speed.

The recovery was led by strength in domestic private demand, fuelled by an explosion of credit in the banking system. Along with the recovery, Turkey's perennial problem surfaced as the

current account deficit reached 10 % of GDP at the end of 2011, clearly at an unsustainable level. Given the glut of global liquidity, the deficit was easily financed with short-term capital inflows. However, the risk of financial and economic turmoil if a reversal in capital flows occurred (sudden stop) convinced economic policy makers to change gears. The new policy framework aimed at an orderly correction of this acute macroeconomic imbalance by engineering a “soft landing” of the economy.

What has happened? Why did the gloomy forecasts of 2008 fail to materialise? How can the contrast between the depth of the recession and the strength of the recovery be explained? Has the recovery ended? Is a soft landing achievable? What types of policies can ensure sustainable growth? We believe that exploration of the issues surrounding these questions, in the context of Turkey’s recent past, will improve our understanding of the policy-making framework of the period, with respect to both weaknesses and strengths, and that it will shed light on current policies. In the conclusion, we offer answers and recommendations regarding these policy issues. To that end, we focus on the past two decades, with a special emphasis on the causes and consequences of Turkey’s growth performance.

We establish that the Turkish economy underwent a remarkable transformation during the last decade (Section 2) at the expense of an accompanying increase in the volatility of growth (Section 3). We first identify the underpinnings of this successful transformation (Section 4) as well as the inadequate policies that helped vulnerabilities to accumulate (Section 5). Despite improvement in the fundamentals of the economy, dependence on external finance for rapid growth not only persisted but actually increased during the past decade. What causes low domestic savings? Is Turkey destined to experience structural external deficits? We propose a solution to this puzzle that is mainly based on improving the previous inadequacy of policy responses to the changing environment (Section 6 and 7).

The conclusion examines recent innovations in policy, especially by monetary authorities, that have dominated the policy debate since the end of 2010. In a sense, the conclusion is an application of the findings of the previous sections on policy issues. In general, we support the new policy framework but maintain important reservations about its implementation.

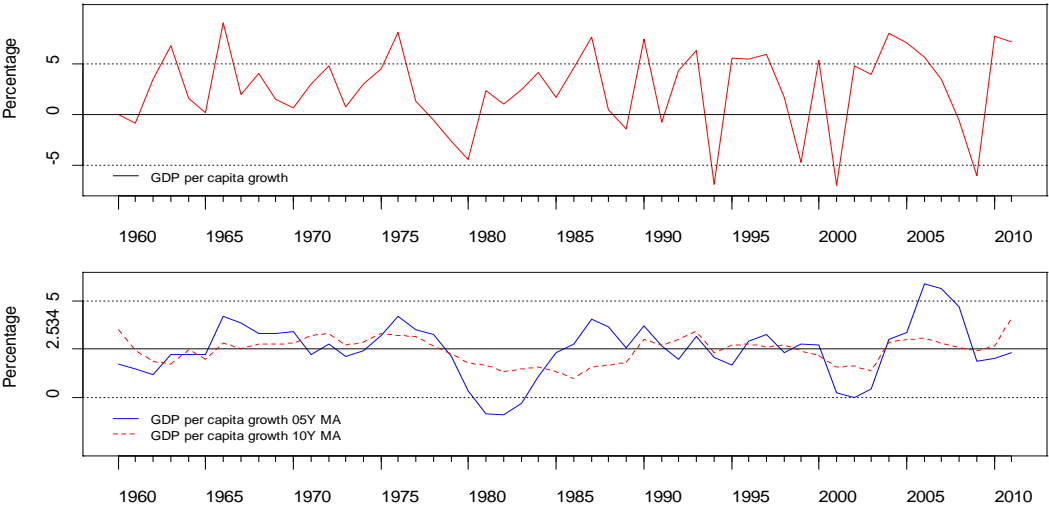
2. Has growth performance improved in the last decade?

The Turkish economy underwent a remarkable transformation, both quantitatively and qualitatively, during the past decade. The result is actually visible to the naked eye. Yet there are claims to the contrary that the economy did not outperform its long-term trends. Did it, or did it not? This is the question we address in this section. Our answer will be affirmative.

Measurement problems often dominate disagreements among professional economists. The literature is full of cases in which the selection of dates or series or measurement units or equations can even reverse trends. The man in the street, in turn, mistrusts almost all official data, believing, not incorrectly, that data are manipulated to please the politicians in charge.

Turkey’s growth performance relative to the past and the rest of the world, especially since 2002 when AKP came to power, is hotly contested. The government uses GDP per capita at current exchange rates to claim a three-fold increase in well-being, a historical record: from US\$ 3.500 in 2002 to US\$ 10.500 in 2011. A dissident economist who prefers GDP per capita at constant TL prices finds only a rise of 41 %, from 1.108 TL to 1.560 TL (1998 prices), which is not remarkable. An alternative approach to diminish the achievement of the period uses total GDP instead of per capita figures, thus hiding behind the lower population growth of the last decade¹.

Graph 1 illustrates the evolution of (real) GDP per capita growth since 1960, both annual rates and moving averages (5-year and 10-year).² The top graph confirms the roller-coaster nature of Turkish growth; extreme highs and lows are the rule rather than exception. This finding suggests that the hard landing in the global crisis and the rapid recovery afterwards depict rather typical behaviour for the Turkish economy. The trapezoidal line makes it impossible to infer trend changes. The volatility issue will be further discussed later.



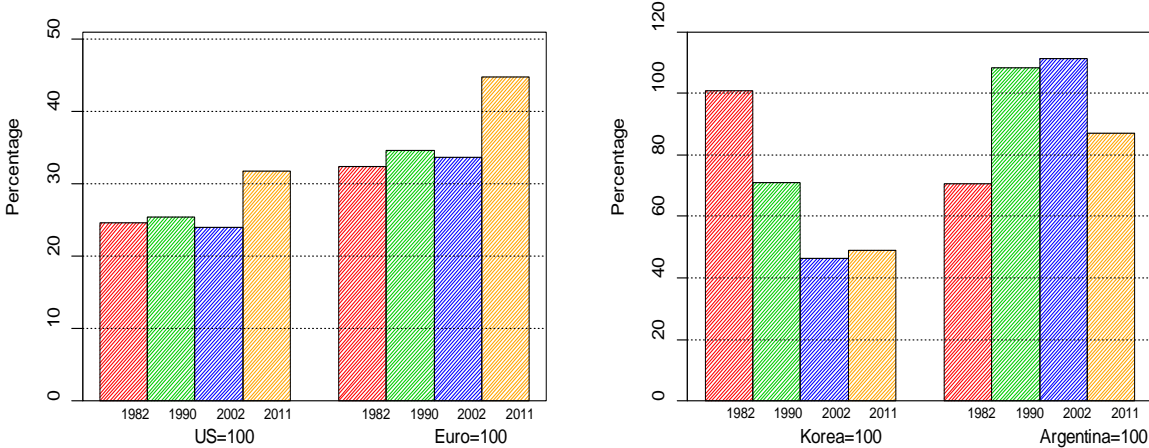
Graph 1
GDP per Capita Growth

¹ Population growth steadily declined throughout the 1980s and 1990s, along with metrics such as urbanisation, and improved female education, with temporary reversals (i.e., during the early 1980s and 2007-09).

² Data are obtained from Turkey Data Monitor (TDM) databank (www.turkeydatamonitor.com). GDP per capita is calculated with annual GDP in TL (constant 1998 prices, chain indexed at base-year switches) and annual mid-year population. In general, except for international comparisons, domestic data sources are preferred when available.

The bottom graph uses moving averages that smooth the short-term fluctuations for better viewing. The average annual growth rate of GDP per capita is 2.5 % for the period, corresponding to a “mediocre” performance overall: it is neither a failure nor a miracle. Naturally, 10-year averages exhibit lower volatility at the cost of providing less evidence about an upward shift in the last decade. GDP peaks at 4 % in 2011, significantly above previous peaks in 1993 (3.4 %) and 1972 (3.3 %), with troughs in 1986 (1 %)³ and 2003 (1.4 %). In turn, the shorter moving averages (5-year) improve the picture, revealing peaks at 5.9 % in 2006, followed by two other dates in the 2000s—2007 and 2008—with peaks at 5.6 and 4.7 %, respectively, all of which are significantly higher than previous peaks in 1976 and 1966 (4.2 %) and 1987 (4.1%). Troughs occur in 1983 (- 0.9 %) and 2003 (0 %). The steep drop after 2007 reflects the depth of the recession during the global financial crisis, as mentioned earlier. In our opinion, this finding constitutes evidence of an upward trend-shift in Turkey’s growth.

However, comparisons with Turkey’s past alone are insufficient to assess economic performance; growth is a relative phenomenon, and a more conclusive analysis requires the inclusion of other countries in the picture. For that purpose, we turn to GDP per capita at Purchasing Power Parity (PPP) at constant exchange rates data computed by the World Bank⁴; this approach also solves some of the measurement problems mentioned above. We simply compare the relative movement of Turkey’s per capita income with four countries, two developed (the US and Euroland) and two developing (Argentina and Korea), at four dates unpolluted by the economic crisis (1982, 1990, 2002 and 2011). The results are shown in Graph 2.



Graph 2
Turkey: Comparing per capita income

³ We ignore two dates of the 1980s (1985, 1982) that lie between 1980 and 2003.

⁴ “GDP per capita, PPP (constant with 2005 prices in US Dollars)” from World Development Indicators (WDI) (databank.worldbank.org). The series starts at 1980.

The graph on the left side tells an interesting story. Clearly, Turkey is not on a path to “catch up” with rich countries from 1982 to 2002; income per capita stagnates relative to both the US and Euroland, at a quarter of the former and third of the latter. The picture changes in the last decade. Turkey picks up 8 percentage points over the US and 12 over Euroland, as they struggle with the crisis. The underlying finding is clear: there is a distinct upwards discontinuity in the relative growth performance in the last decade with the developed West.

What about other emerging market economies?⁵ The comparison with Korea in the right graph confirms the trend. From 1982 to 2002, Korea’s economic miracle implies a fall of more than half of relative income per capita for Turkey, giving us a clear idea about the opportunity cost of these lost decades. In turn, since 2002, Turkey outperforms Korea by a small margin. Again, the change in the growth trend is unmistakable.

