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The Re-making of the Turkish Crisis

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ABSTRACT

By the end of 2018 Turkey had entered a new economic crisis and a lengthy recession period. In contrast to the previous financial crises of 1994, 2001 and 2009, when the economy shrank abruptly with a spectacular collapse of asset values and a severe contraction of output, the 2018 economic crisis was characterized by a prolonged recession with persistent low (negative) rates of growth, dwindling investment performance, debt repayment problems, secularly rising unemployment, spiralling currency depreciation and high inflation. The mainstream approach attributes this dismal performance to a lack of 'structural reforms' and/or exogenous policy factors. However, this analysis shows that the underlying sources of the crisis are to be found not in the conjunctural cycles of reform fatigue, but rather in the post-2001, neoliberal, speculation-led growth model that relied excessively on hot-money inflows and external debt accumulation. This article argues that following the post-2001 orthodox reforms, a foreign capital inflow-dependent, debt-led and construction-centred economic growth model dominated the economy and caused a long build-up of imbalances and increased fragilities that led to the 2018 crisis. The Covid-19 pandemic of 2020–21 further exposed these fragilities, pushing the economy back into a recession with rapid capital outflows causing another round of sharp currency depreciation.

INTRODUCTION

In February 2001, when the economy of Turkey suffered another financial crisis, it had been following an International Monetary Fund (IMF)-directed, exchange rate-based disinflation and austerity programme. The crisis erupted at a point when the economy was seemingly at its zenith as the government had succeeded in implementing the full directives of the IMF's austerity package, including the verbatim administration of a pre-announced currency peg (the infamous 'tablita'), as well as the conversion of Turkey's Central Bank (CBRT) to a currency board, just as Argentina had done in 1991. In the context of a fully open financial account, admitting unregulated, free mobility of finance capital under the tablita of fixed exchange

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rate administration, the country's financial markets could not endure the pressures of speculative attacks of short-term hot money. As the current account deficit widened, financial markets, under the effect of a series of IMF-narrated 'success stories', experienced episodes of moral hazard. The crisis erupted in February 2001 and quickly turned into one of the deepest economic crises that Turkey had ever faced.

This story has been succinctly told, framed as 'the making of the Turkish financial crisis', by Akyüz and Boratav (2003). Less than two decades later we are faced once again with a homemade crisis, but one that is *re-made* this time under conditions of unprecedented liquidity in global financial markets. Following the comprehensive and structural reform programme directed by the IMF and implemented after the 2001 financial crisis, Turkey was seen as the darling of international observers, financial institutions and investors in the 2000s and the early 2010s.[1] Supported by record levels of foreign capital inflows and an unprecedented credit expansion, the economy grew rapidly. This growth was briefly interrupted in 2009 due to the global financial crisis that originated from high finance centres across the Atlantic. Turkey's recovery from the 2009 recession was rapid and seemingly buoyant. Yet, by the second half of the 2010s, Turkey was struggling with a myriad of problems ranging from an ongoing instability in foreign exchange markets to debt repayment problems, accelerating inflation and unemployment rates. By August 2018, as the country's economic growth slowed down and credit-rating agencies began sharply downgrading Turkey's ratings, the country experienced a currency crisis in which the Turkish lira lost significant value (by as much as 35 per cent against the US dollar). This was followed by a rapid acceleration of inflation and a severe deterioration of the balance sheets of the debt-ridden corporations, in addition to an abrupt rise in the rate of unemployment, especially among the young and educated (CBRT, 2018). In 2019 there was a renewed expansion in global liquidity; foreign capital inflows continued, albeit at a much lower level, and the Turkish economy avoided the worst-case scenario. As the year ended, Turkey began to slowly recover. But in 2020 the Covid-19 pandemic further laid bare the imbalances and fragilities of the economy, as foreign capital outflows intensified, especially from the stock and bond markets, leading to a depletion of Central Bank reserves and the Turkish lira hitting new lows, thus increasing the risk of a balance of payments crisis.

Why? What went wrong? While the government tried to put the blame on international speculators working against Turkey, allegedly envious of its successes, orthodox economists and critics of the government claimed that

1. For example, the World Bank's 2013 Turkey Country Report argued that 'Turkey's rapid economic and social progress holds many useful lessons for policy makers in other emerging markets and has been an inspiration to reformers, particularly in the Middle East and North Africa' (World Bank, 2013: 2), while Sachs (2013) praised the remarkable performance of the thriving Turkish economy.

the explanation lay in institutional decay leading to interference in the free workings of the markets, and a delay of 'structural reforms' such as further labour market flexibility and broadening incentives for foreign direct investment (FDI). The argument that 'during the early years of its governance the Justice and Development Party[2] has exhausted the opportunities of IMF-led structural reforms and after 2006, given the lack of enthusiasm for further structural reforms, Turkey entered a phase of lopsided growth well below its potential' is a popular narrative shared by, for example, Gürkaynak and Sayek (2013: 65–66), or many of the reflections of Turkey's top business organization, the Turkish Industry and Business Association (see İmamoğlu, 2020). Similarly, the World Bank's (2019: 10) country memorandum notes that 'economic integration and innovation have boosted firm-level productivity' though 'further reforms are needed to accelerate these positive impacts'; while Özel (2015: 2) states that 'some of these structural reforms have been short-lived, rendering the Turkish economy prone to fundamental risks'.

Contrary to such explanations emphasizing issues of poor governance, delays in structural reforms, or institutional retreat, we argue that the woes of the Turkish economy originated from the structural problems and intrinsic fragilities generated by the speculation-led economic growth model (Grabel, 1995) of the post-2001 crisis era. This model depended on continuous foreign capital inflows and increased indebtedness and was centred around a construction boom.[3] The importance of international financial conditions for this model needs to be stressed as the expanding global liquidity in the 2000s and the quantitative easing policies after the 2008 global financial crisis were significant push factors behind these inflows (Akyüz, 2012, 2014). The economic growth that the model generated has also led to a long build-up of imbalances and increased fragilities in the economy. The balance sheets steadily deteriorated as the external debt of the banks and non-financial corporations reached unprecedented levels, Turkey's net external equity position worsened, and current account deficits widened. The credit expansion led to fragile balance sheets for both firms and households as economic growth increasingly took on a debt-led character. Together with an almost exclusively construction-centred economic growth strategy, overvaluation of the Turkish lira in real exchange rate terms undermined the industrial base of the country, except for a few industries (e.g. automotive) that managed to insert themselves into global value chains. Hence, an unbalanced

2. 'Justice and Development Party' is the English translation of Turkey's Adalet ve Kalkınma Partisi (AKP), founded in 2001 and in power continuously since the end of 2002. For historical reviews of the rise of the AKP see, for example, Esen and Gümüşçü (2016); Yeldan and Ünüvar (2016); Yılmaz and Bashirov (2018).
3. This model has variously been characterized as dependent financialization (Akçay and Güngen, 2019), deficit-led neoliberal populism (Güven, 2016), or a mix of neoliberal developmentalism and authoritarian populism (Adaman et al., 2019).

growth path emerged for the economy. Income distribution remained highly unequal as the economy failed to generate sufficient employment even during the high-growth years. In the end, the economic boom of the 2000s and the early 2010s paved the way for the bust and the ensuing crisis through an accumulation of fundamental imbalances and financial fragilities.

Analysis of the financial crisis in Turkey offers a useful case for understanding the fragilities generated by a foreign capital inflow-dependent growth model (e.g. Akyüz, 2012, 2014; Kaltenbrunner and Painceira, 2015). This article examines the build-up of economic imbalances in Turkey. It documents the increased fragilities in the country's external accounts and discusses the unprecedented credit expansion with a focus on the problems generated by the construction-centred (and increasingly import-dependent) nature of its economic growth model. The study traces the impact of these imbalances on class dynamics and patterns of income distribution, and discusses the similarities and differences between Turkey's 2018 economic crisis and its previous financial crises. Subsequent sections discuss the limitations of the proposed crisis-resolution policies with a specific focus on whether the so-called structural reforms can remedy the situation. The article provides a brief early assessment of how the Covid-19 pandemic has impacted the Turkish economy as it struggles to recover in the wake of the 2018 crisis. It concludes with remarks on the trajectory of neoliberalism in Turkey in this period and the political dimensions of the insistence on this growth model.

A BUILD UP OF IMBALANCES

External Balance

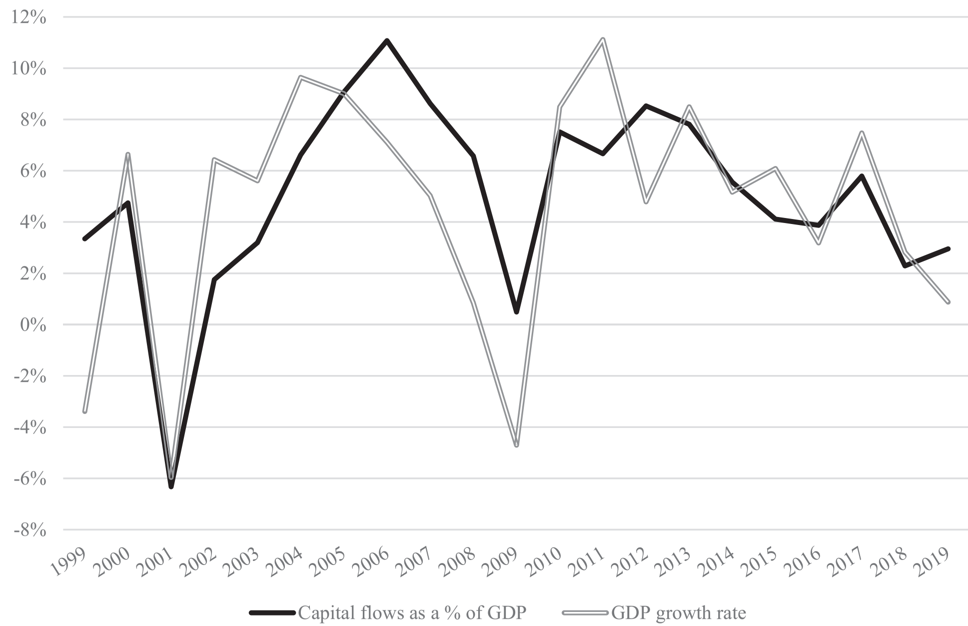
Turkey began trade liberalization in the early 1980s under a repressive military regime. The import substitution industrialization strategy of the pre-1980 era was abandoned and a comprehensive strategy of external liberalization was initiated with a view to switching to an export-oriented growth model through the repression of labour costs and through tax and credit incentives to exporters and favourable exchange rates (as shown in Figure 4, below). Full liberalization of the external account was completed in 1989 with the liberalization of capital movements, mostly to ease the financing pressures resulting from government budget deficits. Like the experiences of most other 'emerging market economies', Turkey's full financial account liberalization was followed by the boom–bust cycles of foreign capital flows, which, in turn, generated high volatility in interest and exchange rates, and unstable swings of economic growth. Periods of economic growth supported by capital inflows were followed by capital outflows and Minsky-type financial crises (Kindleberger, 1996; Minsky, 1982; Palma, 1998, 2000, 2012). Following the 1998 financial crisis, mainly triggered by the contagion effects of the Asian and Brazilian crises, a stabilization programme was prepared in 1999 together with the IMF and put into effect at the beginning of 2000. The poor design of the IMF-directed stabilization programme resulted in a deep financial crisis in 2001 (Akyüz and Boratav, 2003; Boratav and Yeldan, 2006; Dufour and Orhangazi, 2009; Ertuğrul, and Yeldan, 2003; Orhangazi, 2002; Yeldan, 2002). The 2001 financial crisis resulted in a 51 per cent devaluation of the Turkish lira, a 7.4 per cent contraction of GDP and a soaring inflation rate of 61.6 per cent (Yeldan and Ünüvar, 2016).

