Policy Brief

The End of Boom and the Political Economy of Turkey's crisis

Cem Oyvat

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Abstract (Max 150 words)

Turkey has long been enjoying high growth rates with the support of speculative financial flows and a boom in the construction industry. However, the Turkish economy at the same time was step-by-step becoming more fragile during the recent years. The diplomatic crisis between the US and Turkey gave a push to the economic downturn in Turkey that was already coming. Indeed, the Turkish Lira already depreciated by more than 20% against USD in 2018 before the diplomatic tension peaked. The depreciation in the Turkish Lira against USD for 2018 was 41% at the date that this article was written.

Keywords

Turkey, boom-bust cycles, crisis, inequality

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Corresponding author

Cem Oyvat, University of Greenwich, Park Row, Greenwich, London, SE10 9LS, UK,
c.oyvat@greenwich.ac.uk

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"*If they have their dollars, we have people, our God*"... This was Tayyip Erdoğan's response following Donald Trump's sanctions and new tariffs on Turkey, which triggered the collapse of the Turkish Lira. Erdoğan also says "*the attack on economy is the same as the attack on call to prayer and our flag*" in a more recent speech.

The voting behaviour in Turkey is strongly connected to the economic perceptions; however, Erdoğan's popularity also rises at specific moments (such as the failed military coup attempt in 2016 or Turkey's military operation in Afrin) in which nationalism peaks up. For this reason, Erdoğan aims to manipulate the public audience in Turkey by framing the incoming "economic crisis" as an "economic war" or even an "economic jihad". Donald Trump's sanctions and new tariffs on Turkey, which come as a form of punishing Turkey for the detention of US Evangelical Pastor Brunson, provided Erdoğan a scapegoat for the economic crisis and also an opportunity to distract Turkish people's focus on economy through boosting nationalism.

Nevertheless, the reality is very different than the way Erdoğan frames it. Turkey has long been enjoying high growth rates with the support of speculative financial flows and a boom in the construction industry. However, the Turkish economy at the same time was step-by-step becoming more fragile during the recent years. The diplomatic crisis between the US and Turkey gave a push to the economic downturn in Turkey that was already coming. Indeed, the Turkish Lira already depreciated by more than 20% against USD in 2018 before the diplomatic tension peaked. The depreciation in the Turkish Lira against USD for 2018 was 41% at the date that this article was written.

Briefly, three points are crucial for understanding the downturn in Turkey:

1) Turkey has been experiencing chronic current account deficit problem in 2000s. Turkey's current account deficit/GDP ratio was 5.6% in 2017 and 6.7% during the first quarter of 2018.