Adding Argentina to the graph may seem like an odd choice, but it serves the purpose of putting Turkey’s mediocre performance during the last two decades of the 20th century into proper perspective. Yes, income per capita stagnated relative to rich countries; yes, successful emerging economies outperformed Turkey; no, Turkey was not a failure like Argentina.⁶

Micro data and anecdotal evidence also strongly favour our conclusion. Production figures for key inputs and critical indicators of consumer welfare may help convince those who mistrust the quality of national income accounting in Turkey. In the 10 years since 2002, production increased 2-fold for electricity (91 %), cement (98 %) and steel (130 %); domestic air travel jumped 7-fold (to 63 million passengers), and the number of registered vehicles and the enrolment ratio in higher education nearly doubled (respectively to 17 million and 36 %).⁷ Needless to say, these figures all represent much higher growth rates compared to previous decades.

There is also much indirect evidence. For example, in open economies, foreign direct investment inflows are very strongly related to economic performance. There is some circularity, as strong FDI inflows both improve performance and are attracted by it. We leave this subject to the next sections. The data in Table 1 confirm our conclusion above.⁸ In the last decade, FDI inflows averaged 2.1 % of GDP, corresponding to a 7-fold increase from the previous two decades. It is even stronger when we exclude the crisis: 2.4 % of GDP for 2003-07.

⁵ We prefer “emerging market economy” to “developing economy” in order to underline relatively advanced levels of integration with the world economy, namely, through trade and financial flows.

⁶ Another puzzle? Argentina is among the few countries that outperformed Turkey in the last decade.

⁷ Historical data are available from Turkstat: Statistical Indicators 1923-2010 (www.tuik.gov.tr/IcerikGetir.do?istab_id=158). We estimate 2012 data (September 2012).

⁸ Data from Balance of Payments (www.tcmb.gov.tr) and Turkstat.

FDI inflows	US Dollars (in billions)	Per cent of GDP
1980-2002	9	0.3
2003-2011	110	2.1
2003-2007	57	2.4

Table 1
FDI inflows 1980-2011

3. How volatile is the Turkish economy?

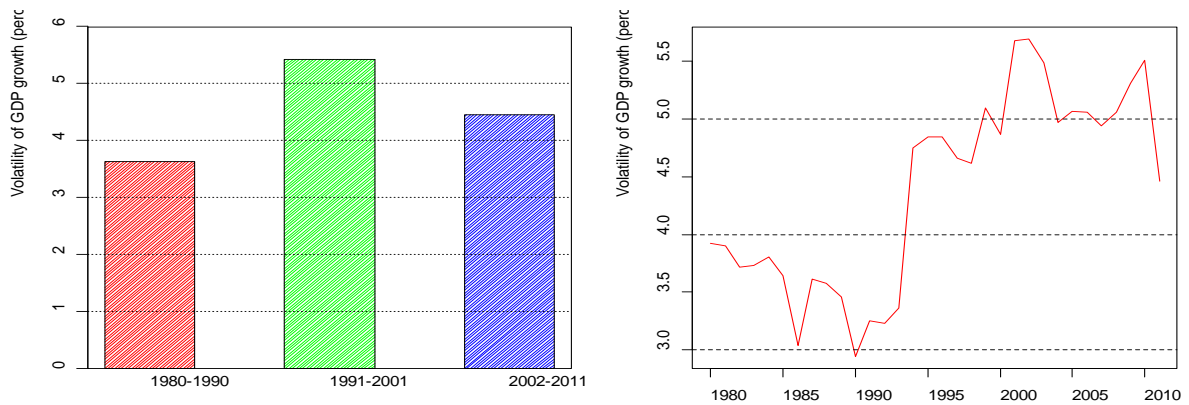
We now turn to the high volatility of Turkey's growth performance, established in Graph 1 above. We begin with some methodological and historical observations. We measure volatility by the standard deviation of annual growth rates of real GDP (not per capita) from the long-term averages. We skip the "command economy" era (1960-1980) because it is neither informative nor interesting for our analysis.

The left hand side Graph 3 plots volatility of GDP growth in Turkey by decades.⁹ Volatility is low in the 1980s (3.6 %) despite decent trend growth (4.5 %). Then, it jumps in the 1990s to 5.4 %, while trend growth falls to 2.9 %. Then, it falls during the 2000s to 4.5 %, with trend growth increasing to 5.4 %. Because these calculations may be sensitive to the choice of years included in the periods, the right hand side Graph 3 provides the 10-year moving standard deviations, with each point reflecting the volatility of the past 10 years. Again, the jump in volatility during the 1990s and early 2000s is clear; after fluctuating around the average, it declines significantly in the last few years (although still above 1980s).

A consensus seems to exist about the "original sin" that triggered the increased instability that higher growth volatility captures: the surprise capital account liberalisation by Özal in 1989.¹⁰ Numerous studies examine the globalisation of financial markets and the contribution of volatile capital flows to higher instability in developing economies; this subject will be further discussed below.

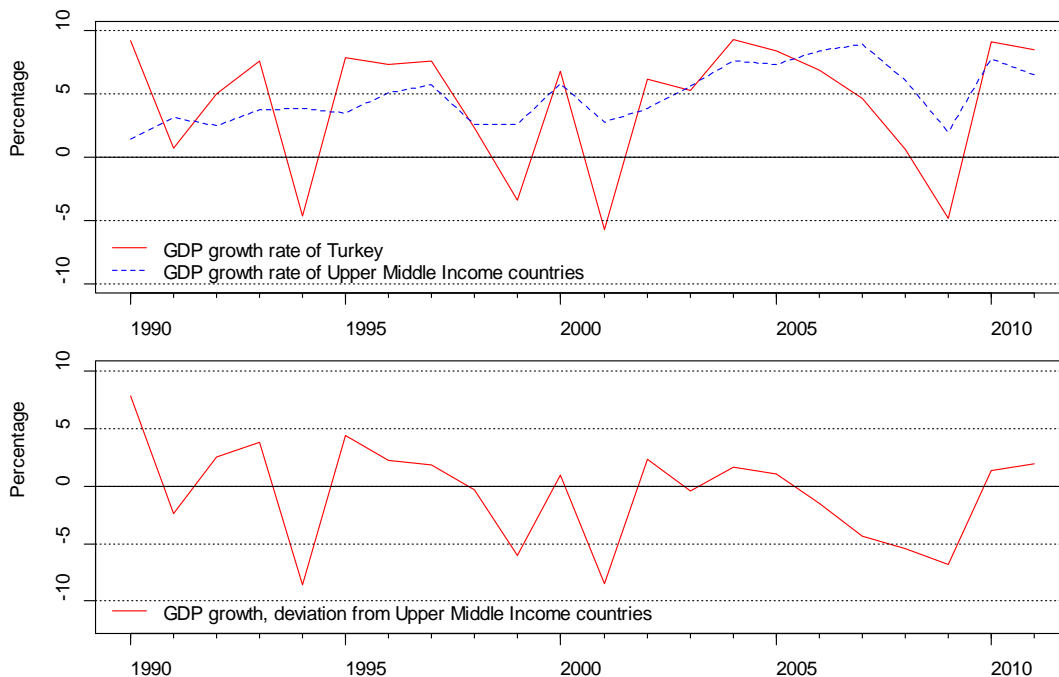
⁹ Volatilities are simply calculated by standard deviations of real GDP growth of the corresponding periods. GDP data at 1998 constant prices are taken from TDM.

¹⁰ Correctly called "premature liberalisation with incomplete stabilisation" by Dani Rodrik (1992).



Graph 3
Volatility of growth by decades

The growth performance of Turkey relative to other economies of comparable characteristics may provide us with additional information, both on the link between domestic and global business cycles and relative volatility. Graph 4 summarises the growth rates of Turkey with the average of upper-middle-income economies after 1990.¹¹



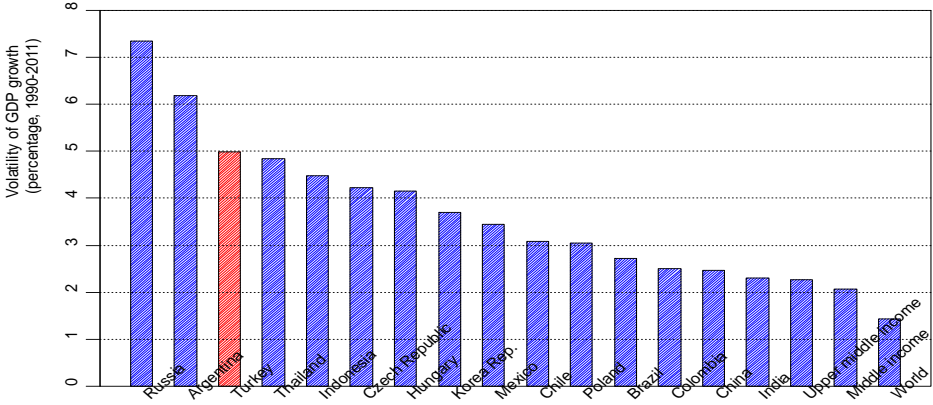
Graph 4
Comparative growth: Turkey and Upper Middle Income economies

The upper Graph 4 gives a first impression of the growth performance of Turkey relative to the control group, whereas the lower Graph 4 illustrates the deviation of Turkish growth from the control group. It is clear that Turkey’s business cycles are not related to the performance of “upper-middle-income countries” prior to the last decade; the crises in 1994, 1999 and 2001 originate from

¹¹ Data from WDI; upper-middle-income countries are defined by the World Bank.

internal forces; i.e., they are homemade. In turn, after 2002, the two cycles begin moving together, although Turkey has a more severe recession during the global financial crisis (2008-09) and a much stronger recovery afterwards.

We finish with a comparison of Turkey’s growth volatility with a representative set of other economies for the post-capital account liberalisation period (1990-2001). In Graph 5, Turkey is third from the top of the list, after Russia and Argentina.¹²



Graph 5
Comparing growth volatility

Let us take stock of our findings before we move on: i) there is an improvement in Turkey’s growth performance in the last decade, pointing to a discontinuity with the period before, and ii) the volatility of growth jumps during the 1990s, falling in the last years but still remaining high compared to the 1980s (with lower growth rates). There is no consensus in the literature on signs of the relationship between growth and volatility and the direction of causality¹³; i.e., to claim higher volatility as the curse of higher growth for the last decade is not possible, yet the exploration of the link is important. We must focus first on the sources of the improvement in growth performance.