The government's response to the crisis was a full-fledged neoliberal structural reform programme that initially aimed to stabilize the economy through an orthodox policy of high interest rates and overvalued exchange rates. The macroeconomic framework was based on an inflation-targeting 'independent' Central Bank, and an effectively contractionary fiscal policy focused on attaining primary budget surpluses. A rapid and widespread privatization programme supported both the primary budget surplus target (set at an ambitious rate of 6.5 per cent of GDP) and the target of complete liberalization and marketization of the domestic economy (Dufour and Orhangazi, 2009). Securing 'credibility' through an independent, inflation-targeting Central Bank and a fiscal policy administration offering a primary surplus was intended to ensure that the country's risk premium would decline, foreign capital would start flowing back into the country and domestic interest rates would start falling. As a result, increasing consumption and investment would generate sustained growth. Thus, what was envisaged was crowding-out in reverse, with the oxymoronic motto of expansionary fiscal contraction (Giavazzi and Pagano, 1990).

In fact, a virtuous cycle was to emerge in the following years. As Turkey was going through the fundamental neoliberal structural reforms and was restructuring its banking sector, global liquidity increased and banks looked to invest a sizeable amount of financial capital in lucrative markets. Turkey enjoyed accelerating economic growth together with currency appreciation and relatively rapid disinflation, which in turn led to further capital inflows. As a result, the ongoing structural reform programme (politically enhanced by the devotion to it of the newly formed AKP government) was hailed a 'success story' (e.g. Sachs, 2013; World Bank, 2013). We document the main dynamics of this growth pattern in Figure 1, which underscores the joint paths of foreign capital inflows as a percentage of GDP and the rate of economic growth since the end of the 1990s. A striking picture emerges which shows the economy expanding during times of increased capital inflows and contracting when inflows are reversed (as in 2001) or when they just slow down (as in 2009 and 2018).

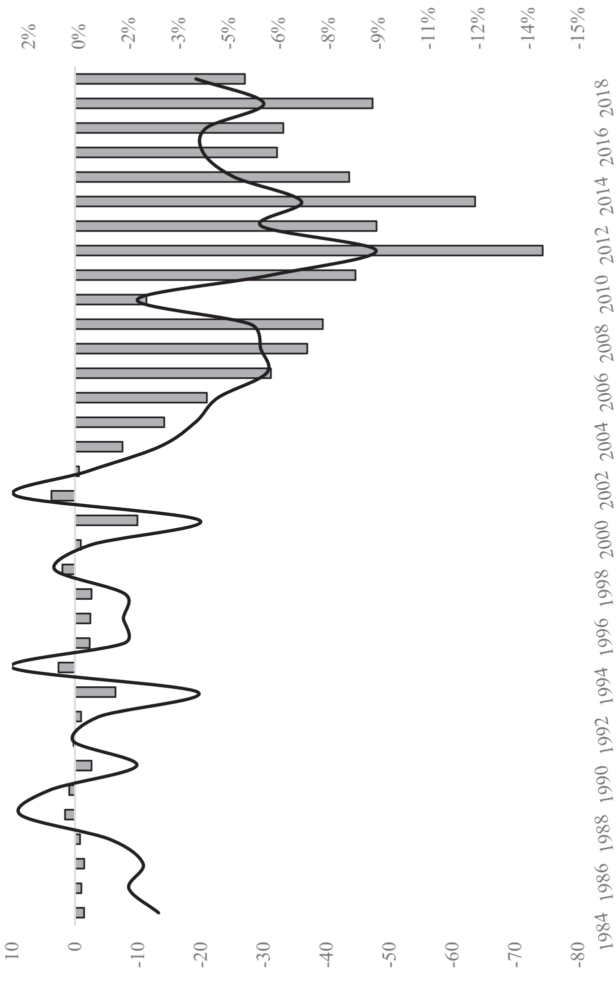
The mirror image of the increased foreign capital inflows after 2002 is seen in the widening current account deficit as shown in Figure 2. While chronic current account deficits have been a characteristic of economic growth since the liberalization of capital flows, these deficits were usually small. However, current account deficits widened significantly throughout

Figure 1. Foreign Capital Inflows as a Percentage of GDP and GDP Growth Rate



Source: Central Bank of the Republic of Turkey, Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

Figure 2. Current Account Balance in US$ Billions (bars, left axis) and as a Percentage of GDP (line, right axis)



Source: CBRT Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

the 2000s and the 2010s. As we discuss in detail below, the widening of the current account deficit was directly related to the increased foreign capital inflows and the concomitant currency appreciation, and reflects the increased import dependency of the economy in this period.[4] In fact, according to Turkstat Foreign Trade Statistics, more than 85 per cent of total imports consisted of capital and intermediate goods.[5]

While the push factor behind the increasing capital inflows after 2002 was the increase in global liquidity, the pull factors were the prevailing high domestic interest rates and the prospects of capital gains.[6] Despite the rapid disinflation process, interest rates did not adjust immediately; throughout the post-2001 expansion and up to the eruption of the global financial crisis of 2009, the real interest rates on government debt instruments remained above 10 per cent. Between 2003 and 2008 the high interest rates attracted speculative short-term capital inflows leading to speculation-led growth (as described in Grabel, 1995). Although interest rate levels declined in the 2010s, they remained significantly higher than the prevailing interest rates in the world and rates in similar emerging markets, after the global financial crisis brought interest rates in major economies near to zero. Hence, the main pillar of economic growth in this period has been increased foreign capital inflows through the maintenance of relatively high interest rates.

One way to look at this phenomenon is to calculate the speculative arbitrage rate offered by the Turkish economy to international capital markets. This financial arbitrage can be calculated as the end result of an operation that converts foreign finance capital into Turkish liras at the initial rate of exchange, and, after earning the domestic rate of interest offered in the Turkish asset markets, re-converts it back to the foreign currency at the then prevailing foreign exchange rate. Then, we compare this 'domestic' rate of arbitrage offered with the 'foreign' rate of opportunity costs.[7] Algebraically, the *net* arbitrage gain is calculated as

$$\frac{1 + RD}{1 + \Delta\varepsilon} - RF$$

Thus, during the course of this operation, financial speculators would gain the domestic rate of R^D, and lose at the rate of depreciation of the Turkish lira, $\Delta\varepsilon$. The net difference between the two prices would give us the net

4. The extent of import dependency has been the topic of many studies and doctoral dissertations in this period. One of the key studies remains that of the Central Bank of Turkey (Saygılı et al., 2010).
5. See Turkstat Foreign Trade Statistics: https://data.tuik.gov.tr/Kategori/GetKategori?p=Dis-Ticaret-104
6. See Koepke (2019) for a recent review of the empirical literature on the push and pull factors in driving capital flows to emerging markets.
7. We are indebted to an anonymous referee of *Development and Change* for suggestions of comparison of the domestic rate of arbitrage against the foreign rate of interest (here LIBOR) serving as an opportunity cost of this operation.

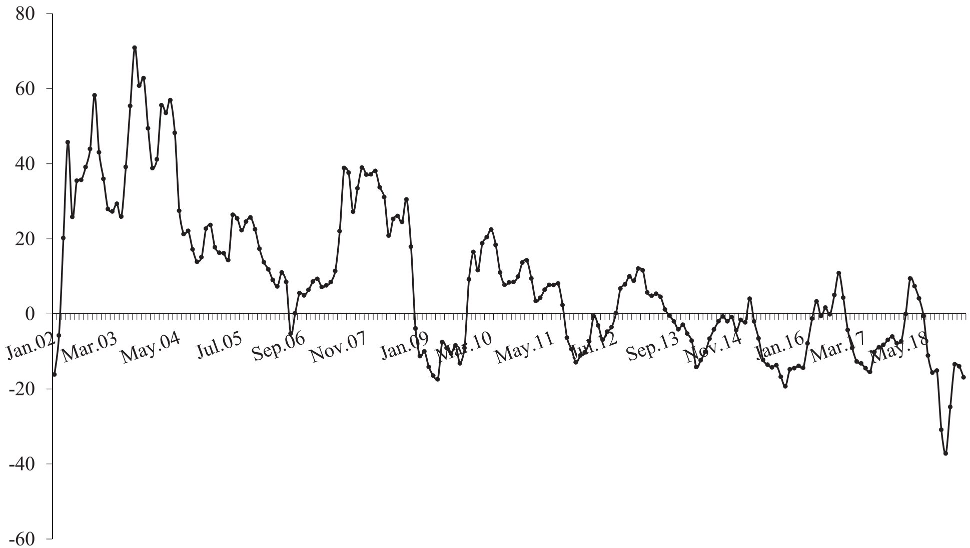
financial arbitrage gain offered domestically. Comparing this domestic gain against the foreign rate of interest, R^F, we reach the net gain in arbitrage from the Turkish financial markets — net of the opportunity costs abroad. We calculate the evolution of such gains in Figure 3. Here, the main hypothesis is that the financial *arbitrageurs* would invest their foreign monies at the domestic instrument that would bring the highest rate of return in the domestic asset markets (in most cases government debt instruments). For the R^F value we use the monthly London Interbank Offered Rate (LIBOR).