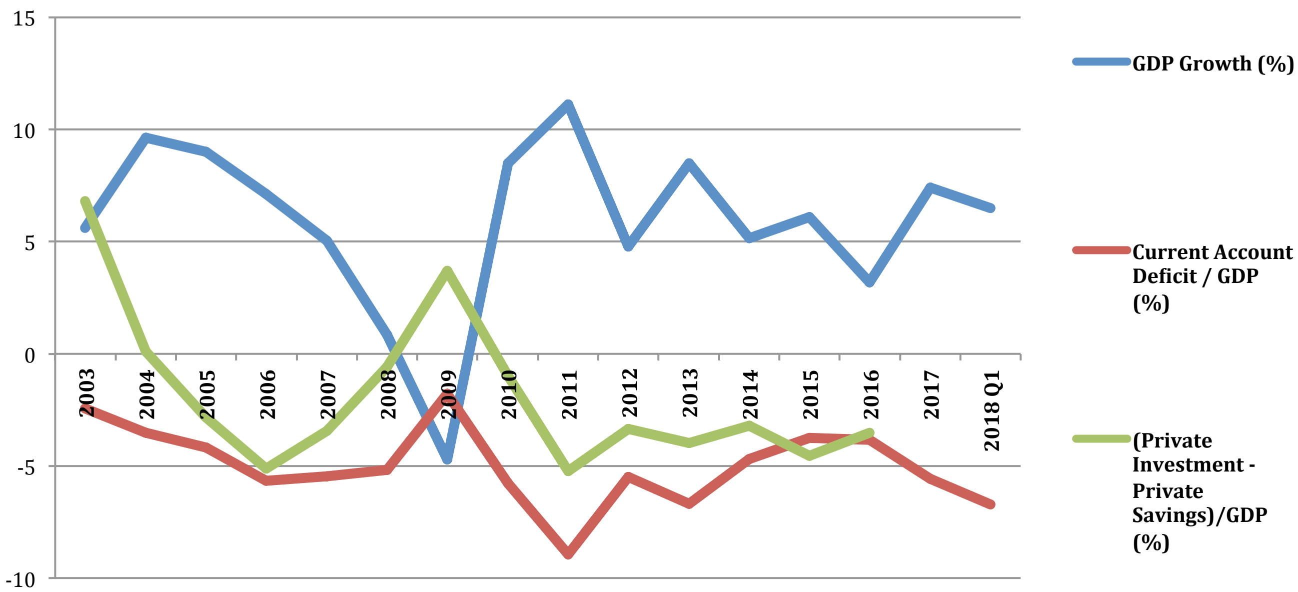
2) The gross external debt as a share of GDP (%) in Turkey increased from 36.7% in 2011 to 52.9% in the first quarter of 2018. The increase is mainly driven by the external indebtedness of the private sector.

3) The gross foreign currency reserves of the Central Bank of the Republic of Turkey (CBRT) depleted from $112.0 billion in December 2013 to $78,3 billion in July 2018 and to $70,4 billion in August 2018, while Turkey's foreign currency needs are rising.

Turkey's chronic current account balance problem

Turkey has historically been an economy that grew by giving current account deficits. However, the current account deficit in Turkey has been particularly high in the post-2002 period. During 2010-2017, the current account deficit as a share of GDP (%) was on average 5.6%, which is the largest amongst OECD and G-20 countries. At times of boom, the investment-savings gap in the private sector has been the main root of the current account deficit. The high current account deficits were possible mainly with the support of low interest rate/high money supply in the higher-income countries in an environment in which the regulations on capital inflows are low[1].

Figure 1: GDP growth; current account deficit and private investment-private savings gap in Turkey as a share of GDP (%)



Source: WDI (2018) and author's calculations based on Republic of Turkey Ministry of Development (2018)
Note: GDP growth (%) for 2018 Q1 is growth compared to the first quarter in 2017

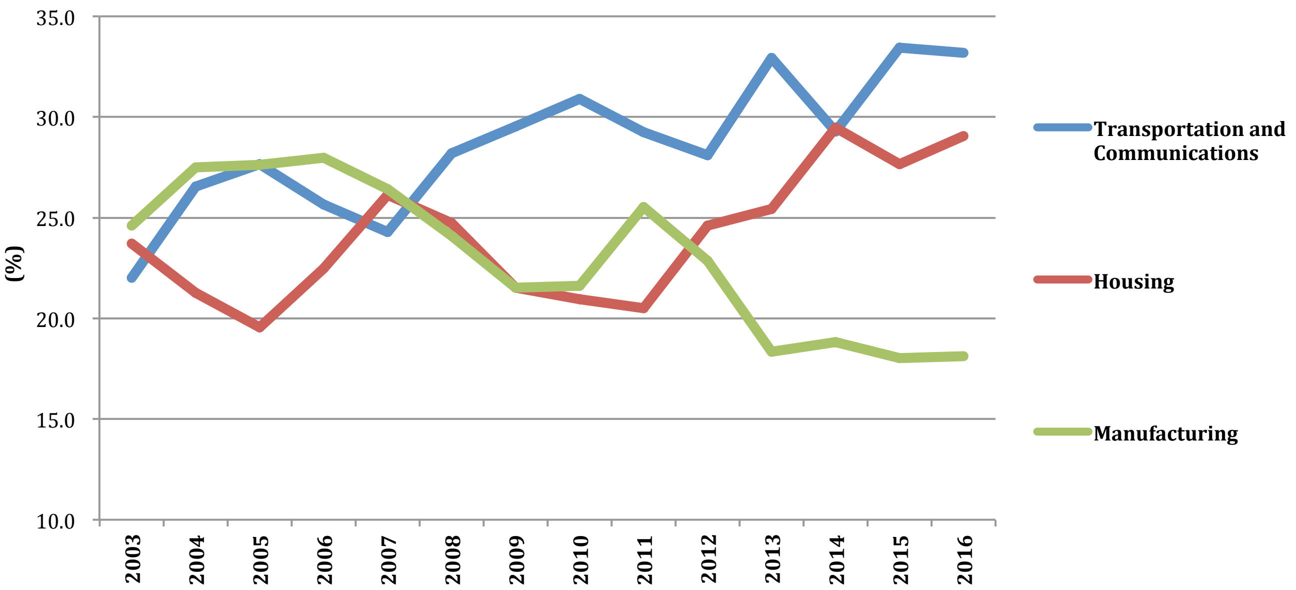
Imports of primary, intermediate and capital goods rather than imports of consumption good constitute the vast majority of imports in Turkey. In other words, the industrial production