4. What went right? The magic of fiscal consolidation

An improvement in the overall performance of a large economy is a complex process involving many layers of institutions and policies. In real life, many positive developments occur

¹² Real GDP growth data from WDI; volatilities are measured as the standard deviations of the growth rate within the period.

¹³ The link between economic growth and volatility is theoretically ambiguous (see Imbs, 2007). Ramey and Ramey (1995) present evidence to suggest that mean output growth rates are adversely affected by their volatility. These findings, however, are in contrast to earlier studies by Kormendi and Meguire (1985) and Grier and Tullock (1989). Imbs (2007) finds that growth and volatility correlate negatively across countries but positively across sectors.

simultaneously, making it difficult to establish the correct order of causality. Often, what seems at first glance to be the cause is in fact a consequence of the process.

We begin by differentiating deliberate domestic efforts from external/global events outside the control of domestic actors. The impact of the former may be permanent, unless it is reversed later, whereas the latter may be of only a temporary and random nature. First, we examine the role of the outside world.

A positive supply shock in the last decade may explain part of the improvement in economic performance. The natural indicator is the terms of trade data. Turkey is resource-poor country; it is a net importer of energy and minerals and has limited prime agricultural land. Therefore, the country is adversely affected by a rapid rise in commodity and energy prices, as occurred during the last decade. The result is deterioration in the terms of trade, from 101 in 02Q02 to 89 in 02Q12: a decline of 12 %.¹⁴ In other words, the improvement in economic performance took place despite headwinds from international terms of trade.

What about the global business cycle? It features two parts. On the real economy side, above-trend growth in the world, especially in trade partners, is an important positive externality for an open economy and may partly explain the improvement in economic performance. This situation was somewhat true for Turkey during the early years, 2003-07¹⁵; however, the trend reversed dramatically with the onset of the global financial crisis in 2008 and was further aggravated by the crisis in the euro region, which comprised the market for half of Turkey's exports before the crisis. Looking at the decade as a whole, we find below-average growth rates and above-average volatility for the world economy. Again, this scenario resulted in headwinds, not stern winds, for Turkey.

On the financial side, the availability of cheap funding from global financial markets may provide another positive externality to an open economy. Indeed, except for fall 2008, when all markets froze briefly, the world has been awash with liquidity during the last ten years, first through reserve accumulation by countries with large external surpluses and then by record injections of liquidity by developed country central banks. Turkey certainly benefited from these liquidity injections, which easily financed ever-increasing current account deficits during the decade. Therefore, it is not surprising that many observers attribute the above-average growth rates of the period to the relief from the external finance constraint resulting from global financial conditions.

However, the coexistence of large deficits and rapid GDP growth does not necessarily imply direct causality from the first to the second. In fact, external deficits could result from improvements in the fundamentals of the economy coupled with macro policies biased towards domestic demand,

¹⁴ Turkstat: Foreign Terms of Trade data, 2003=100.

¹⁵ The world economy slowed during 2001-02 after the dot.com bubble burst in the U.S. but picked up rapidly in 2003.

and global finance would then simply accommodate these factors. A counterfactual argument may help us at this point. Would capital inflows be that strong if macroeconomic policies remained unchanged from the 1990s to the 2000s? The availability of liquidity and a low-risk appetite overall are necessary conditions for capital inflows, but it is the country-risk that has the final word. This controversial issue is the topic of our next section.

Let us therefore turn our attention to domestic factors, usually summarised by the catch-all word “fundamentals”. Again, we need to distinguish between at least two layers. The deeper analysis follows the footprints of “institutional economics” by exploring structural and institutional aspects. These range from meta-economics, such as property rights, rule of law, and level of trust, to institutions of social justice, such as education and social safety networks, and to the economic playing field, including competition, innovation, and infrastructure. These factors are the ultimate causes of the increases in total factor productivity (TFP) that can sustain high growth rates in the long run.¹⁶ However, they have important analytical shortcomings for our purpose. First, lags are often long, with the impact appearing in the medium to long run (many years to decades). Secondly, they are of a qualitative nature, so it is difficult to produce convincing quantitative evidence. Nevertheless, we will uphold that substantial improvement was registered in economic fundamentals during the last decade.

The record speaks for itself. An important example of indirect evidence is the large jump in FDI (Table 1 above). Another example is the privatisation revenue from State Owned Enterprises: measured at 0.2 % of GDP during 1986-2002, the figure increased nearly 4-fold to 0.9 % during 2003-07 and remained high even after the crisis, at 0.7 % during 2008-10. The list of factors is long: school enrolment ratios and public health insurance coverage have increased; utility markets were opened to competition; public and private research and development was encouraged; the road network was overhauled; and investment in rail and urban public transport was accelerated. Their positive contributions to total factor productivity, even if difficult to measure today, seem evident to us.

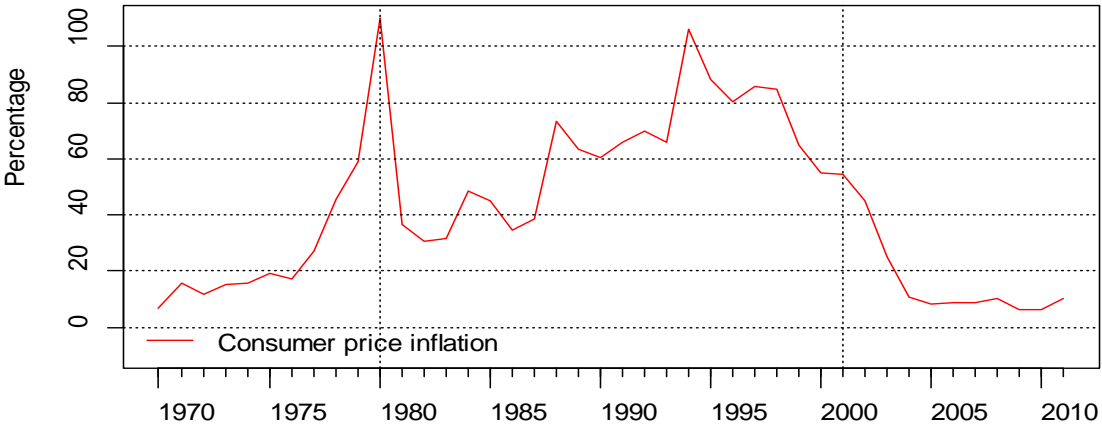
Why is this, and why after 2003? A large part of the answer lies in the political economy of the AKP. Defined as “mildly Islamist” by *The Economist* and as “conservative democrat” by its own leadership, AKP is an unusual political phenomenon both at the domestic and regional-global level. We set aside the political aspects and concentrate on economics. To the great surprise of many people, the AKP’s statist and anti-Western discourse while in opposition was dropped at the

¹⁶ Does the institutional framework matter during the “catch-up” period as much as some economists claim? There is also evidence to the contrary. In the recent past, several countries successfully achieved export-led rapid growth during early and mid-stages of industrialisation, despite widespread corruption, nepotism (“crony capitalism”), lack of rule of law, arbitrary state intervention, etc., simply by reducing real wages to levels offsetting the negative impact of “wrong” (!) fundamentals. Notably, the implication is that for every level of institutional development there exists a real wage rate that allows for “rapid catch-up”.

cloakroom once in power. Instead, its policies turned out to be more business- and market-friendly and more globalisation-oriented than any other government in recent history. The wider implications and a detailed analysis of this critical political event remain outside the scope of our current narrative.

The second layer of “fundamentals” is not as deep because it involves the more mundane world of macroeconomic policies, including inflation, interest rates, exchange rates, budget balance, public debt, and external balance. It is symbolised by another catch-all word: “stability”. The asymmetries with the first layer are worth mentioning. First, stability does not enhance TFP growth, but instability inhibits it. Secondly, lags are short, often quarters and at most a few years. Thirdly, they are quantifiable unlike those of first layers.

Let us begin with price stability, which is usually the most visible and politically sensitive of all stability indicators. Turkey constitutes a unique case among large emerging market economies with its inflation history: three decades (1974-2003) of very high consumer price inflation (average 55 % p.a.), twice above the critical 100 % level without encountering hyperinflation yet never below 30 %, either. It is no easy task to achieve such high levels of inflation with a respectable growth rate for such a long period without experiencing some form of hyperinflation or crash¹⁷. The rise and fall of consumer inflation during the last 40 years is summarised in Graph 6.¹⁸



Graph 6
Consumer price inflation: 1970-2011

Why is such high inflation present? The question obviously raises important political economy issues.¹⁹ The inflation’s origins in the second half of 1970s are somewhat better known. The

¹⁷ We must note another peculiarity of Turkey’s inflation experience: no indexation throughout the period. This context provides a technical explanation of why hyperinflation never occurred. The political economy of this intriguing event is obviously more complicated.

¹⁸ Data from Turkstat; year-end CPI change; chain-indexed at base-year switches.

¹⁹ For an old interpretation, see Akat (2000).

oil price shock hit Turkey twice; first, inward-looking (import substitution) industrialisation became even more unsustainable with the large jump in energy import costs; second, weak coalition governments coupled with political instability made it impossible to reverse the populist policies initiated earlier. In 1980 the most severe economic crisis in Turkey's history paved the way for the first set of market reforms and some export orientation, which put an end to this period. The last decade (1990s) is also relatively easy to interpret; again, political instability, weak coalition governments and populist policies are the usual culprits. These topics will be discussed later.

The 1980s, in turn, are more problematic. Turkey had a reformist single-party government capable of delivering rapid growth (with low volatility), yet inflation not only persisted but moved to a higher plateau by the end of the decade. Are we missing something? Our answer points to the structural transformation undertaken by Özal's ANAP, especially in external trade, by lowering trade barriers and encouraging exports. Trade liberalisation entails one of two choices: either large external deficits or substantial currency depreciation. The former was unthinkable after the devastating balance of payments crisis of 1978-79. The latter implied two costly possibilities: either a depressed domestic market or a "price-income-exchange rate" spiral. Given Özal's domestic political constraints, the second option seemed to be the lesser evil. Rising inflation in the 1980s may therefore be considered the price of opening up without necessary austerity measures at home—a trade-off worth remembering.