According to the calculations portrayed in Figure 3, Turkey offered a speculative arbitrage rate above 30 per cent in the aftermath of the 2001 crisis and well into the beginning of 2004, and it has become one of the leading emerging markets in the world of financial speculation. While the US and the OECD interest rates were at 2.5–4 per cent levels, Turkey continued to offer quite high arbitrage gains over dollar-denominated assets. Such returns enabled Turkey to attract huge sums of speculative finance capital with a significant 'hot' component during 2003–04 and then again in 2007. While these speculative arbitrage rates seem to be lower in the post-2009 period, Turkey was still continuing to offer quite high speculative rates compared with the near-zero interest rates in advanced economies. However, since 2012, the rate of arbitrage has dwindled significantly, and geopolitics, rather than financial calculus, has played a more important role in setting the patterns of hot-money flows.

This standard arbitrage approach is useful in understanding the surge in portfolio flows into the bond markets, as shown in Figure 4. In addition, FDI constituted a significant share in the mid-2000s due to a wave of large privatizations. FDI and equity inflows continued after 2009 as capital gains prospects played a key role in these inflows. High domestic interest rates and low exchange rates, together with prospects of stable or appreciating Turkish lira, played a major role in the increase in external debt. In Figure 4, this appears as the rather overlooked 'other' category, which is mostly composed of borrowing by banks and non-financial corporations from abroad. The deregulation in 2009, which enabled non-financial corporations with no foreign exchange earnings to borrow from abroad, was also effective in this increase (Akçay, 2018).

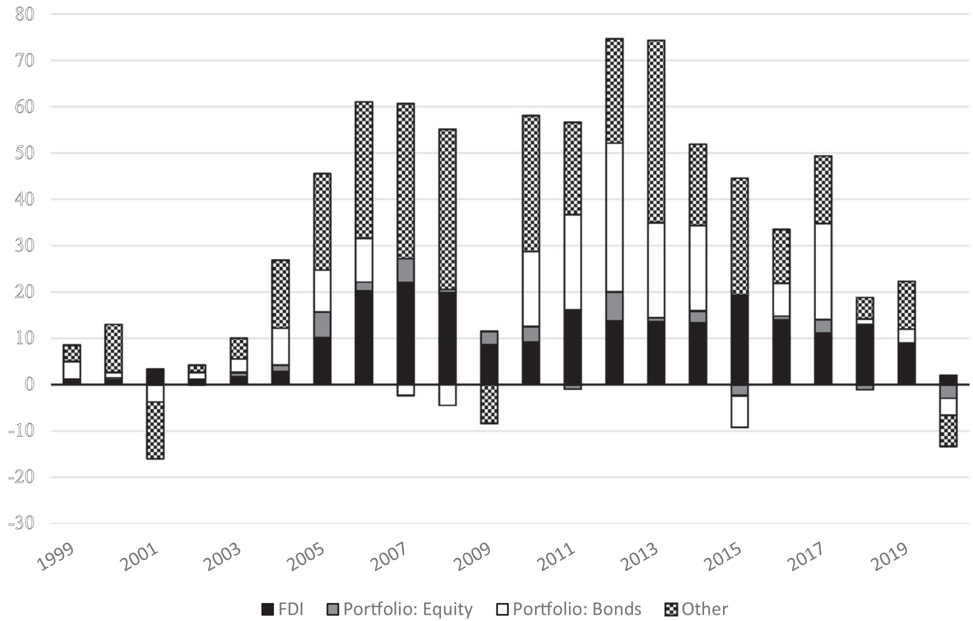
The immediate result of increased foreign capital inflows in the aftermath of 2003 has been a significant appreciation of the real exchange rate. As the high interest rates attracted capital inflows, the abundance of foreign exchange led to an overvaluation of the Turkish lira. The Central Bank focused exclusively on maintaining price stability, and currency appreciation helped to keep inflation under control via cheapening of imported consumer products, but also — more importantly — intermediate goods. Figure 5 shows the path of the real exchange rate over an extended period and also illustrates the three main episodes of financial-cum-real crises of the Turkish economy (i.e. April 1994, February 2001 and the ongoing crisis starting in August 2018), with the adjustments therein set against the background of January

Figure 3. Speculative Arbitrage in the 2000s (%)



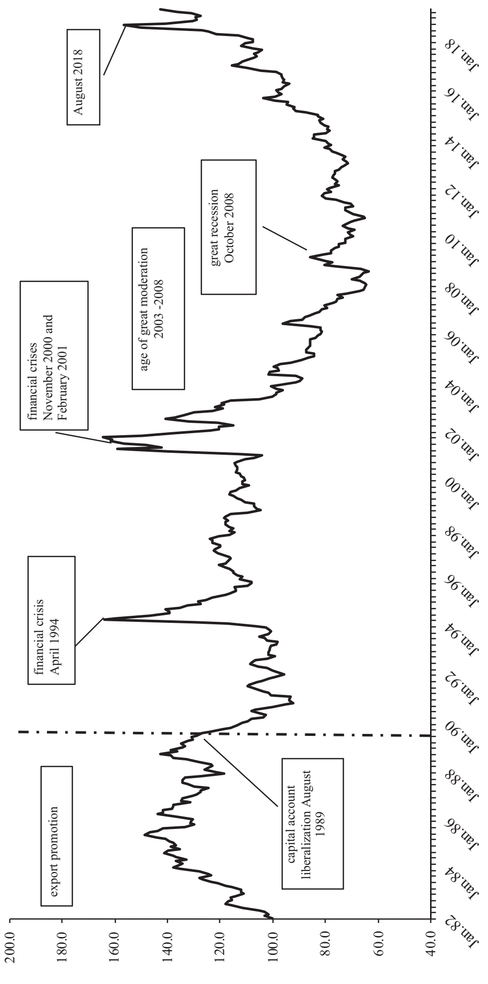
Note: Speculative arbitrage is calculated as 1 + the interest rate divided by 1 + the change in the exchange rate minus one.
Source: Authors' own calculations based upon data acquired from the CBRT Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

Figure 4. Components of Capital Inflows, 1999–2020



Note: 2020 data include the first 4 months of the year.
Source: CBRT Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

Figure 5. Real Exchange Rate Index (TL/$) PPP in Consumer Prices, 1982–2018 (1982=100)



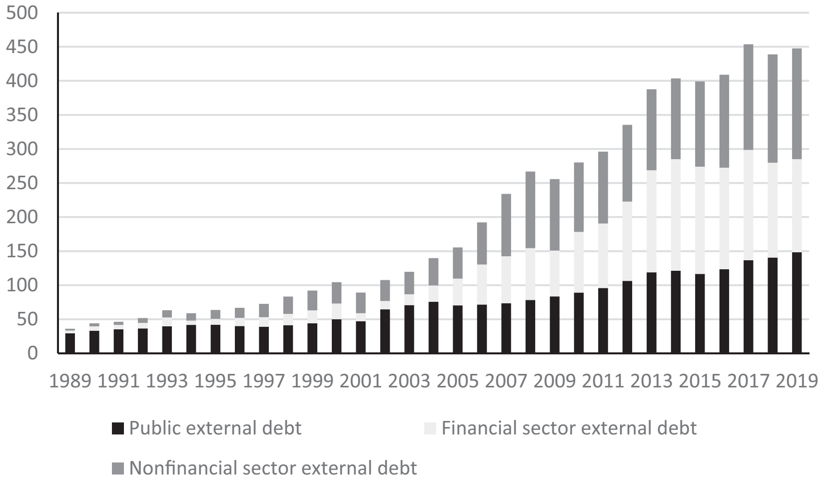
Note: Real exchange rate in PPP terms with producer prices as the deflator.
Source: Authors' own compilation based upon data from the CBRT Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

1982 as the benchmark year. The export promotion era of the post-1980s is visible with real exchange depreciation. Following the capital account liberalization of 1989, Turkish lira appreciated significantly as a result of the inflow of abundant foreign exchange. The consequent widening of the current account deficits was no longer sustainable by late 1993, and the Turkish economy entered a severe economic crisis in April 1994.

This cycle has been repeated in the context of different conjunctures, albeit with a shared underlying structural background: the invigoration of speculative hot money led by lucrative arbitrage opportunities, deterioration of macroeconomic balances and the harsh realities of a sudden stop. In fact, Turkey provides one of the most vivid examples of UNCTAD's (1998: v, 55) assessment that: 'the ascendancy of finance over industry together with the globalization of finance ha(d) become underlying sources of instability and unpredictability in the world economy. … In particular, financial deregulation and capital account liberalization appear to be the best predictor of crises in developing countries'. Almost all recent episodes of financial-cum-currency instability indicate that the observed sharp swings in capital flows are mostly a reflection of large divergences between domestic financial conditions and those in the rest of the world. These divergences may well have been required to implement national objectives. Reversals of capital flows are often associated with a deterioration of the domestic macroeconomic fundamentals. However, 'such deterioration often results from the effects of capital inflows themselves as well as from external developments, rather than from shifts in domestic macroeconomic policies' (ibid.: 56). Simply put, under the regime of speculation-driven growth, the world economy had been investing too little of its resources in non-financial, real-sector activities, and was growing too slowly to provide sufficient jobs. Under these conditions monetary policy became ineffective, and as counter-cyclical fiscal policy was ruled out for ideological reasons, all national economies, developed or developing, lost control over all instruments of austerity, leaving the fate of capital investments and employment generation to the caprices of finance.

Focusing on the period of our analysis, data reveal that from 2001 until the financial crisis in September 2008, when the conditions of the global asset markets completely changed, the Turkish lira appreciated by as much as 70 per cent. This was accompanied by a build-up of external debt. Despite the rapid increase of the level of external debt, its ratio to GDP appeared at around 45 per cent as a result of growth, but more importantly due to the appreciation of the currency, which overstated the country's GDP in US dollars. In fact, this appreciation hid much of the fragility associated with the increase in external debt and the attendant increase in the current account deficit. After 2008, the total increase in external debt was higher than the increase in national income, and a significant portion of this external debt was of a short-term structure. Figure 6 shows the rise in private sector external

Figure 6. External Debt Accumulation (US$ billions)



Source: CBRT Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

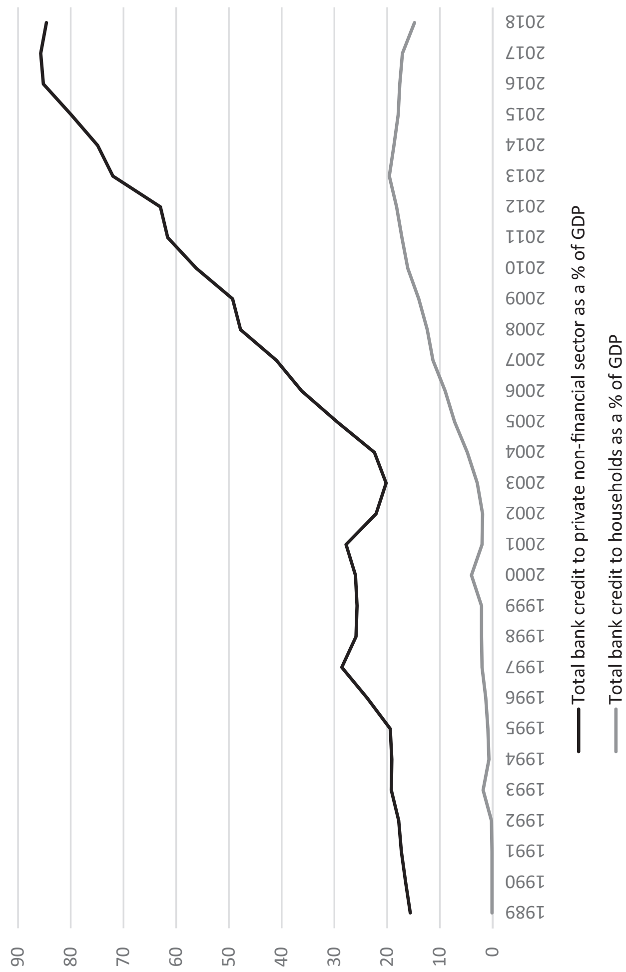
debt, with the non-financial corporations rapidly borrowing not only from the banks and financial institutions, but also from abroad.