[1] Turkish Statistical Institute (Turkstat) revised its national account calculations in 2015. According to Turkstat's previous GDP series, the average GDP growth rate for 2010-2015 was 5.2%. This average increased to 7.3% with Turkstat's revisions on GDP calculations. Turkstat's revisions also changed the sectoral shares, investment and savings rates in the national accounts calculations. However, Turkstat's GDP revisions are subject to serious criticisms. Inconsistencies between GDP series, and data on production in manufacturing industry, employment, electricity use, construction inputs were noted by a number of economists. For this policy brief, I use the official statistics by reserving the criticisms on the data, since an alternative dataset is not available.

is strongly dependent on import goods. Therefore, high growth is associated with rapidly rising current account deficit in this period (Figure 1).

However, the large share of investments (relative to savings) have not yet led to a structural technological change in industry that would reduce the current account deficit problem. The Erdoğan government also did not develop efficient industrial policies that would increase the domestic value added of industrial products. The Erdoğan government rather followed an easier path and implemented policies that would boost growth through construction projects. Especially after 2009, the Erdoğan government consistently supported the housing investments through a new urban development law in 2012, and public housing investments of Mass Housing Administration. Moreover, the capital in Turkey was directed to massive infrastructure projects such as the $10.2 billion worth new airport in Istanbul built and will be operated by a consortium of five Turkish contractors. As a result, the composition of investments shifted from industry to construction as in Figure 2. Between 2005 and 2016, the share of manufacturing in investments declined from 27.6% to 18.1%, while the share of housing increased by 9.5 percentage points.

Figure 2: Share of selected sectors in total (private & public) investments in Turkey (%)



Source: Republic of Turkey Ministry of Development (2018)

With the new composition of investments, unsurprisingly, the construction sector's share in GDP increased from 4.5% in 2003 to 8.6% in 2017. Nevertheless, the boom also now left the construction sector in Turkey highly indebted at a period in which the stock of unsold homes peaked. The construction firms that are mainly indebted in foreign currency already started to declare bankruptcies and requested debt restructuring.