Numerous studies have examined the relationship between price stability and growth performance in the long run.²⁰ The results from Barro (1995) were recently used by the Central Bank (CBRT) for a counterfactual calculation.²¹ If annual inflation had averaged 5 % during the period 1973-2002, in 2011, GDP per capita at current exchange rates relative to the U.S. would reach 31 % instead of the actual 22 %. The size of the counterfactual may be challenged but its sign is beyond doubt; i.e., the decline in average inflation from 80 % in the 1990s to 10 % in the last decade would go a long way in explaining a reasonable upward shift in Turkey's growth performance.

The negative impact of high and volatile inflation on output works through two channels. The first channel is its consequences: distortions in resource allocation caused by high inflation. These consequences include increased uncertainty, shorter horizons for rational calculation, higher risk

²⁰ The majority of economists would agree that inflation has distortional effects on long-term economic growth if it reaches high levels. However, defining the "high" level is a matter of debate. In a frequently cited work, Bruno and Easterly (1998) showed that once the rate of inflation exceeds some critical level, which Bruno and Easterly estimated to be about 40 per cent, significant declines occur in the level of real activity. In a recent study, Kremer et al. (2012) estimated that threshold as low as 17 %.

²¹ See Başçı (2012a). Barro (1995) suggested that a likely channel by which inflation decreases growth is through a reduction in the propensity to investment. His estimation shows that the impact of an increase in average inflation by 10 percentage points is a decrease in the ratio of investment to GDP by 0.4 to 0.6 percentage points and a reduction of the real per capita GDP growth by 0.2 to 0.3 percentage points (all annual).

premia and real interest rates, and asset and liability dollarisation. Although domestic entrepreneurs may adapt quickly, foreigners correctly interpret inflation as a sign of economic instability and refrain from inward investment.

The other channel involves the cause of inflation itself: the monetisation of large public sector deficits. Of course, “inflation is everywhere and always a monetary phenomenon”, but such high levels of inflation are always accompanied, with varying methods, by the monetisation of large public deficits.²² The rest is well-known; public deficits crowd out private investment and place further pressure on real interest rates, with immediate negative impacts on TFP growth.

Thus, we come to the interesting story of Turkey’s public finances. Unfortunately, serious measurement obstacles must be surmounted to obtain a realistic picture. For example, i) off-budget spending reached record levels during the 1990s, often hidden in the balance sheets of state banks and other non-budget state agencies. The costs of bank restructuring, important for 2001 and the years beyond, also fall into this category. ii) High inflation distorts interest payments on Turkish Lira (TL) debt, by definition recorded nominally in the budget. It could also result in high seignorage revenues. iii) The compatibility of flows (deficit) with stock (debt) is necessary. Fortunately, public debt data are reliable. iv) Gross National Product data are not published after 2008.

These factors prevented the use of a single homogenous methodology for the period we are interested in, namely 1993 to 2011, and obliged us to divide it into two sub periods, each with its own distinct methodology. For the more difficult period, 1993-2002, a detailed calculation exists that addresses all of the measurement problems from the bottom up, as summarised in the left side of Graph 7.²³ The surplus in 1995 reflects the capital gains accrued to the Treasury from an unexpected large jump in inflation the year before. The deterioration towards the end of the period is visible to the naked eye. Real deficits break all-time records in 1999 (15 %) and 2001 (18 %).

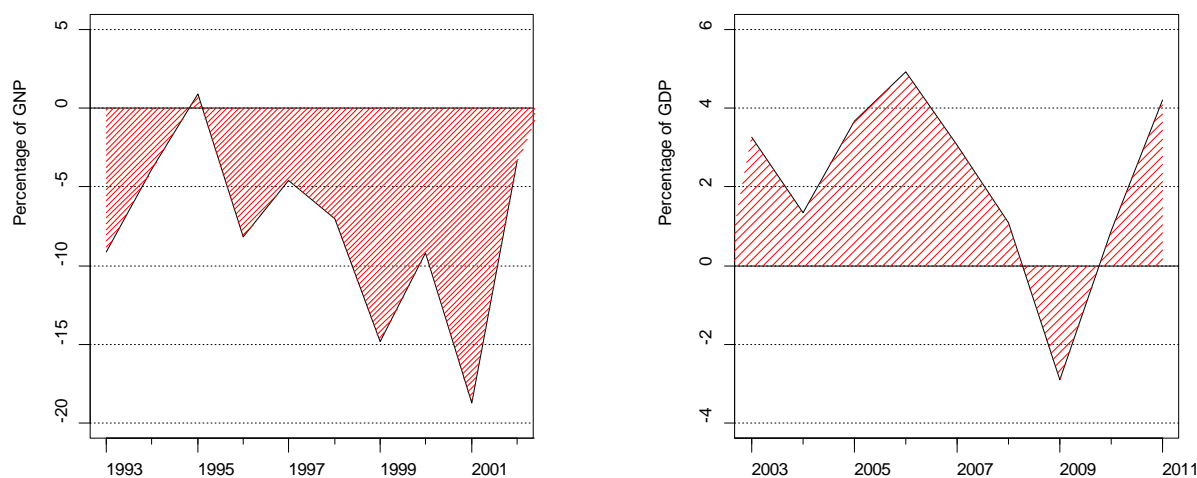
For the last decade, we use a more roundabout method and calculate real public deficits directly from the annual change in net public debt stock, summarised in the right side of Graph 7.²⁴ The contrast with the previous period is striking: except for 2009 (global crisis), the public sector balance is in surplus every year, reaching 5 % of GDP in 2006 and, despite the fall in 2009, reaching 4

²² Private sector borrowers face balance-sheet constraints very rapidly; thus, the increase in money supply is limited well before hyperinflation is reached. The public sector, in turn, has no similarly tight balance-sheet constraint and has the ability (through the Central Bank) to monetise its deficits and debt.

²³ The data were kindly supplied to us by Caroline Van Rijckenghem based on her work: Van Rijckenghem (2004). See also Emil et al. (2005).

²⁴ Our method was to inflate net public debt of the previous year by the current year GDP deflator; this corresponds to an unchanged level of real public debt and therefore, a balanced public sector (no deficit or surplus). The difference in the actual net public debt gives the actual public sector balance. This method bypasses the tedious calculations as in the previous period. Obviously, it includes all financial capital gains and losses of the public sector, seignorage, exchange rate fluctuations, privatisations, etc., and, in this way, is a realistic estimate of net result of the public finances. Net public debt data is from Treasury; nominal GDP and GDP deflators (1998 series) are from Turkstat.

% in 2011. In our opinion, such impressive fiscal consolidation goes a long way in explaining the superior growth performance of the last decade.²⁵



Graph 7
Public Sector Balances 1993-2011

5. What went wrong? External deficits as the “curse of stability”

In the last days of 1999, faced with a desperate economic situation, collapsing output, rising inflation, and spiralling public debt, the government approved an “exchange-rate-based disinflation program” under a standby arrangement with the IMF. The program bore fruit immediately: budget discipline, some structural reforms, resumption of growth, and falling interest rates and inflation pleased the markets, the government and the population. However, by the end of the summer, worries about the government’s lack of focus and the widening current account deficit reappeared. In the fall, authorities failed to prevent liquidity problems at an overleveraged mid-sized private bank, the largest holder of T-bills, from turning into a full-scale liquidity crunch. Despite additional loans from the IMF, a severe attack on the TL by February 2001 convinced IMF policymakers (the Turkish side was reluctant) to abandon the exchange-rate anchor by letting the TL float.²⁶ For Turkey, this dramatic event had far-reaching consequences, both economic and political.

Kemal Derviş, a well-known Turkish economist (at the time vice president at the World Bank), joined the government as minister of Treasury, with expanded authority over all matters pertaining to the design and implementation of the post-crisis stabilisation process. In May, his new program, “The Transition to a Strong Economy”, established the policy and reform framework.²⁷ Its basic diagnosis was simple: crises resulting from large imbalances at public finances and external account

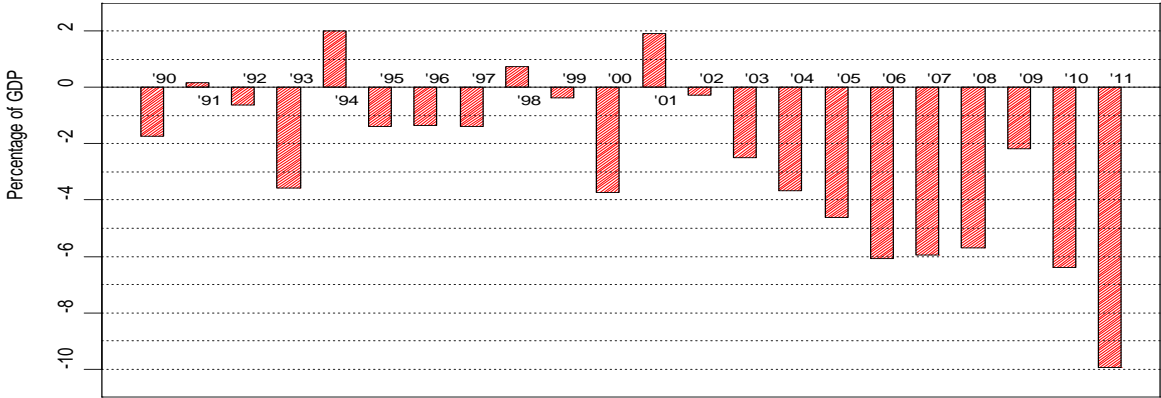
²⁵ In that sense, we believe that this period of Turkish Economy constitutes an example of expansionary austerity. See Guajardo et al. (2011).

²⁶ See Üçer and Van Rijckeghem (2005) for a detailed story of the crisis.

²⁷ Available at www.tcmb.gov.tr/yeni/announce/strengteningecon.pdf.

were responsible for Turkey’s poor economic performance.²⁸ Therefore, their correction became the two pillars of the program. Fiscal consolidation would reverse the adverse debt dynamics, relieve inflationary pressures, free resources for private investment, and reduce interest rates, among other benefits. An export-led growth strategy would balance the external account and reduce the reliance on foreign capital for development. Supported by a series of structural reforms in the markets, including social security and education, these factors would put Turkey on a sustainable path of rapid growth.