In short, Turkey was faced with a deteriorating external balance due to increased capital inflows leading to wide current account deficits and a rapid accumulation of external debt. This rendered the economy extremely vulnerable to a slowdown or even a reversal of capital inflows; this build-up of external fragilities occurred alongside a rapid domestic credit expansion, which we examine in the next section.

Domestic Credit Boom

Turkey's success in the era of 'great moderation', supported by increased capital inflows and lower inflation rates, led to a decline in domestic interest rates and encouraged an unprecedented increase in the volume of domestic credit. It is important to note that the nominal interest rates were still higher than world interest rates, as discussed above, and hence, as long as the exchange rate remained stable, the economy attracted capital inflows. From the perspective of firms and households, on the other hand, domestic real interest rates reached historical lows during this period, leading to an expansion in borrowing (see Figure 7). At the same time, the difference between nominal domestic and world rates encouraged firms to continue expanding their external borrowing.

Figure 7. Credit Expansion in the 2000s



Source: Bank for International Settlements, credit to the non-financial sector statistics; www.bis.org/statistics/totcredit.htm (accessed 23 September 2020).

It is worth noting that most of the foreign debt accumulation over the 1990s was due to the borrowing needs of the ailing public sector. Government budget deficits were seen as responsible for the economic problems prior to the 2000s, and through widespread privatizations and primary budget surpluses, such deficits have since been brought under control (Yeldan and Ünüvar, 2016). Yet, while the borrowing needs of the government declined, credit to the private sector steadily expanded. The increase in capital inflows supported the domestic credit boom in two ways. First, capital inflows into financial markets led to an increase in financial asset prices, and hence, an increase in the net worth in the economy that can be used as collateral, enabling a decline in leverage ratios. In the same process, capital flows also contributed to the decline in interest rates, enabling firms and households to borrow more. Second, a significant portion of the capital flows went directly into the banking sector to be converted into domestic credit. These processes are not specific to Turkey; capital flows to 'emerging markets' led to credit and asset bubbles as domestic banks borrowed from abroad to fund domestic lending (Akyüz, 2012, 2014; Orhangazi, 2014; Orhangazi and Özgür, 2015). Furthermore, expansion of credit contributed to the widening of the current account deficit through its expansionary impact on demand by increasing imports of consumption goods as well as intermediate and capital goods, exacerbating the import dependence of domestic production.

A novel feature of the 2000s has been the rapid increase in household borrowing. Starting from around 2 per cent in 2002, the household debt to GDP ratio had reached almost 20 per cent by 2013 (see Figure 7). When we look at the components of household credit, the fastest growing components have been consumer credit and housing loans (Karaçimen, 2014). It is not surprising that this increase in household debt resulted in an increase in the debt servicing burden of households, and as the rate of increase of disposable income lagged behind the interest expenditures of the household sector, this boom tapered off around 2013. Karaçimen (ibid.: 164) shows that 'for a time, it appeared that Turkey's growing consumer credit market would mainly serve the middle- and upper-income households because they have stable incomes …. However, over the last decade, consumer credit has increasingly penetrated into the daily lives of low-income households and increasingly been used to pay everyday expenses'.

As the credit boom continued, debt dynamics were ignored and Turkey, in comparison with advanced economies that had higher debt ratios, was declared safe. However, as Minsky (1982) and others (e.g. Kindleberger, 1996; Palma, 1998, 2000, 2012) show, credit booms are often followed by financial crises through similar structural dynamics. At the beginning of the boom, the expanding credit volume contributes to economic growth by supporting increased production and consumption. This economic expansion is usually accompanied by soaring stock and/or real estate prices as credit growth also supports and enables more investment in these assets by investors and speculators. Inflation-targeting central banks refrain from intervening in the credit boom provided that inflation rates remain stable and economic expansion continues, allowing the credit boom to take on a life of its own. As the growth rate of credit exceeds the rate of growth of the economy, the debt repayment capacity of the economy starts to falter and macroeconomic fragility increases. Once credit growth, for whatever reason, slows down and is reversed, dynamics of deleveraging take over. In the case of Turkey, for example, the CBRT usually made comparisons with advanced economies with higher debt-to-GDP ratios and these debt dynamics were ignored (e.g. CBRT, 2018). However, when in 2018 the CBRT was forced to increase interest rates to stabilize the foreign exchange markets, credit expansion came to an abrupt halt and debt repayment problems emerged with both small and large corporations declaring bankruptcy.

Fragility of the external account, together with the debt-led characteristics of economic growth, made the economy increasingly vulnerable to the exchange rate as well as interest-rate movements. This also rendered investment and consumption vulnerable to shifts in global financing conditions and risk appetite. This was coupled with the increased dependence of economic growth on domestic credit expansion. The situation worsened with the unbalanced nature of economic growth in this era, which became increasingly dependent on imports and was centred mostly on the construction sector, as well as a high structural unemployment rate. We turn to these issues in the following sections.

Unbalanced Growth: Import-dependent, Construction-centred Growth

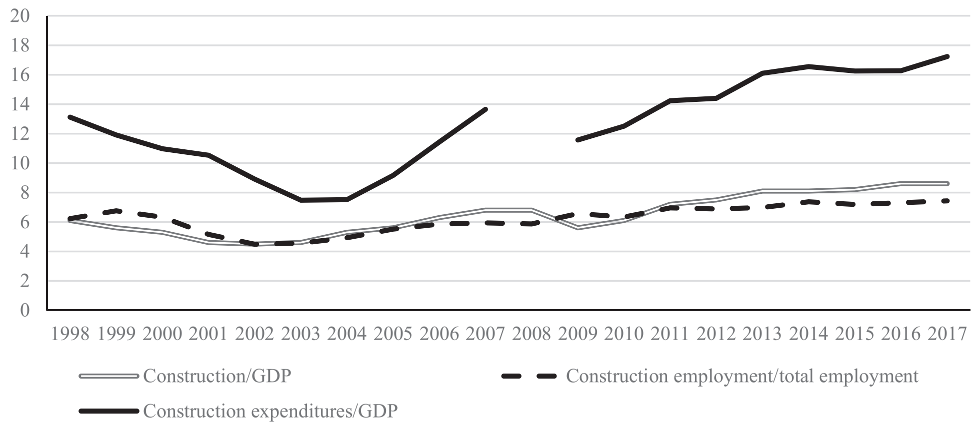
The accumulation of domestic and external financial fragilities in the 2000s and the 2010s was accompanied by unbalanced economic growth. First and foremost, this was a prolonged period of overvalued real exchange rates, coupled with a diversion of incentives away from exportables and domestic intermediates. As shown in Figure 5, this was mainly the result of an unprecedented rise in foreign capital inflows that led to a cheapening of imported intermediate products, which at the same time resulted in a loss of export competitiveness in many sectors. The overall impact has been slow industrial growth, which has led to concerns of premature de-industrialization as the share of industrial production within GDP declined (Bakır et al., 2017; Rodrik, 2016).

Second, a deliberate government policy gradually surfaced in support of the construction sector, via often clientelist incentivization. Construction activities rapidly expanded mainly due to three mechanisms. First, as the share of agriculture in total production declined, the 2000s witnessed a significant migration flow towards urban centres, leading to an increased need for housing and other types of structures including touristic venues, shopping malls and various types of infrastructure. In addition, the 1999 earthquake highlighted the need to update current housing that was deemed unsafe, which contributed to an increase in construction activity. Second, the relatively low and stable inflation rates coupled with the financial expansion enabled banks to introduce long-term housing loans, which generated an increasing demand for housing. In the process, a classic speculative wave emerged, leading to housing bubbles in which, financed by readily available credit, increases in demand generated spiralling cycles of further increases in demand, with the expectation of further increases in housing prices. Yet, the third and most important factor behind construction-centred growth was the government's deliberate investment strategies. The government began a massive construction spree that included the building of new public buildings, new public universities, highways, subways and airports. In 2004, the Public Housing Authority (PHA), initially established to provide low-cost housing to low-income households, was granted special privileges — the utilization of idle public land to engage in construction through subcontracting — and effectively turned into a contracting agency of the government (Balaban, 2012; Çavuşoğlu and Strutz, 2014; Sönmez, 2015).

The government's policy choice to engage in construction was partly due to the fact that, under the conditionalities of the post-2001 macroeconomic framework, it had to generate primary budget surpluses, which severely limited its opportunities to spend. The urban rents generated by the PHA, however, allowed the government to finance large infrastructure investments outside the government's budget. At the same time, these rents were used for ensuring political support and funding business groups who were close to the government. The government controlled the issuing of construction permits, the choice of projects and developers, and the opening up of public land to construction. This allowed for a large space within which the government could operate and enabled it to generate rents for certain groups of the capitalist class close to its political views, and to use part of the rents generated to acquire political support from large groups who benefited from these construction projects. In the meantime, the large employment generation capacity of the construction activities and the stimulus it provided for the rest of the economy through increased demand for a large number of intermediate products from a variety of industries contributed to economic growth.