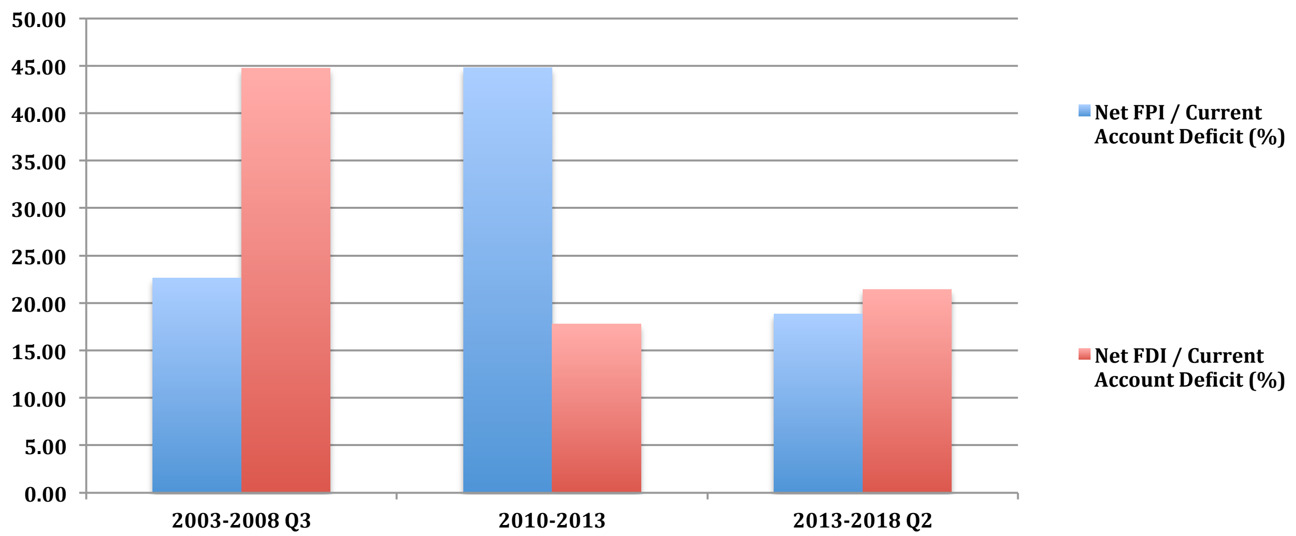
Why is Turkey facing the economic downturn 'now'?

Considering Turkey's high current account deficits between 2003-2017, the more interesting question is 'how did Turkey not experience a debt crisis until now' as opposed to 'why Turkey is experiencing an economic downturn'. We can understand this by dividing the story into four periods.

1) Years of growth, FDI and privatisations (2003-2008 3Q)

During the first period from 2003 to the third quarter of 2008, Turkey attracted high Foreign Direct Investment (FDI) and ended by financing almost a half of its current account deficit by FDIs. Total net FDI inflows/Total current account deficit was 48.1% in this period, as in Figure 3, which shows the ratios between total Foreign Direct Investment and total Foreign Portfolio Investment to total current account deficit in the given periods.

Figure 3: FPI and FDI as a share of total current account deficit in Turkey (%) for the given periods



Source: Author's calculations based on Central Bank of the Republic of Turkey (2018) data

Nevertheless, the flow of FDI's was not entirely sustainable as a significant part of this was privatisations of public firms and acquisitions of other Turkish firms, rather than new physical investments. Lebanese firm Oger's purchase of Turkish Telecom for 6.5 billion dollars in 2005, Russian-Kazakh firm TransCentral Asia Petrochemical's purchase of oil refinery- PETKIM for 2.1 billion dollars in 2007; British American Tobacco's purchase of Turkish tobacco firm-TEKEL for 1.7 billion dollars in 2008 are examples of these 'FDI's in the form of privatizations.

Moreover, 18.1% of current account deficit was covered by Financial Portfolio Investments (FPI) during this period. High money supply boosted by lower interest rates in the US and the relatively lax capital account regulations in Turkey played an important role on these capital inflows. The high growth rates supported by FDIs and FPIs also boosted Tayyip Erdoğan's popularity as Erdoğan's Justice and Development Party (AKP) increased its votes from 34.3% in November 2002 to 46.6% July 2007.

2) The Global Crisis and Turkey's downturn (2008 Q4 -2009)

During the period of global crisis (2008 Q4-2009), the net financial portfolio inflows stopped and turned negative. Moreover, Foreign Direct Investments are reduced by 59.4% in 2009. Due to the large gap between private investments and savings, the significant decline in capital inflows availability also significantly reduced the investments during the global crisis of 2008. As a result, Turkey experienced a negative growth rate of -4.7%, which is lower than most of the other emerging economies. However, the recovery started by the end of 2009 with the help of expansionary fiscal and monetary policies of the Erdoğan government and the Central Bank of the Republic of Turkey.