Turkey’s impressive success in fiscal consolidation has already been established. What about the other target of the programme? The results are again impressive but for opposite reasons. Graph 8 summarises the behaviour of the external balance since 1990.²⁹ Turkey’s current account deficits, averaging less than 1 % of GDP during the 1990s, have been expanding steadily since 2002, reaching 6 % in 2006 and 10 % in 2011. In our view, the picture is crystal clear: there is a distinct discontinuity in Turkey’s external balances after 2002 and not exactly in the direction targeted by Derviş’s program.



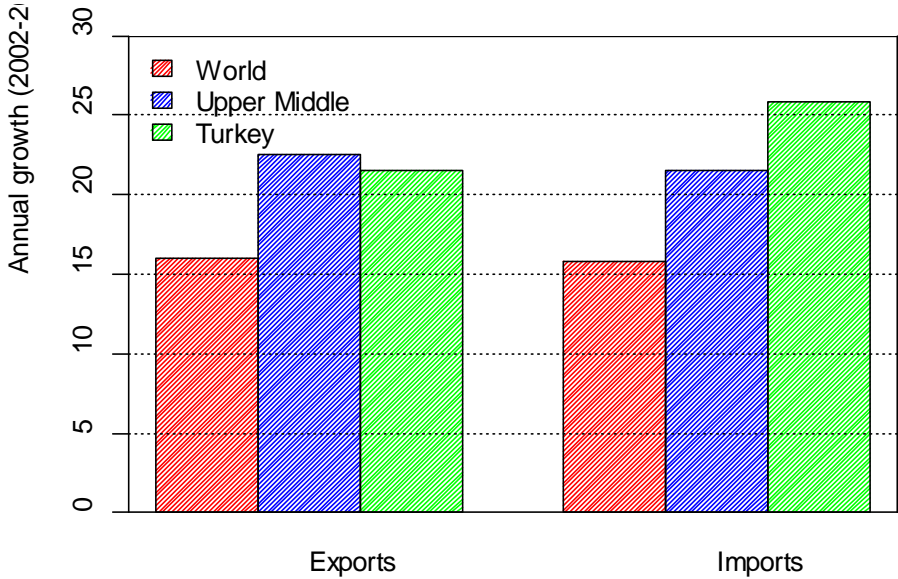
Graph 8
Current account deficit as % of GDP (1990-2011).

This is indeed a bizarre situation that requires careful examination. It is bizarre because normally we expect, in the spirit of economic theory, a fiscal consolidation of such amplitude, accompanied by successful disinflation plus floating exchange rates, to substantially shrink the external deficit. In this case, this outcome was also designed into the stabilisation program. What went wrong? Was the program at fault? Was it badly implemented? Could external developments explain it? We start with the balance of payments. The other side of the accounting identity, i.e., an even larger contraction in private domestic savings, will be addressed separately in a later section.

²⁸ Usually, the two are interlinked (“twin deficits”). However, during the years prior to the crisis in 2001, Turkey did not exactly fit the twin deficit template; public deficits were much larger than the external deficit. These topics will be discussed later.

²⁹ Data from WDI: “Current account balance (% of GDP)”

On the trade front, poor export performance relative to the world and peer nations may explain the rise in external deficits. Graph 9 shows that Turkey’s exports of goods and services grew, on average, 22 % annually between 2002 and 2008 (onset of the global crisis), 6 points higher than the world (16 %) and only 1 point below upper-middle-income countries³⁰, demonstrating no sign of a meaningful export underperformance. Therefore, the burden must fall on imports, and indeed it does; average annual import growth, at 26 %, is 10 and 4 points above the world and upper-middle-income countries, respectively. Turkey is clearly an outlier by a meaningful margin; i.e., it exhibits outstanding import performance. Establishing the diverging behaviour of exports and imports is important for our analysis.



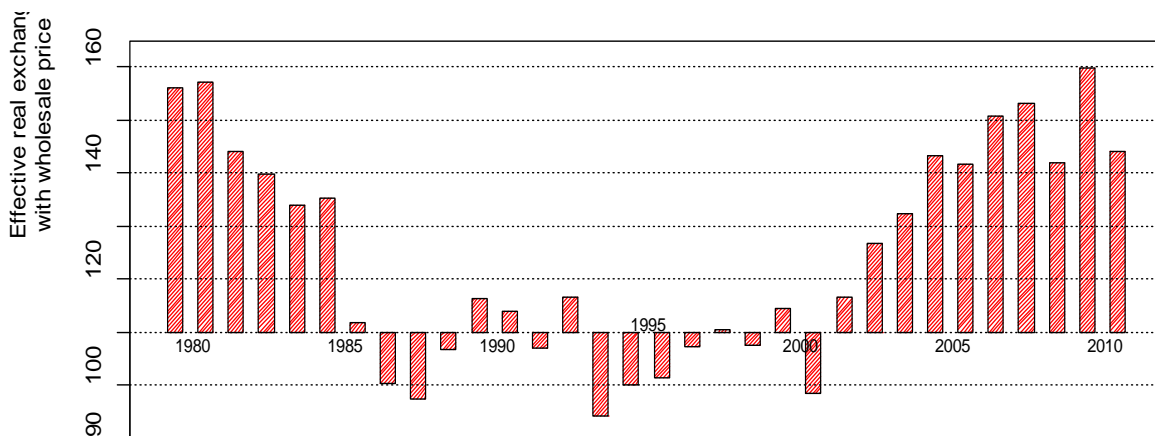
Graph 9
Average Growth in Trade 2002-2008 (Goods and Services)

Markets, policymakers and the public were all aware of the problems posed by large and expanding external deficits. However, the explanations proposed were neither coherent nor satisfactory. One typical causality emphasises structural weaknesses. At one extreme, we find generalities concerning national characteristics, such as “Turks are spendthrifts!” If so, how can we account for very small external deficits during the 1990s? Why did Turks become spendthrifts after 2002? The other approach wrongly places the blame on insufficient export growth, underlining weak fundamentals such as “inadequate human capital” or “labour market rigidities” or “lack of R&D”. These triply miss the point. First, were these fundamentals stronger during the 1990s? Secondly, the issue is not export competitiveness but import explosion. Third, fundamentals affect TFP and sustainable growth but have only an indirect impact on competitiveness. Do large U.S. trade deficits

³⁰ Data from WDI: “Exports of goods and services (BoP, current US Dollars)”; “Imports of goods and services (BoP, current US Dollars)”.

reflect similar weaknesses in fundamentals? The answer to the puzzle lies, in our opinion, in macroeconomic policies.

It is worth recalling two elementary principles of supply-demand analysis. The first is the link between quantities and prices. In Econ101, students are trained to look for a price distortion when there is a quantity imbalance in the market. After all, market economies owe their efficiency to the adjustment in quantities when prices change, and vice versa. Here, the trade balance is the quantity and the exchange rate is the corresponding price. The short run may be influenced by other factors, but the real exchange rate plays a critical role in the determination of the external balance in the long run. Unfortunately, in Turkey, the exchange rate is either neglected or its impact minimised whenever the external deficit is analysed. Graph 10 shows the real exchange rate movements from 1980 to 2011.³¹ The average for 1990s is 110; the “Great Depreciation” of the 1980s and the “Great Appreciation” of the last decade is very visible.



Graph 10
Effective Real Exchange Rates 1980-2011 (1995=100)

The last two graphs provide interesting reading together. In the last decade, rapid export growth coincided with rapid appreciation of the TL. Thus, we infer that tradable sector TFP growth was more than sufficient to offset the costs of currency appreciation. To us, this is further evidence of the improvement in Turkey’s fundamentals during the 2000s. This observation begs another question: does this mean that TL is at fair value? Establishing a value for the equilibrium real exchange rate involves difficult theoretical and practical (measurement) problems, including assumptions (targets) about the level of sustainable external deficits and growth rates compatible with political (labour market) realities. These measures are beyond the scope of our work; we believe

³¹ Data from CBRT; old series, discontinued since June 2010 and replaced by a new series (2003=100).

that the TL has been (and still remains) overvalued by some margin, though this fact is not all that is relevant to the analysis below.³²

The second elementary supply-demand principle distinguishes between income and substitution effects when faced with shifts in the demand curve. Let us apply it to our case, namely, the impressive increase in demand for imports. To make the analysis simpler, let us assume, as it is often done, that the TL is not overvalued. This assumption makes the large jump in imports a one-to-one reflection of a similar large jump in domestic demand.³³ This is a critical conclusion; the cause of the external imbalance lies with domestic expansionary policies implemented after 2002. As fiscal policy was tight throughout the period by any measure, monetary policy becomes the culprit by default.

Are we stirring up the hornet's nest? Once the economy recovered from the crisis in 2001, monetary policy became the topic of an intense debate in public opinion. Typically, tradable sectors blamed the tight policy stand (high real TL interest rates) of successive CBRT governors for the appreciation of the TL and therefore of the external deficits. In turn, financial market analysts, as well as some academic economists, have been supportive of them. This is not the place to go into the details of monetary policy or the actual transmission channels through which it worked. We also bypass another interesting question: had Derviş remained at the helm of policymaking, could he have prevented this outcome, and how?

We take a different approach by taking policy makers at their word and accepting their claim that monetary policy was tight in order to achieve disinflation. However, this assumption contradicts our observation that monetary policy was loose. It does not make sense; monetary policy cannot be tight (high real TL interest rates) and loose (rapid domestic market growth despite fiscal surpluses) at the same time. Well, it actually might.

An important legacy of high inflation with capital market liberalisation experienced during the 1990s was widespread asset and liability dollarisation by the public. In domestic bank deposits, deposits in foreign exchange (mainly in US\$) accounted for half of all deposits in 2000. The crisis in 2001 increased the ratio further to 62 % (October); it remained above 40 % until the summer of 2005, falling to 33 % at the end of 2008 and 30 % by September 2012. Needless to say, the real return depended just as much, if not more, on actual currency movements. Therefore, real interest rates uniquely on TL assets (adjusted by CPI) did not correctly describe the conditions in the credit

³² "Big Mac exchange rates", calculated by The Economist, list TL among the overvalued currencies, usually by a small margin. More sophisticated estimates by Cline and Williamson (2011) put TL among the most overvalued currencies.