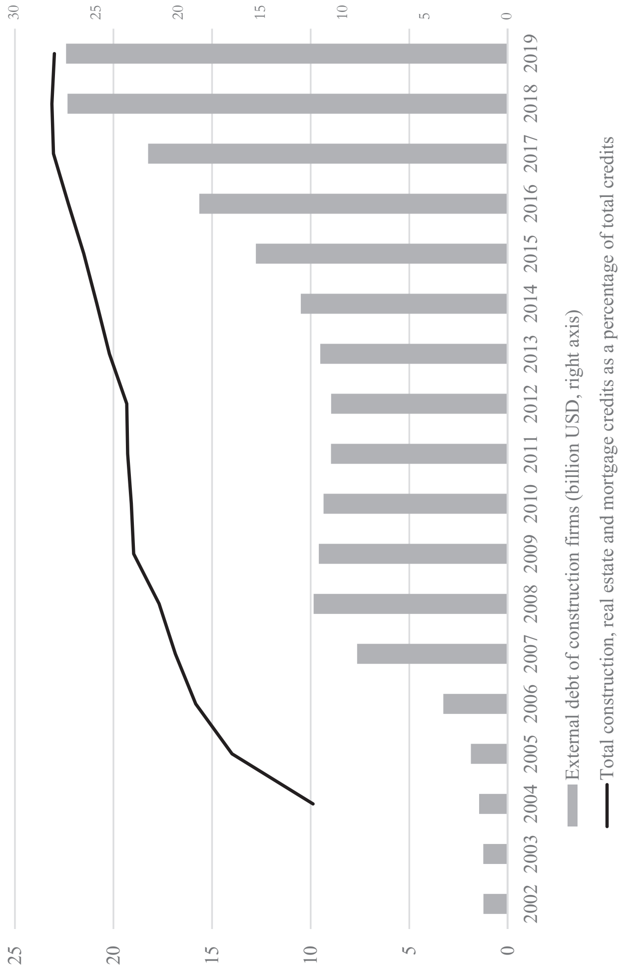
Figure 8 shows the increasing significance of construction within the economy during the 2000s and 2010s. After the 2001 financial crisis, the share of construction spending within GDP increased rapidly from a low of 7.5 per cent in 2004 to 17.2 per cent by 2017. Meanwhile, employment in the construction sector constituted around 7.4 per cent of all employment by 2017, significantly higher than the 4.5 per cent in 2002. During the same period, the share of manufacturing in the economy oscillated between 15 and 18 per cent and the share of manufacturing employment within total employment remained stagnant at around 20 per cent. As Figure 9 shows, this increase was enabled by the credit boom as construction, real estate

Figure 8. The Share of Construction within the Economy



Note: The construction expenditures as a percentage of GDP series is broken due to a change in the national accounts.
Source: TurkStat; https://data.tuik.gov.tr/Kategori/GetKategori?p=ulusal-hesaplar-113&dil=2 (accessed 23 September 2020).

Figure 9. *Construction, Real Estate and Mortgage Credits and External Borrowing of the Construction Firms*



Source: CBRT Electronic Data Dissemination System; https://evds2.tcmb.gov.tr/index.php (accessed 23 September 2020).

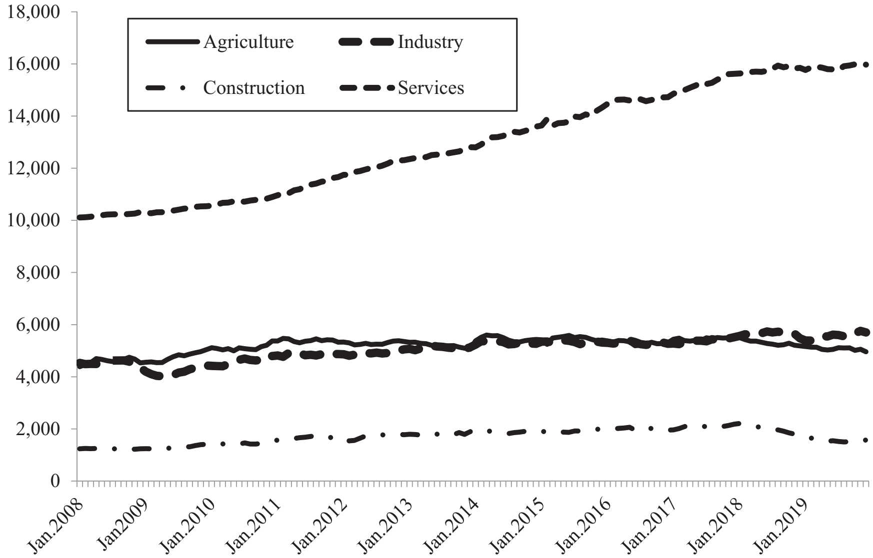
and mortgage credits increased rapidly after 2004. By 2006 the construction and real estate companies also began increasing their external borrowing, from a low of around US$ 1.5 billion to more than US$ 26 billion by 2018. In addition to external borrowing, the construction sector's borrowing in foreign currency from domestic banks increased from US$ 2.4 billion in 2006 to around US$ 21 billion in 2018 according to the CBRT's Financial Stability Report 2018 (CBRT, 2018).[8] This increase is an even greater source of fragility as it involves both local lenders and borrowers. The construction-centred growth model depended on the availability of cheap credit and proved fragile against any shocks to credit growth or to the interest rate, as became evident after 2018. Moreover, the construction sector also became more import-dependent (Özcan-Tok and Sevinç, 2019) and hence costs of production were sensitive to volatilities of the exchange rate.

The idea that a misallocation of resources reveals itself as an important factor in helping us to understand income differences across countries is one of the leading arguments of the new growth literature. For example, Jones (2013) argues that the way a given economy's stock of resources, human capital and knowledge are allocated across firms and industries will have a lasting impact on the economy's overall level of total factor productivity, and hence long-term growth. This idea has a long tradition in the history of economic thought, dating back to the seminal works of Hirschman and Nurkse. However, in contrast to either the Hirschmanian notion that the task of development policy is to maintain tensions, disproportions and disequilibria (Hirschman, 1958), or Nurkse's well-known argument that 'the governments of developing countries ought to follow a strategy of generating large investments in a number of industries *simultaneously*' (Nurkse, 1971: 128), the Turkish path was marred with political nepotism, crony policies and diversion of domestic resources away from productivity enhancing investments in industrial sectors.

When we consider the fragilities presented in the previous sections, it seems clear that the economy began suffering from a malign mix of currency and external risks, interest rate risks, as well as risks of resource misallocation and excess production in construction, all of which increasingly depended on expansions in capital inflows, credit and further growth of the construction sector. The impact of this model of speculative growth on class dynamics and patterns of income distribution is briefly examined in the next section.

8. We are indebted to an anonymous referee of *Development and Change* for bringing this issue to our attention, and to Feridun Tur for extrapolation of the scarce data.

Figure 10. Employment by Sectors, (1,000 Workers, Seasonally Adjusted)



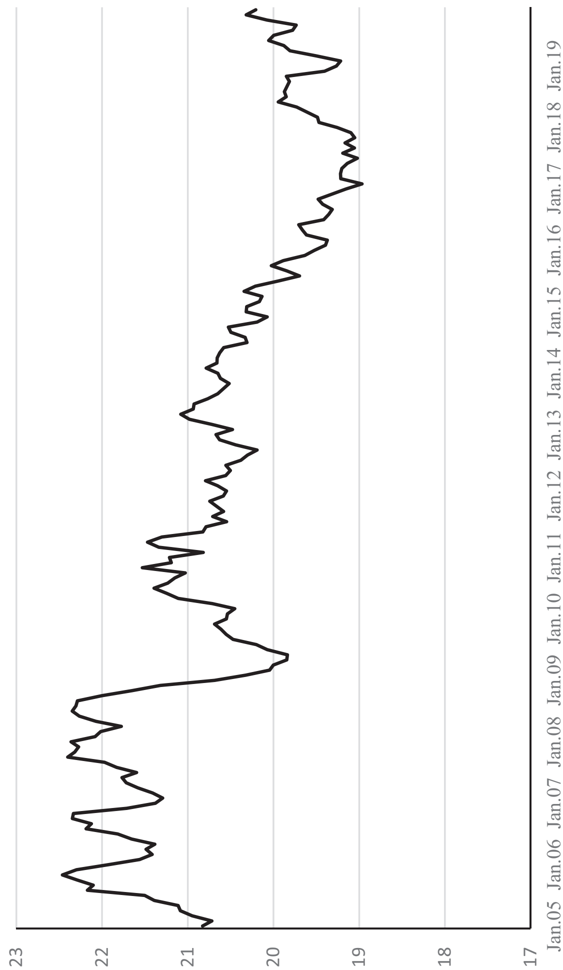
Source: TURKSTAT Household Labour Force Statistics; https://data.tuik.gov.tr/Kategori/GetKategori?p=istihdam-issizlik-ve-ucret-108 (accessed 1 November 2020).

Class Dynamics and Patterns of Income Distribution

Current Account Deficit and Stagnant Industrial Employment in the 2000s

'Jobless growth' has been a major characteristic of the 2000s and the 2010s as the unemployment rate rose above 10 per cent in the aftermath of the 2001 financial crisis; despite a long expansion, it has not returned to pre-2001 levels. As mentioned above, the structural overvaluation of the Turkish lira, not surprisingly, manifested itself in ever-expanding deficits on the trade and current account balances. As traditional Turkish exports such as textiles lost their competitiveness, new export lines emerged. Yet, these new export lines proved to be mostly import-dependent, assembly-line industries, such as automotive parts and consumer durables. They utilized cheap imported materials, assembled in Turkey with low value added, and were re-directed for export. Being mostly import-dependent, they had a low capacity to generate value added and employment. Thus, the speculative, debt-ridden model of lopsided growth took its toll mainly on domestic industry. Industrial employment stayed almost stagnant with less than 5 million workers, while almost all gains in employment went to services and to construction — before the latter sector collapsed abruptly with the onset of the 2018 crisis. This is shown in Figure 10, while the period of ongoing de-industrialization is depicted in Figure 11.

Figure 11. Share of Industrial Employment in Total, 2005–19 (Seasonally Adjusted)



Source: TURKSTAT Household Labour Force Statistics; https://data.tuik.gov.tr/Kategori/GetKategori?p=istihdam-issizlik-ve-ucret-108 (accessed 1 November 2020).