3) Years of quantitative easing, capital availability and financial inflows (2010 – 2013)

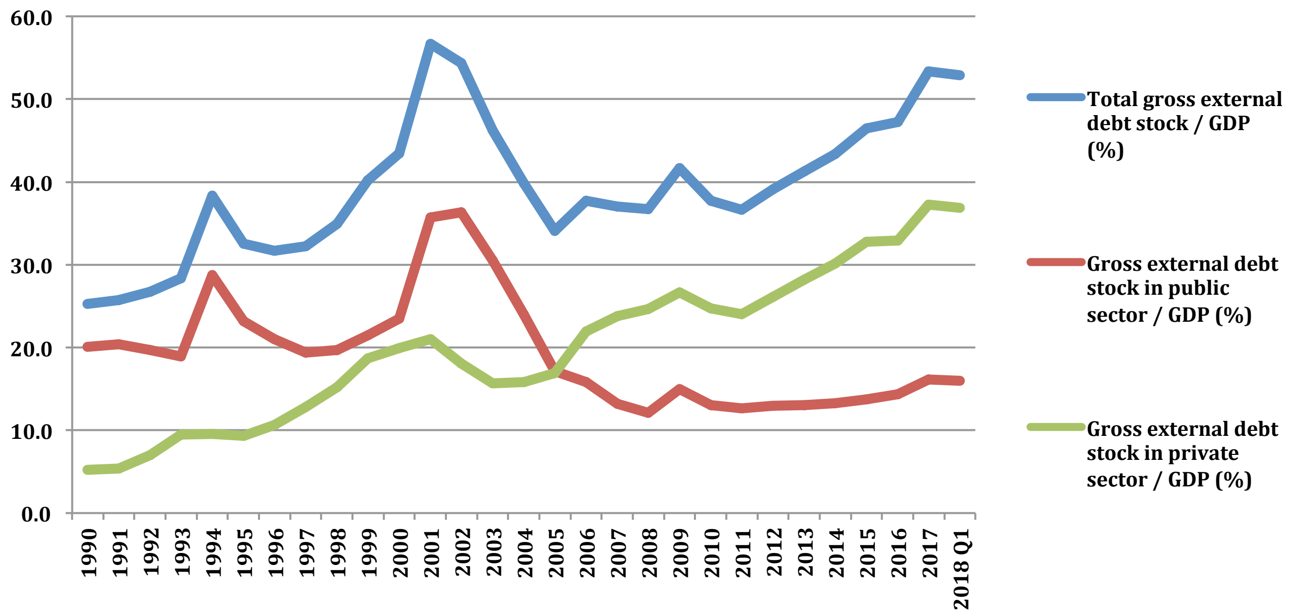
2010-2013 are the years of FED's quantitative easing, low interest rates throughout the world and capital flows to emerging market economies. During this period, Turkey continued to give current account deficits, which are on average 6.7% of GDP. 44.8% of this current account deficit was possible through Financial Portfolio Investments that global economic conditions provided. Net FDI was limited, only covering 18.3% of current account deficit. Hence, according to official statistics, Turkey experienced a very high average growth rate of 8.2%, which was fragile and strongly dependent on the inflows of Financial Portfolio Investments.

4) Accumulating external debts and depleting foreign currency reserves (2014 – 2018)

During the post-2014 period, the current account deficit has continued to be high. Nevertheless, the years of high global liquidity in the world were over with the end of quantitative easing and FED's policy of rising interest rates. Moreover, in this period, Turkey also had a series of diplomatic crises with the US and EU countries, and started to suffer from global exclusion at a global level at a time when it was still highly dependent on international financial capital. The evident outcome is that Turkey did not receive FDIs, or FPIs sufficient enough to cover the majority of its current account deficits.