³³ This is a truism: Governor Erdem Başçı pointed to it in a presentation to the cabinet while comparing Turkey to Greece, Spain and Portugal (Başçı, 2012b). Slide 13 in his presentation demonstrates domestic demand overtaking GDP from 2003 onwards. The difference (theoretically equal to external deficit) widens until 2008, then somewhat falls only to reach a peak in 2011. We excluded a similar graph due to space limits.

channel. Businesses and consumers could borrow foreign exchange and pay even grossly negative TL real interest rates in case of an appreciation of the TL, while both nominal and real interest rates on TL loans were exorbitantly high.

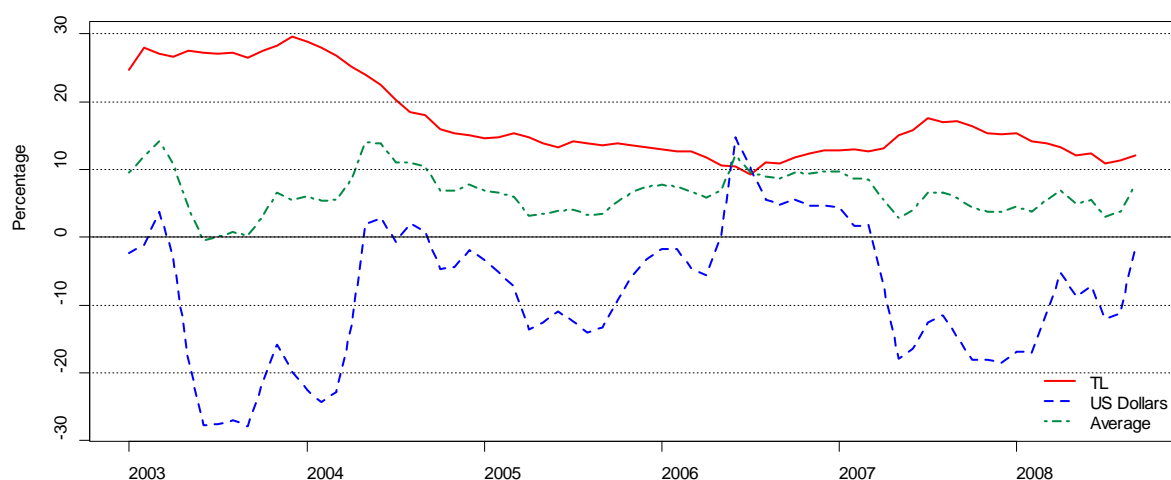
Real TL interest rates for TL and US\$ assets and their weighted average for the period 2003 to 2008 (onset of the global crisis) are shown in Graph 11.³⁴ As a warning, these are real TL costs of the deposits to banks³⁵; as such, they constitute the floor for the real TL cost of the loans for borrowers. The average assumes that deposit and loan currencies match, which is not an unreasonable assumption. Except for brief periods in the summers of 2004 and 2006, real TL interest rates on US\$ loans have been negative, pulling down the average real interest rate substantially below the visible TL real interest rates, even to zero at times (summer 2003). The annual average of real interest rate is below 6 % in half of the period covered: 5.5 % in 2003, 5 % in 2005 and 5.8 % in 2007; while visible TL real interest rate is always in two digits. The graph is fertile ground for many other observations but on other occasions.

Who is to blame: CBRT, for keeping TL interest rates too high and neglecting other indicators³⁶, or the abundance of global liquidity leading to the large appreciation of the TL? Technically, the answer would be “yes” to both; together they constituted a win-win combination. Still, we opt for a broader view, in line with our analysis above, and claim that Turkey has been a victim of its own success, in the sense that the large external imbalances of the last decade are the direct result of the mismatch between Turkey’s achievements and perceptions and expectations of dismal performance that markets, population and policymakers themselves held. Stated bluntly, TL interest rates were kept high by central bankers simply because they did not believe that fiscal correction and other improvements in fundamentals were politically feasible.

³⁴ Data: one-month maturity nominal interest rates for TL and US\$ deposits and share of TL deposits in total from TDM; monthly average nominal US\$ exchange rate from CBRT and monthly CPI from Turkstat (chain indexed to 1995 series for the period before 2003). Use of one-month maturity allows the calculation of ex-post real TL interest rates correctly on an annual basis.

³⁵ Deposit holders pay withholding tax and their nominal and real return is lower.

³⁶ Since the global crisis, the weaknesses of the inflation-targeting framework and the unique role it attributes to the interest rates have lost their appeal, and central banks moved on to macroprudential policy tools. Our analysis confirms the need for other indicators (beside interest rates) for a correct evaluation of monetary policy: balance sheet of the CB, credit ratios, monetary base, etc. See Borio (2011) and Goodhart (2012) for a discussion of these issues.



Graph 11
Deposit real interest rates 2003-2008

In that sense, Turkey faced during the last decade an acute case of “stability curse”.³⁷ We have already referred to FDI inflows and privatisation revenues. Financial stability allowed residents and non-residents alike to discover the attraction of TL assets, thus leading to large financial flows and catching policy unprepared. The rest is history. It is therefore time to take a closer look at capital inflows.

6. Capital Flows: The main driver of Turkish Business Cycles?

The previous section explicitly linked larger external imbalances to increasing capital inflows after 2002. We also pointed to other similar periods since Turkey liberalised the capital account in 1989. The volatility of capital flows obviously poses a major policy challenge to most emerging market economies. If (and when) capital flows reversal happens (sudden stop), financial crises and deep output contractions become inevitable. Therefore, the reliance on external finance for investment and growth is a topic of intense debate in Turkey, as elsewhere.

A number of economists consider capital account liberalisation and unfettered capital flows as serious obstacles to global financial stability (see Köse et al. 2010, for a review). Voluminous literature following the work of Calvo (1998) and Calvo and Reinhart (2000) emphasises the linkages between “sudden stops” and output losses occurring in economic crises. Whether most financial crises in emerging market economies can be characterised by sudden stops in capital flows is a matter of debate. Hutchison and Noy (2006) distinguish between the output effects of currency

³⁷ Similar to the “natural resource curse” or the “Dutch syndrome”; fiscal correction (financial and price stability) replacing the discovery of oil.

crises and sudden-stop crises and find that sudden-stop crises have a largely negative but short-lived impact on output growth over and above that found with currency crises.

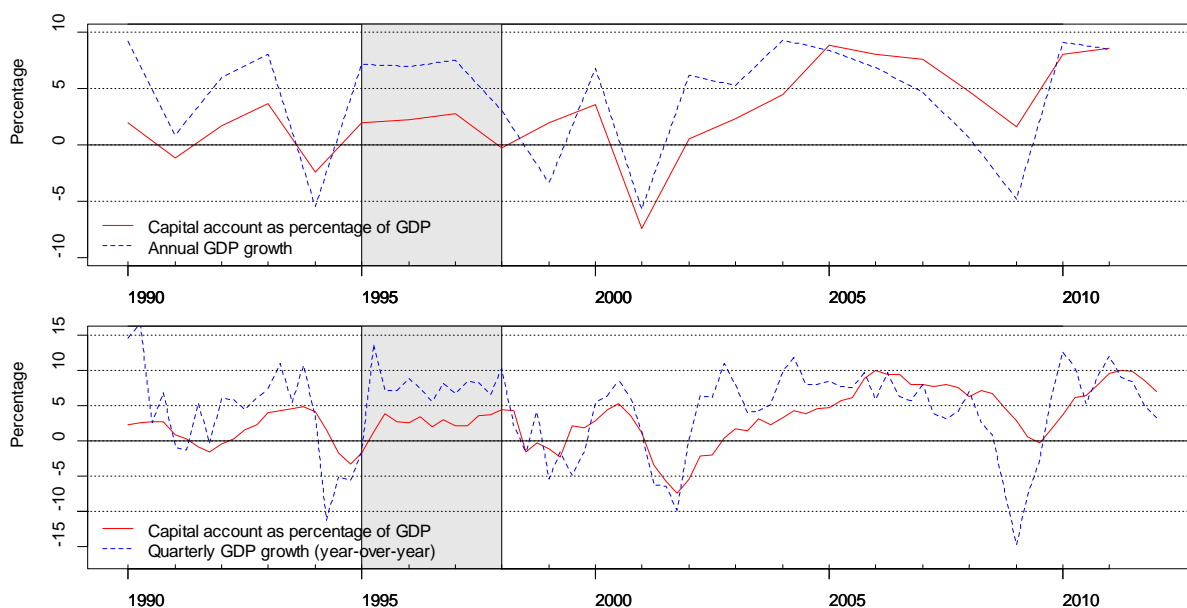
The other strand of the literature focuses on the link between the surge in capital flows and sudden stops. In a recent study, Agosin (2012) finds that a surge in capital flows (a capital boom) can predict future sharp contractions in capital flows (sudden stops). Moreover, the probability of a country undergoing a sudden stop increases considerably with the length of the boom. Cardarelli et al. (2010) identify 109 episodes of large net private capital inflows to 52 countries over 1987–2007. Episodes of large capital inflows are often associated with real exchange rate appreciations and deteriorating current account balances. More importantly, such episodes tend to be accompanied first by an acceleration of GDP growth, but growth often drops significantly afterwards. Reinhart and Reinhart (2008), considering a large set of countries, conclude that capital inflow bonanzas are no blessing for advanced or emerging market economies. In the case of the latter, capital inflow bonanzas are associated with a higher likelihood of economic crises (debt defaults, banking, inflation and currency crashes).

The above literature implies a boom-bust cycle associated with the volatility of capital flows. To be more specific, emerging market economies, following a surge in capital flows that entail an expansion in domestic credits, usually experience a consumption-driven boom period. This period culminates in a series of weaknesses associated with real appreciation, low returns in tradable sectors and large current account deficits. The resulting sharp turnaround in financial flows³⁸ leads to drying up of domestic credit, thus causing a liquidity crunch. To generate the external surplus needed in the short run, domestic demand falls sharply. The subsequent loss in the value of currency encourages demand for domestic tradables, both at home and abroad. Eventually, the economy settles down, capital flows in again and growth resumes.

The analysis above bears many resemblances to the course of the Turkish economy since capital account liberalisation in 1989. International studies covering Turkey as an emerging market economy in their data set classify the periods 1992-1993, 1995-2000, 2003-2008 as capital booms and 1991, 1994 and 2001 as sudden stops (Hutchison and Roy (2006), Cardarelli et al. (2010), Angosin (2012)). In Graph 12, we plot capital account as a share of GDP and GDP growth rate to investigate the relationship between capital flows and the growth performance of the economy since 1989.³⁹

³⁸ Broner and Rigobón (2006) showed that capital flows to emerging markets are more volatile than those to developed countries.