Figure 11 shows the severe decline in the share of industry in generating employment as stated above. This decline is most visible throughout the 2010s, between the 2009 crisis and the 2018 crisis. Industrial employment seems to lose a share of almost 3 percentage points until mid-2017. The upswing observed at that point is, unfortunately, due to the disproportionate decline in aggregate employment rather than an expansion of industrial employment per se. As a matter of fact, total employment, which was around 28.5 million in March 2018, and which peaked at 29.3 million in August of that year, receded to a low of 26.1 million in March 2020 (the latest data available at the time of writing). This amounts to a total loss of 2.4 million jobs, seasonally adjusted, from March 2018 to March 2020.[9]

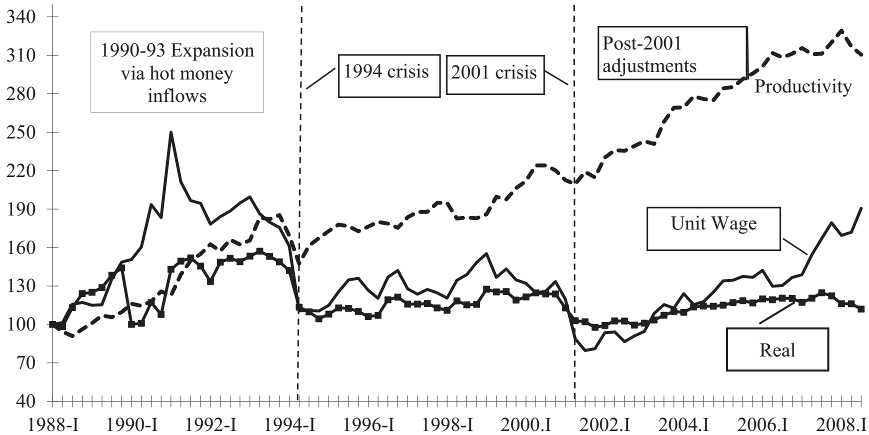
Thus, as traditional exports dwindled, the newly emerging export industries were not vigorous enough to close the trade gap. As Turkey consumed more and more whose value added lay abroad, and found it profitable to do so with an appreciated currency financed by speculative financial inflows, the external deficit widened, and foreign debt kept accumulating. The costs of this speculation-led growth were seen in terms of job losses, persistence of informalization, and a decline of real-wage income. According to official estimates, informal employment stood around 50 per cent of total employment at the beginning of the 2000s and, despite a decline that began in the mid–2000s, it remained at 30–40 per cent of total employment in the 2010s.[10]

Developments in the Wage Remunerations of Labour

The post-2001 period had also witnessed a pattern of contraction and then stabilization of manufacturing wages. Such a transfer of financial returns through very high real interest rates offered to the financial system was bound to have repercussions on the primary categories of income distribution. It is clear that the creation of such a financial surplus would directly necessitate a squeeze of the wage fund and a transfer of the surplus away from wage labour towards capital incomes, in general. It is possible to find evidence of the extent of this surplus transfer from the trajectory of manufacturing real wages. Figure 12 shows the dynamics of manufacturing real wages and provides contrasts against productivity of labour over a broad time horizon to indicate the basic turning points of the wage path. The wage rate in private manufacturing was typically following the business cycle with a lag throughout the post-1990 reform age. Clearly, the most important observation is the opening gap between productivity of labour and its real wage remunerations.

9. See: https://data.tuik.gov.tr/Kategori/GetKategori?p=istihdam-issizlik-ve-ucret-108
10. See: https://data.tuik.gov.tr/Kategori/GetKategori?p=Istihdam,-Issizlik-ve-Ucret-108

Figure 12. Productivity and Real Wages in Private Manufacturing (1988=100)



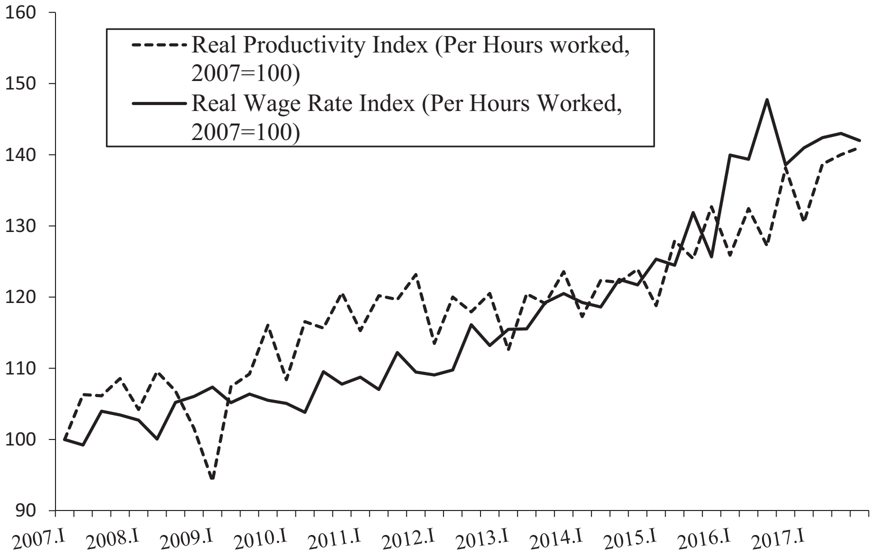
Source: TURKSTAT Manufacturing Sector Annual Reports; www.sbb.gov.tr/temel-ekonomik-gostergeler/#1542268521132-a9825b93-fa4c (accessed 1 November 2020).

Unfortunately, detailed wage data are quite scarce in Turkish statistics and we must rely on alternative sources for the full picture. Data from the Ministry of Development on the new series cover 2007 to 2017[11] (see Figure 13 for the main economic indicators). Post-2007 data reveal that, at least in the case of the manufacturing sector, real wages continued to follow productivity gains until 2013; the series moved roughly in order until 2016. Turkey then entered a period of severe political disruption with frequent elections and a referendum over the change in the form of government from a parliamentary to an executive presidential system. That period coincided with a brief episode of wage support reflecting a concern with capturing the votes of the middle classes by the government. Deceleration of labour productivity, coupled with an acceleration of inflation, started to choke real wage rates, and labour remunerations once again seemed to fall behind the rate of growth of productivity. Unfortunately, our data series comes to an official close by 2018 and we must rely on independent studies to draw a conclusion on this issue.

Furthermore, the post-2001 economic crisis period was also characterized by authoritarian practices in terms of labour relations and regulations since maintaining competitiveness mostly depended on maintaining the large gap between productivity and real wages. As Bozkurt-Güngen (2018) succinctly expresses it, intensification of labour exploitation through long working

11. In 2018 the Ministry of Development was shut down under the new presidential government regime. For more on the main economic indicators, Ministry of Development (formerly State Planning Organization), see: www.sbb.gov.tr/temel-ekonomik-gostergeler/#1542268521132-a9825b93-fa4c (accessed 1 November 2020).

Figure 13. Real Productivity and Wages in Manufacturing (2007=100)



Source: Ministry of Development (formerly State Planning Organization) Main Economic Indicators; www.sbb.gov.tr/temel-ekonomik-gostergeler/#1542268521132-a9825b93-fa4c (accessed 1 November 2020).

hours became a basis for generating absolute surplus value. In short, in an economy characterized by relatively low labour force participation rates, high unemployment, and mostly stagnating real wages, expansion of credit became quite important for households as discussed above.

Moving from the functional to the size distribution of income,[12] a relevant popular metric used by many economists is the comparison between the income shares of the top 1 per cent and those in the bottom 50 per cent. Data presented in Figure 14 disclose two different Turkish realities, separated by the eruption of the global crisis. Before 2007, thanks to an appreciated currency and modest inflation rates, the incidence of poverty seemed to decline while income distribution improved. Post-2008 adjustments to the global crisis, however, openly impacted on the bottom 50 per cent while the top 1 per cent income groups are observed to expand their income shares by as much as 8 percentage points.

On the other hand, household-level income distribution seems to have barely changed over the course of events. The poor stayed poor, while the rich got richer. As shown in Table 1, a direct comparison from 2006 to 2017

12. Technically, we follow the customary tradition in referring to the shares of remunerations of the factors of production as *functional distribution* of income. In contrast, the *size distribution* of income follows the total income received by households irrespective of the sources of that income and is generally documented in quintiles of income ladder.

Figure 14. Income Inequality: Top 1% versus Bottom 50%

Source: TURKSTAT Household Income Surveys; https://data.tuik.gov.tr/Kategori/GetKategori?p=gelir-yasam-tuketim-ve-yoksulluk-107&dil=1 (accessed 1 November 2020).

Table 1. Distribution of Household Disposable Income (Turkish lira)

	No of households ('000)	Cumulative percentage groups (income, TL) 10%	25%	50%	75%	90%	Mean Income (TL)>
2006	17,284	4,555	7,140	11,387	18,474	28,054	15,102
2017	23,096	15,584	22,192	34,709	53,906	82,694	46,131

Source: TURKSTAT, Household Income Surveys; https://data.tuik.gov.tr/Kategori/GetKategori?p=gelir-yasam-tuketim-ve-yoksulluk-107&dil=1 (accessed 1 November 2020).

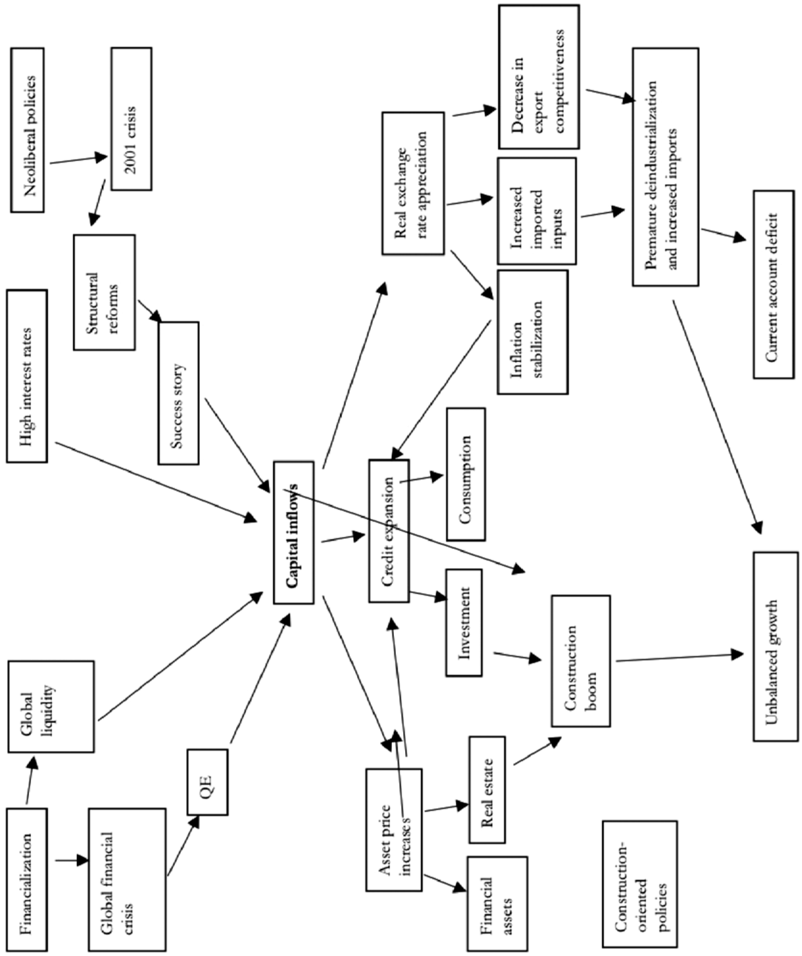
reveals that between 50% and 75% of the household of the household population received less than the mean income. Measured in Turkish lira units, these data have the advantage that they are not distorted by currency movements and give a direct estimate of household disposable income.