Under these conditions, the depreciation of Turkish Lira was also inevitable. Central Bank of the Republic of Turkey tried to stop the currency attacks through supplying its foreign currency reserves. However, unlike 2003-2007 and 2009-2013, the CBRT's foreign currency reserves declined in the post-2014 period and indeed Turkey's foreign currency reserves were used for financing 14.6% of the current account deficit. This left CBRT with limited instruments to use at the peak of Turkey's economic downturn.

Figure 4: Gross external debt stock of Turkey as a share of GDP (%)



Source: Central Bank of the Republic of Turkey (2018)

In the post-2014 period keeping the investment-savings gap in private sector has been possible through accumulating external debt in the private sector. The total gross external debt stock as a share of GDP during this period increased from 41.2% in 2013 to 52.9% in the first quarter of 2018 (Figure 4). The recent level of external indebtedness is close that of the Turkey's debt crisis in 2001. A noticeable rise in the external indebtedness of private sector was in 2017, in which Turkey also had a high growth rate of 7.4% and a current account deficit of 5.6% of GDP. The overheating in this period was possible through CBRT's low interest rate policy, which is a result of Erdoğan's pressure on CBRT to keep the interest rates low. Also the Erdoğan government boosted the credit growth through a fund called Credit Guarantee Fund (CGF). In 2017, Credit Guarantee Fund provided collaterals to 11.8% of commercial credits and supported the boom by incentivizing the investments of small and medium enterprises.

What is next and what are the possible effects of the economic downturn on the working classes?

The recent depreciation of the Turkish Lira left private companies in Turkey in a difficult position as their debts in USD or/and Euro increased almost by 21% in terms of Turkish Lira. However, the most significant effects of the depreciation might not have been actualized yet as the debt repayments of private companies were relatively low in August and larger share of repayments are due September and especially October 2018. Hence, September and October are likely to be harder months for the Turkish economy and the worst of the economic downturn might yet to come.

The previous economic crises of 1994 and 2001 in Turkey led to significant declines in the wage shares, which was not the case in 2008/09. The difference between two is likely to be the hyperinflation in 1994 and 2001 and relatively low consumer inflation rate of 6.5% in 2009. The downward stickiness of nominal wages is likely to reduce the damage on real wages at the time of an economic crisis; however, the nominal wages cannot keep up with the rising prices when unemployment problem also becomes noticeable. The inflation for domestic production goods was already 32.1% for August 2018. With the recent depreciation of the Turkish Lira the rise in consumer prices is likely to exceed 25%, which also would damage the real wages at a peak of a crisis.

On top of this, all social movements including labour movements are under severe pressure under the highly authoritarian Erdoğan rule. Erdoğan government already developed a questionable habit of banning labour strikes due to alleged "national security" reasons. With the new executive order of president Erdoğan, a public institution called Public Inspection Committee had been granted the right to investigate and fire union leaders. Hence, workers in Turkey currently have a limited capacity to react against their deteriorating living conditions.

Another issue that relates to class conflict in Turkey is the fiscal policy during the crisis. Business circles including the Turkish Industry and Business Association (TÜSİAD) and Union of Chambers and Commodity Exchanges of Turkey (TOBB) have long been calling for austerity measures against the crisis. Finance Minister Berat Albayrak responded to these calls by saying "*Turkey will not compromise on fiscal discipline and reducing inflation is a top priority*". Of course, the content of the 'fiscal discipline' is the main issue here. Austerity measures might mean taxing top 1% and increasing the taxes on wealth and luxury goods or it might mean cutting the social expenditures, reducing pensions and increasing taxes on wage goods. So far, the Erdoğan government implemented austerity measures through cutting public education expenditures by around $330 million.

In summary, the economic crisis in Turkey is not merely an outcome of a political crisis instigated by Donald Trump. Turkey is now paying for the years of finance-led growth supported by speculative financial capital inflows, and a construction boom. With existing fragilities the crisis in Turkey is likely to deepen. Hence, the following months are likely to be hard for the Turkish economy and the working people in Turkey.

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