³⁹ For annual figures, we use TDM (GDP growth and GDP in US\$) and CBRT (capital account) as our data source. Capital account represents financial flows, including FDI, but excludes CBRT reserve accumulation and net errors and omissions. The GDP figures in US Dollars are obtained by using the nominal GDP and period average US\$ / TL exchange rates.



Graph 12
Growth and capital flows

Both annual and quarterly figures indicate a strong link between the growth of GDP and the direction and volume of capital flows. This link appears to suggest that when capital inflows are abundant, growth is strong; when flows reverse, the economy contracts. This finding confirms the view that the Turkish economy is prone to boom-bust cycles originating from capital flows. Econometric analysis further confirms this view; a significant amount of variation in output growth is explained by the fluctuations in capital flows.⁴⁰ This observation, together with its implied policy warnings, is widely shared among market professionals, some academicians and even policy makers in Turkey and international organisations such as the IMF and World Bank (IMF, 2012; World Bank and Ministry of Development of Turkey, 2011).

The facts summarised above have led some observers to claim that the external finance constraint is the main impediment of growth in Turkey. This heavy reliance on capital flows to attain high growth is, in turn, attributed to the inadequate level of domestic savings. The logic of the argument is relatively straightforward. If domestic savings are scarce, rapid growth can only be attained with greater access to foreign capital. However, this is a short-term gain due to the volatile nature of capital flows, leading to boom-bust cycles in the long run. Therefore, sustainable rapid growth can only be secured with a substantial increase in private savings (households and firms). The

⁴⁰ Using quarterly data, we estimated a bivariate VAR(4) among output growth and the share of capital flows in output. The (generalised) forecast error variance decompositions derived from this VAR suggested that up to 38 per cent of variations in output can be explained by the capital flows. While this percentage is equal to 24 in the very short term, it quickly increases and reaches to 38 in 8 quarters. When we include the real exchange rate as a third variable into the VAR, this percentage of capital flows reduces to 36 only, but the real exchange rate gets 39 per cent. The results are available upon request.

policy implications are also clear: any effort to improve growth potential while reducing volatility must focus on policies that will lift domestic savings. Unfortunately, at this point, the path forward becomes unclear. The question is how to increase the savings of households that are believed to be spendthrifts by nature or that have become so when credit is available. A tactic to accomplish this feat is not evident. We return to this issue below.

Understandably, the analysis above has attracted many followers. However, we are not certain about the direction of the postulated causality from capital flows to growth. We already mentioned that causality may run in the reverse direction or in both directions, in the sense of both variables being affected by a set of possibly unobserved variables lurking in the background, such as increased productivity, better fundamentals and/or macroeconomic policy stances accompanying these features (the discussion in Section 4 above).⁴¹

An intriguing exception to the apparent link between capital flows and growth becomes evident in the aftermath of the 1994 crisis: during the period 1995-98, growth remains strong despite the weakness of capital inflows. The period is shown as the shaded area in Graph 12 to highlight the case of strong growth performance without abundant capital inflows. Similar episodes of fast growth without capital inflows can be observed during the 1980s, but these predate capital account liberalisation. Do these counterexamples provide enough proof to discard the hypothesis of the external finance constraint on growth? In our opinion, the common denominator for the exceptions is implicit in Graph 10 on real exchange rates; they are associated with a depreciated (or depreciating) currency, and therefore, a policy mix favouring exports over domestic demand.

Let us continue with this logic. The data are obviously compatible with the alternative causality: large public deficits (before 2002) or credit expansion to the private sector (after 2002) will lead to an explosion of domestic demand only if large capital inflows are forthcoming. These, unless appropriate monetary policy measures are implemented, will result in substantial currency misalignment (the “Great Appreciation”) and falling international competitiveness and profitability of the tradable sectors. Now we turn our attention to this critical topic.

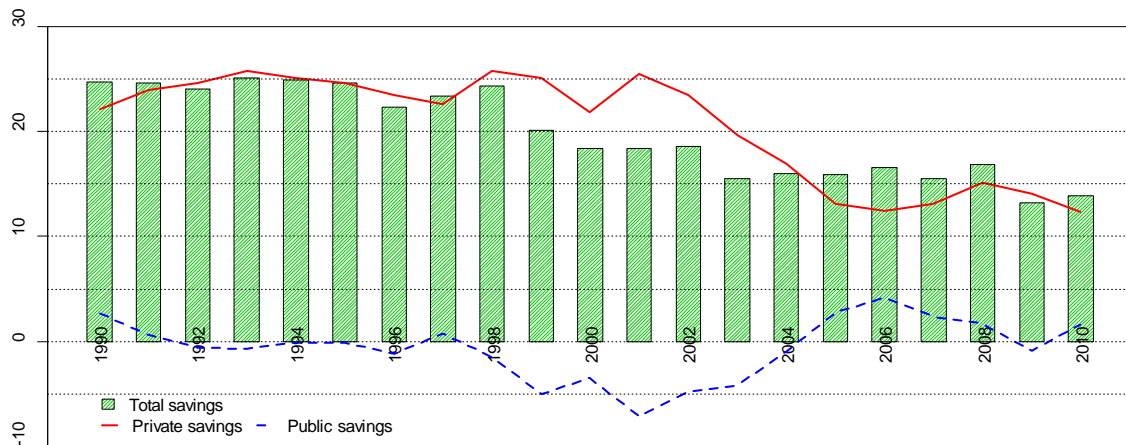
7. Savings: Why are they so low?

We already touched upon the “inadequate domestic savings” hypothesis, reflected in official texts from Ankara and Washington, D.C.⁴² as well as articles on Turkey by prominent economists, among others by Rodrik (2009), Blaszkiwicz-Schwartzman and Öz (2012), Van Rijckeghem and Üçer

⁴¹ See Collins (2007), who argues that capital flow indicators are likely to be endogenous in growth regressions, making it difficult to identify causal effects. In the econometric analysis mentioned in the previous footnote, we test for Granger-causality between the capital flows and growth and find evidence on bivariate causality.

⁴² The references to the IMF, the World Bank and the Ministry of Development are above.

(2009). Therefore, it is important to finish our analysis by taking a closer look at the behaviour of aggregate, public and private savings; Graph 13 summarises⁴³ their behaviour (as a share of GDP) since 1990.



Graph 13
Private, Public and Domestic Savings (1990-2010)

The emphasis in policy circles has been on the sharp decline in domestic saving rates in the 2000s. Indeed, after fluctuating in the 22 to 25 % range from 1990 to 1998, domestic savings were hit by turbulence in 1999 and 2001, reaching a first trough in 2003 at 15.5 %. However, instead of recovering with rapid growth, savings encountered another trough in 2009 at 13 %. By the end of 2011, domestic savings stood at 14 % of GDP, by far the lowest domestic saving rate among large emerging market economies.

However, the composition of domestic savings between private and public savings had changed dramatically as a result of the impressive fiscal consolidation of the past decade (Section 4). Public sector average saving rates moved up by 2.3 points, from – 1.5 % during 1990-2002 to 0.8 during 2003-2010. Obviously, the improvement is much stronger when we make point comparisons, for example, between 1999 (-5 %) and 2006 (4.2 %).

Even sharper declines in private savings are visible in Graph 13. Private savings averaged 24 % during 1990-2002. In five years, it registered a record decline of 11 points, reaching 13 % in 2006. The global crisis caused a weak and short-lived recovery, but it fell back to 13 % in 2011. The average for 2003-11 is 14.5 %. What can be the cause of such a sharp fall in private savings given the strong

⁴³ The only official data on domestic, public and private savings are published as part of “General Equilibrium of the Economy” by the State Planning Organisation (today part of the Ministry of Development, www.dpt.gov.tr) Below, we touch upon some of the shortcomings of the saving data.

performance of the economy, both quantitatively and qualitatively, during the last decade? This puzzle certainly needs to be explained⁴⁴.

Several explanations have come forth: see, among others, Van Rijckeghem and Üçer (2009) and World Bank and Ministry of Development of Turkey (2011). One relies on the concept of precautionary savings. Accordingly, following the decline in inflation and macroeconomic vulnerabilities and enhanced financial stability, Turkish households, feeling more secure about future, have suddenly lost their motives to save against future uncertainties. Another underlines the possibility that households, seduced by the availability of cheap and easy credit, have suddenly increased their borrowing, thus causing a large drop in the net private household savings.⁴⁵

The lack of saving data prevents a more precise analysis of the private saving behaviour. It is worth recalling that existing data are derived from national income identity; domestic saving equals gross capital formation minus net exports, while private saving equals domestic saving minus public savings. First, discrepancies between data on public sector overall balance and public saving could imply (that is our impression) an underestimation of the latter. In other words, the decline in private saving rates is most likely much sharper than depicted in the official data above.

Secondly, and even more seriously, there is no data on the breakdown of private savings into household and corporate savings. Most policy proposals involve measures to increase household saving habits, yet nobody knows its share of in the total domestic savings in Turkey. In addition, savings calculations are based on gross investment, i.e., they include the replacement of existing equipment and structures by firms (depreciation), usually through own-funds. There are many reasons to assume corporate savings constitute a much higher proportion of private savings in a rapid growth (catch-up) environment. There is, therefore, a strong possibility that the large drop in private savings is the result of lower corporate propensities to save and invest and not from the “spendthrift consumers”.⁴⁶ In that case, periods of currency appreciation would correspond through lower profitability in the tradable sector and lower corporate savings. Unfortunately, we have no way of empirically testing this otherwise plausible hypothesis. However, the observed relationship between the real exchange rate appreciation and savings provides support for our hypothesis

⁴⁴ The Ricardian equivalence hypothesis comes to mind. The decline in domestic savings shows that it is not one to one; private savings fall much more than the increase in public savings.

⁴⁵ Other explanations include demographics such as a high young dependency ratio and educational characteristics. See the above references for a complete list.