'THIS TIME IS DIFFERENT'

A combination of push factors (global liquidity in the 2000s and the quantitative easing of policies after 2008) and pull factors (high domestic interest rates, currency appreciation and the 'success story' of IMF-led structural reforms starting in 2002) resulted in a prolonged period of net private capital inflows into the Turkish economy which in turn increased vulnerability and external fragility against a sudden stop or reversal. The external debt of both financial and non-financial corporations reached unprecedented levels, making them fragile in terms of changes in global lending conditions and currency shocks. The capital inflows led to a long period of overvalued real exchange rates, increasing the import dependency of the whole economy, widening the current account deficit and rendering the economy more vulnerable to exchange rate movements. Capital inflows contributed to credit expansion, which, in Minskian fashion, further increased the financial fragility of the economy. As government policy favoured construction to be the leading economic activity, an unbalanced growth period emerged. Figure 15 summarizes the growth dynamics and the concomitant accumulation of fragilities.

In 2013–15 there were early signs of a financial crisis brewing, beginning with the US Federal Reserve's tampering decision around mid-2013. The announcement by the Federal Reserve signalled that global liquidity conditions were about to change, which led to a slowdown in capital flows towards 'emerging markets'. In January 2014, during a period in which Turkey's currency rapidly declined due to negative global conditions coupled with political instability, the Central Bank had to increase interest rates in an emergency meeting held at midnight to stabilize the currency (CBRT, 2014). As the 'taper tantrum' faded away and capital flows continued in 2014 and 2015, economic growth also continued. However, a major policy dilemma ensued. While low interest rates were important for debt-led, construction-centred economic growth, the global conditions that made low interest rates possible were disappearing. After the failed coup attempt in 2016 and a one-quarter decline in GDP, the government decided to support credit growth wholeheartedly to avoid a recession. This decision was made partly for political reasons, in the context of the 2017 regime change referendum: the government did not want to risk holding a vote during an economic contraction. The government-sponsored Credit Guarantee Fund (CGF), which was initially established to support small and medium-sized businesses, was the preferred tool to support credit growth (CGF, 2017). The main contradiction of this policy was that the increase in credit-supported economic growth contributed to the current account deficit, making the Turkish lira more vulnerable. Following the change to a presidential system in 2017, the government decided to go for early elections in 2018, and again with the same logic, used all available tools not to allow a contraction before the election. However, the Turkish lira started sliding ahead of the election, and in the summer of 2018 a political rift between the US and Turkey over the arrest of an American pastor caused a sudden outflow of both foreign and domestic capital, which resulted in a sharp depreciation of the currency. The currency crisis rapidly evolved into a debt crisis as many firms applied for bankruptcy protection and banks were forced to restructure a significant amount of outstanding debt. By early 2019, the economy was in recession, and found itself in uncharted waters as partial capital controls in foreign ex-

Figure 15. *Overview of the Foreign Capital Inflow-dependent, Debt-led, Construction-centred Economic Growth Model*



Source: Authors' own compilation based upon Orhangazi (2019: Figure 12).

change markets were imposed to prevent speculation on the Turkish lira (see Akçay, 2018 for a depiction of the 2013–18 period).

Around 2013, in the wake of the 2008 financial crisis, a 'this time is different' argument emerged regarding the economy. Financial institutions such as the World Bank took the position that Turkey had completed a series of structural reforms in the aftermath of the 2001 crisis, strengthened its banking system, and managed to get public debt under control, and thus the country was now considered to be immune from financial crises (e.g. Sachs, 2013; World Bank, 2013). The resilience of Turkey's financial system during the global financial crisis, coupled with a significant increase in capital inflows afterwards, declining domestic interest rates and seemingly robust economic growth, were all seen as proof of this assessment. In fact, hopes were raised so high that the government declared that Turkey would become one of the 10 largest economies of the world by 2023.[13] This time it was indeed different, but not in the sense that the economy was now more stable; rather in the sense that new forms of external fragilities compared with the earlier crises of the Turkish economy in the 1990s and the early 2000s were on the rise. We identify four significant differences.

First, in the previous crisis episodes, the source of fragilities mostly originated from the government's budget deficits and public borrowing requirements, while this time it was the excessive and rapid expansion of domestic credit that, on the one hand, made the construction-centred economic growth possible but, on the other hand, made the economy more vulnerable to changes in credit conditions. It is important to remember that the financial crises of the 1990s made most developing countries cautious of public sector deficits. In Turkey, economic policies after the 2001 crisis were built on fiscal discipline while the CBRT focused on inflation targeting. However, as Palma (2012) shows, fiscal discipline and price stability are not enough to maintain financial and macroeconomic stability during periods of capital inflows, as demonstrated in the case of Brazil and in countries in East Asia in the 1990s. Eichengreen and Gupta (2014) argue that the taper tantrum of 2013 affected developing economies with low levels of budget deficit and public debt. Caldentay and Vernengo (2012) show that excessive fiscal conservatism may worsen problems when the economy depends excessively on private spending, which is likely to collapse in the event of a decline in capital inflows as seen in Central American economies in the 2000s. Furthermore, as Ivanova (2017: 2) notes, credit booms follow a similar dynamic

13. Turkey's GDP was on the order of US$ 800 billion in 2014, when the target was set. For the target to be reached, Turkey would need to achieve a growth rate of roughly 8 per cent per annum in real terms. That would mean doubling of the potential growth rate over more than a decade. The unattainability of this target proved to be obvious given the recent crisis-prone growth episode. See: 'Erdoğan: Our target is to be among the top 10 economies by 2023', www.bloomberght.com/haberler/haber/1357849-erdogan-hedefimiz-2023te-ilk-10-ekonomi-arasina-girmek (in Turkish, accessed 1 November 2020).

which increases the credit volume at the early stages of the business cycle. This stimulates consumption and investment, and hence contributes to economic expansion. Provided the price level remains relatively stable, central banks refrain from intervening in the credit expansion. However, the credit boom eventually leads to asset price inflation, and depending on which asset class is at the centre of the investor and speculator interest, credit expansion finally gives way to financial distress. In this respect, it is important to note that capital inflows and domestic lending are linked to each other in a pro-cyclical manner. As capital inflows increase, the risk premiums of the country usually fall, and at the same time, cross-border banking increases the lending capacity of domestic banks. If the credit growth exceeds domestic deposit growth, banks can resort to wholesale funding from foreign banks (Brunnermeier et al., 2012: 11). Hence, a divergence emerges between credit expansion and domestic deposit growth (Lane and McQuade, 2014).

The uncontrolled credit expansion made the containment of a negative credit shock difficult as the fragilities were not centred on a single entity, such as government debt, but spread and dispersed over the whole economy. In 2018, it became clear that excessive and unpayable debt had spread around most of the non-financial corporate sector, and a series of bankruptcy pleas followed.[14] In 2020 it is still not clear how much of the domestic debt is unpayable as the government takes a piecemeal approach to the issue and forces the (public) banks to restructure debt for certain sectors or groups of firms.

The second major difference is the length of the preceding expansion. Earlier crisis episodes came after short intervals — at most a couple of years — of expansions in foreign capital inflows, which were followed by sudden stops or reversals. The current expansion, though, lasted from the early 2000s into the 2010s with only a brief interruption during the Great Recession. While the quantitative easing policies of the post-2008 era provided the push factor for the continuation of capital inflows, the country's preference for a strong Turkish lira in order to help with the disinflation process, and the absence of capital controls, ensured that no policy action was taken to slow down these inflows. On the contrary, in 2009, the government relaxed the foreign borrowing rules for corporations. Although in the earlier regulations, firms with no foreign currency income source could borrow in foreign currency, now all firms were granted this option (IMF, 2010: 11). In addition, the CBRT introduced a 'reserve option mechanism' that allowed the domestic banks to keep their required reserves in foreign currency at the

14. Banking Supervision and Regulation Agency data reveal that Turkey's Non-performing Loans Ratio stood at 4.2 per cent in July 2020. This is against the reported foreign exchange reserves of US$ 45.1 billion in July 2020. The Foreign Exchange Reserves equated to 2.6 months of imports in July 2020. The volume of domestic credit reached US$ 598.5 billion in July 2020, representing an annualized increase of 41.5 per cent.

CBRT, hence giving them an incentive to borrow in foreign currency instead of domestic currency to meet their reserve requirements. As such, the CBRT began to use non-conventional mechanisms, but it preferred not to intervene and pretended that a debt-led growth model was stable even though there were no built-in stability mechanisms hindering capital outflows.[15]

Third, the long period of capital inflows kept the Turkish lira overvalued for a long time, leading to an increase in import dependence and a loss of industrial base in export-oriented sectors. In previous financial crises, sudden declines in the value of the currency usually helped the economy to recover as they spurred increases in the export volume. However, this time, both the erosion of the traditionally export-oriented industries and the increased dependence of production on imported inputs rendered an export-led recovery weaker.

Finally, the fourth difference can be found in the institutional and policy environment of 2015–20. The rapid chain of events that took place in this period, including a failed coup attempt, a fundamental political regime change, the erosion of institutional decision making and the re-start of armed conflict within the country, together with Syria-related developments, all contributed to an increase in both political and economic uncertainties. The government's reluctance to provide a coherent policy framework to deal with the crisis results in a fragmentary approach. On the one hand, this includes a debt-financed fiscal expansion, the use of state banks to continue credit expansion, and selective bailouts and deals to save firms politically close to the government. On the other hand, it attempts to put the burden on the working class through increased taxes and wage suppression. The lack of an orthodox policy framework to tackle the crisis is leading many to call for structural reforms. The IMF has also joined this group and in its latest Article IV Mission Concluding Statement calls for a focus on structural reforms with a special emphasis on increasing labour market flexibility (IMF, 2019: 2). We now briefly discuss whether the so-called structural reforms can actually bring relief to the economy.