⁴⁶ Although the corporate savings estimated by the World Bank and Ministry of Development of Turkey (2011) by using firm level survey data do not seem support our hypothesis, Yükseler (2011) indicate that the capacity of firms producing value added by main activities dropped significantly from 2002 to 2008 in industry, manufacturing and services sectors (see also Özlale, 2012). Özmen et al. (2012) asserts that the savings of nonfinancial firms as a percent of net sales are lower than those of nonfinancial firms in major developing countries.

indirectly; see Montiel and Serven (2008), Eichengreen (2008) and Rodrik (2008) for international evidence on the link between real exchange rates, savings and growth.^{47,48}

8. Conclusion: Is rebalancing through a soft landing possible?

We began by pointing to the contrast between the depth of the recession in 2009 and the strength of the recovery afterwards. In our opinion, the trajectory of the economy and of economic policy since the fall of 2008 supports the main arguments of this article.

First, the global financial crisis, the worst since the 1930s, caused only limited and short-lived damage in Turkish financial markets, validating the improvements in fundamentals we highlighted in section 4. In turn, lower financial fragility permitted, for the first time in memory, the use of countercyclical policies to alleviate the output loss of the crisis and trigger the rapid recovery. The policy response was delayed; monetary policy began easing gradually after November 2008 and fiscal policy after February 2009⁴⁹ but was still effective once implemented. Interestingly, the global crisis gave the final push to the normalisation of monetary policy; real short-term interest rates fell to historical lows, often negative.

The resurgence of growth coincided with the global liquidity glut, massive capital inflows, appreciation of the currency and record external deficits.⁵⁰ This finding is important because it means that policymakers had failed to profit from the window of opportunity supplied by the crisis to initiate the rebalancing of the economy. On the contrary, the imbalances of the pre-crisis period were aggravated by the weak recovery in Turkey's export markets, especially the euro zone. Graph 14 traces GDP growth and the proportion of capital flows excluding FDI to GDP from the onset of the global crisis (2008Q3) to the summer of 2012 (2012Q2).⁵¹ Capital inflows (mainly short term) gradually rise during the recovery and reach a peak in the spring of 2011 at 9 %.

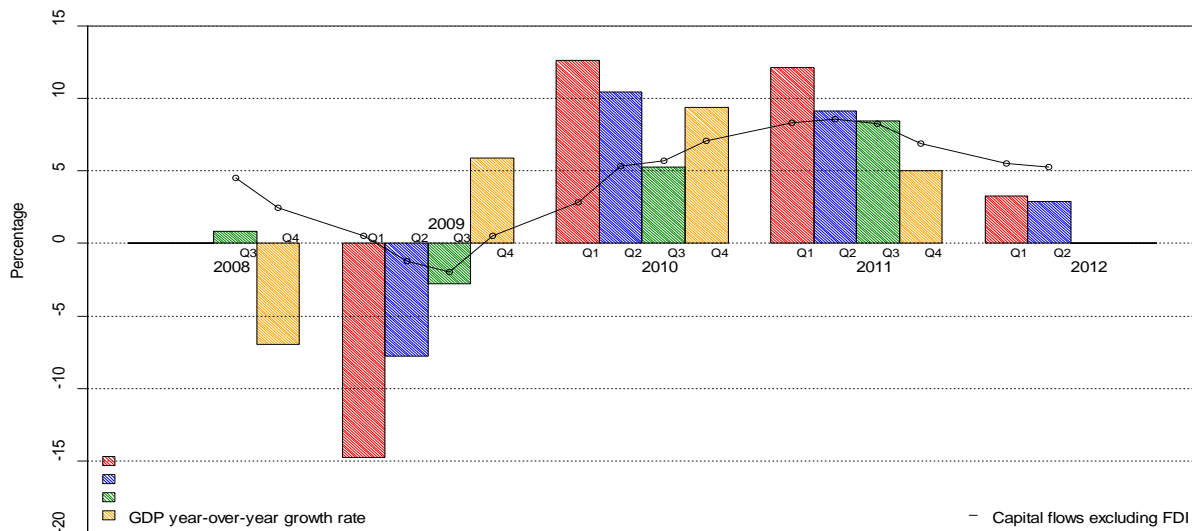
⁴⁷ Obviously, since capital inflows are associated with appreciations, this observed relation is also consistent with the hypothesis that the drop in savings is due to easy credits and mostly resulted from the behaviour of households.

⁴⁸ Günay and Kılıç (2011) find that non-tradable sector is financially more constrained than tradable sector and, with non-tradable sector being more constrained, credit movements become an important determinant of boom-bust cycles.

⁴⁹ GDP was contracting (yoy) by -7 % in 08Q4 and -14.7 % 09Q01.

⁵⁰ Interestingly, while the current account deficit reached 10 % of GDP in 2011 (6.4 % in 2010), its stock counterpart, net investment position (NIP) fell from 49.6 % of GDP to 42 % according to IMF estimates. Because NIP estimates require complex corrections for valuation changes of existing assets, data is not entirely reliable.

⁵¹ The quality of financial flows has weakened in the period after the 2008 crisis. In the period 2003-2008, Turkey received significant inflows in the form of foreign direct investment and long-term borrowing.



Graph 14
GDP growth and capital flows (FDI excluded).

In section 5, we underlined the contrast between the strong fundamentals of the economy (including the tight fiscal policy stance and low debt ratios) and the vulnerabilities implied by large external imbalances. Unless interventions were made immediately, the risk of a “sudden stop” would further increase. This time, policy responded to the task and changed gear, mainly in monetary policy, to engineer a soft landing towards a more balanced growth path.

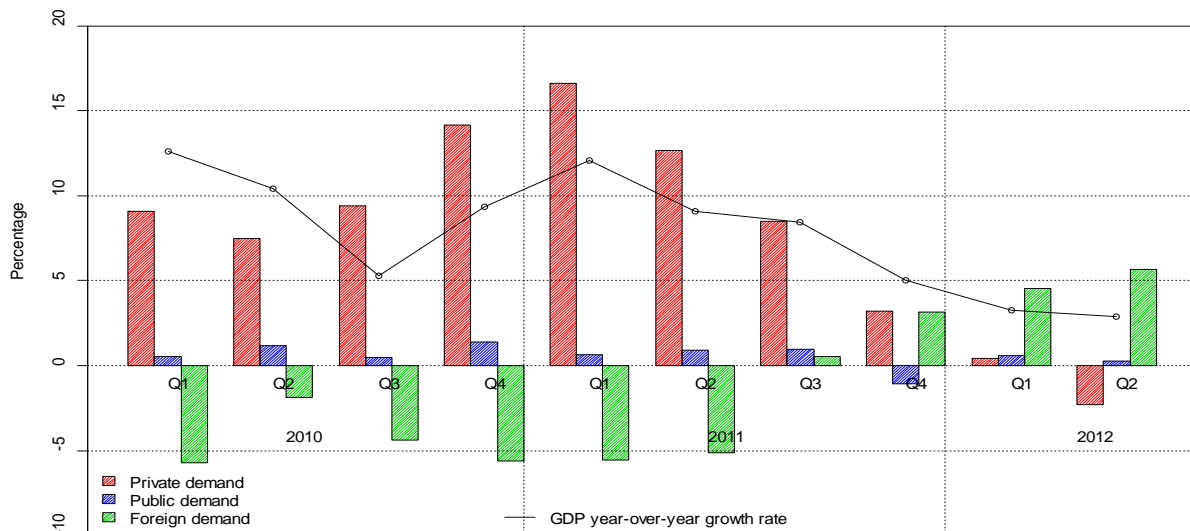
The focus of the new monetary policy framework was on “financial stability” (another catch-all concept) as the CBRT emphasised on many occasions.⁵² The new policy targeted a gradual shift in the composition of aggregate demand, called rebalancing, with a lower contribution to growth from domestic demand and a higher contribution from external demand. The two instruments used, namely currency depreciation and direct control over the credit channel, again support the main themes of this article. The new policy framework was innovative and contradicted the prescriptions of orthodox monetary policy. It also took the financial markets by surprise and was heavily criticised; however, the CBRT, with the support of the government, persisted and implemented it successfully.⁵³ This is not the place to discuss the details; the references above will help the interested reader.

Graph 15, tracing the behaviour of the sources of growth since 2010, allows us to see the impact of the new policy framework.⁵⁴

⁵² See Kara (2012), Başçı and Kara (2011) and several presentations of Governor Erdem Başçı and his deputy governors (available at www.tcmb.gov.tr). See also Özatay (2012), Akkaya and Gürkaynak (2012) and Akçay and Ocakverdi (2012).

⁵³ However, not uneventfully; there were many skirmishes with the financial markets, which had difficulties in digesting the newly found self-confidence and assertiveness of the monetary authority.

⁵⁴ Data from Turkstat; columns measure the contribution to yoy growth of GDP for each demand category. Inventory change is included in yoy GDP growth rate (line).



Graph 15
Sources of growth (contribution to GDP).

The two instruments have clearly delivered the results targeted by the CBRT; the first sign of the rebalancing appeared by the summer of 2011, and domestic demand growth was subdued while external demand became positive for the first time since the global crisis. By the summer of 2012, the contribution of domestic demand to growth turns negative, while that of external demand gains further momentum. The opportunity cost of the rebalancing is the decline in the growth rate, to 2.9 % in the spring of 2012, with a year-end target at 3.2 % by the government (below 3 % by market forecasts). This is a politically difficult problem; facing three elections (local, presidential and national) in the next three years, AKP needs high growth and low unemployment for success at the polls.

What policy options exist? Further easing of monetary policy would help both domestic and external demand, the former through the credit channel and the latter through currency depreciation.⁵⁵ A competitive currency diverts resources (investment, employment, profits, etc.) from non-tradable sectors to tradable sectors, narrowing the external deficit and the private saving gap. However, it also puts cost pressures on inflation. The extent of exchange rate pass-through is still disputed although recent estimates indicate a decrease to 15 % (Kara and Ögünç, 2011). Therefore, CBRT's reluctance to pursue this option despite a fiscal tightening recently (fall 2012) can only be explained by the fear of losing control over inflation and its hard-earned credibility as an inflation hawk. In other words, Turkey is once more the victim of its own past, haunted by the ghost of decades of chronic high inflation.

⁵⁵ Capital Controls, such as Tobin tax, may support the monetary policy in determining the required depreciation given the current environment ample international liquidity.

There is no such thing as a free lunch and no rebalancing without risks or hefty price. Higher inflation seems the lesser evil compared to lower growth in the context of Turkey's current realities. Perhaps now is the time to reset Turkey's memory and start with a clean plate.

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