STRUCTURAL REFORMS AND THE WAY FORWARD

The 'structural reform' agenda of the IMF and the World Bank, in its broadest sense, aims to create a global market society through minimizing government regulations and interventions in the economy. In the 1990s this agenda was imposed on several developing countries through policies coded as the

15. See Kara (2016) for a discussion of the so-called 'macroprudential' policy framework of this period.

Washington Consensus.[16] From the original list of 10 requirements, there are four major items currently remaining on the agenda.

The first item, 'austerity', includes cutting public spending and increasing tax collection to balance government budgets in order to keep public debt below certain thresholds. Behind this policy approach lies the belief that increasing public debt leaves less funding for private investment, creating an obstacle to private sector investment and economic growth. Therefore, it is argued by those defending this policy approach that government budget deficits need to be kept to a minimum through spending cuts or increases in tax collection. The taxation side usually includes an increase in indirect taxes (such as sales or value added tax) rather than an expansion of the tax base over capital incomes, possibly by way of an increase in the taxation of corporate profits or on the incomes of the wealthy. The implicit assumption here is that lower taxes on corporations induce more private investment. In fact, one of the pillars of the post-2001 crisis policy framework in Turkey has been primary budget surpluses. Yet the fragilities and vulnerabilities of the country's economy (as summarized above) accumulated in a period when the primary government budget balance was in surplus and the ratio between government debt and GDP was kept well below the suggested thresholds. The current instability does not stem from public debt, nor is there any reason to expect that austerity policies would address the prevailing structural problems and fragilities of the Turkish economy. On the other hand, the AKP government does not seem willing to follow austerity policies as a whole, and since the 2018 currency crisis, prefers to increase public borrowing and spending as much as possible to keep the economy afloat. The important question in this regard is where that public spending goes — towards creating jobs and alleviating poverty through social programmes and investment in education, health and so on, or only to selective firm bailouts, unproductive construction programmes and funding military missions.

The second item on the structural reform agenda involves the privatization of all sorts of public enterprises and the opening up of all areas of the economy to private capital. As the narrative goes, the public sector, without the profit motive, is inefficient, and therefore prone to waste whereas the private sector would intrinsically increase efficiency of resource allocation and quality of services provided. Turkey has already privatized the vast majority of its public enterprises. It has also removed most barriers to private markets, including agricultural subsidies, and has opened up almost all mar-

16. The term 'Washington Consensus' was originally coined by Williamson (1989: 1) 'to refer to the lowest common denominator of policy advice being addressed by the Washington, DC-based institutions to Latin American countries as of 1989'. Williamson noted the similarities between the policy 'advice' advocated by institutions such as the International Monetary Fund, World Bank and the United States Department of the Treasury. The original term and conditionalities led to a bourgeoning body of research, with additions and finer adjustments as country experiences continued to develop (see Rodrik, 2001 for an augmentation).

kets to foreign competition as part of the post-2001 crisis policy framework. As such, again, there is no reason why privatizing whatever is left would contribute to getting rid of the financial fragilities accumulated. Yet, in 2016 the government established a Sovereign Wealth Fund and grouped all public assets and enterprises under this fund. While the objectives of this policy action are not clear, it is expected that the fund will be used as a parallel budget to disguise the true balances.

The third item on the structural reform agenda in the last decade pertains to pension reform. According to this agenda, the costs of public pension funds and social security systems are increasing and therefore putting a greater strain on the government's budgets. Therefore, social security premiums need to be increased, retirement age raised, the public's role in social security decreased, and a private pension fund system should be supported to enable individuals to save for their own retirement. In the context of Turkey, attempts to spread private pension funds intensified in recent years, with the claim that this policy would increase savings and hence lead to increased investment in the economy. However, this claim ignores the fact that a major problem for the social security system in Turkey is the lack of efficient collection of employer payments in the system, which essentially aims to put all the risks onto individuals.[17]

Fourth, labour market reforms and an overall intensification of labour market flexibility constitute an important part of the intended structural reforms. According to this approach, regulations in labour markets, such as high minimum wages and high severance payments, make it difficult for employers to lay off workers, which in turn makes them reluctant to expand employment. In addition, high labour costs are also argued to keep costs high and to decrease the export competitiveness of the economy. However, as we have shown above, the Turkish economy is characterized by persistent high unemployment and a growing productivity wage gap. The main structural problems originate not from tight labour markets and high labour costs, but from the foreign capital inflow-dependent, debt-led, construction-centred growth model that has, on the one hand, increased financial fragilities and, on the other hand, contributed to a process of unbalanced economic growth.

None of the items on this structural reform agenda problematizes the excessive dependence of the economy on foreign capital inflows, the resulting exchange rate misalignments, and the economy's import-dependence consequences. Similarly, neither the debt-led nor the construction-centred characteristics of the economy is questioned. These agenda items do not address the immediate issues of debt deflation or skyrocketing unemployment rates. A real reform programme needs to re-think the fully liberal external

17. See Sarıtaş (2019) for a recent evaluation of the push for pension reform in Turkey and the promotion of private pension schemes; and Buğra (2020) who places these developments in the context of social policy making in Turkey in the last decades.

accounts and debt-driven nature of the economy and consider ways to de-financialize the economy to make it work for the majority rather than for domestic and international rentiers. However, given the current political environment, there seems limited space for serious policy discussion.

THE 2020 COVID-19 SITUATION: BEFORE AND AFTER

The Covid-19 pandemic has hit the Turkish economy at a time when the country is still suffering from the adverse effects of the 2018 financial crisis and the macroeconomic imbalances have not been resolved in a sustained fashion. By the end of 2019, GDP growth was only 0.9 per cent, total employment had decreased by 703,000 compared with the previous year, and the unemployment rate had increased to 13.6 per cent (16 per cent for the non-agricultural labour force; 23.9 per cent for the young labour force). Table 2 provides an overview of the state of the Turkish economy over the 2017–19 cycle. As a result of the expansionary — and yet ad hoc and abrupt — fiscal expenditures implemented against the ongoing contraction of the domestic economy, fiscal balances deteriorated severely. At this conjuncture, total domestic investment expenditures contracted by 12.4 per cent. Projections by the IMF reveal that, as a result of the economic measures of isolation and employment disruption, Turkey's GDP will likely contract in 2020.

This economic structure unavoidably restricted the effectiveness of the policy measures that could be implemented against any crisis. The stimulus package that the government had initiated consisted mostly of tax breaks and credit supports administered mainly through the public banks. A ban on layoffs had been announced together with the re-initiation of a 'short-term work programme', revived from the days of the 2009 financial crisis. However, the terms of both the short-term work programme and the overall unemployment insurance proved too rigid, and their effect has been quite limited (DISK-AR, 2020; Taymaz, 2020; Yeldan and Voyvoda, 2020). A study by Elgin et al. (2020) has revealed that the size of Turkey's stimulus package compares unfavourably to programmes implemented globally. As of May 2020, the size of the stimulus package implemented by Turkey remained below 1 per cent of GDP, while Japan led the field with a package worth 21 per cent, followed by the US with 17 per cent; comparable upper-middle-income economies were generating higher performances than Turkey, such as Spain (7.3 per cent) and Korea (2.2 per cent).

The Covid-19 pandemic has hit the Turkish economy very hard. Early data at the time of writing indicate that the crisis has affected industry and the tourism and hospitality sectors very adversely. TurkStat data[18] for the month

18. See: https://data.tuik.gov.tr/Kategori/GetKategori?p=sanayi-114&dil=2

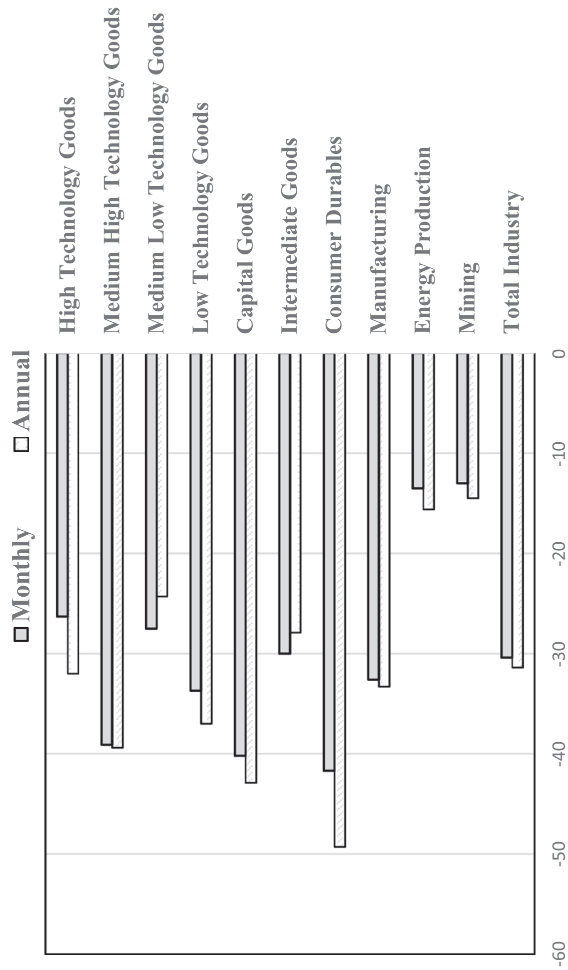
Table 2. Macroeconomic Indicators Prior to the Covid-19 Crisis

	2017	2018	2019
Growth			
GDP	7.5	2.8	0.9
Aggregate Consumption	5.9	1.2	0.9
Public	5.0	6.6	4.4
Private	6.2	0.0	0.7
Aggregate Investment Exp.	8.2	−0.6	−12.4
Aggregate Domestic Savings / GDP	25.4	26.2	27.4
Savings – Investment Balance / GDP (*)	−5.6	−3.4	1.1
Public	−1.9	−2.7	−2.9
Private	−3.7	−0.7	4.0
Foreign Economic Indicators			
Current Account Balance (US$ billions)	−47.4	−27.0	8.7
Total Exports (US$ billions)	157.0	176.9	181.4
Total Imports (US$ billions)	233.8	231.2	207.8
Foreign Debt Stock (US$ billions)	454.4	443.7	436.9
Public (inc. CBRT)	137.9	145.7	163.2
Private	316.5	298.0	273.7
Short-term Debt	120.3	117.6	123.0
Labour Markets			
Total Employment (1,000 people)	28,189	28,738	28,080
Open Unemployment (1,000 people)	3,454	3,537	4,469
Unemployment Ratio (%)	10.9	11.0	13.7
Non-agricultural Unemployment Ratio (%)	13.0	12.9	16.0
Young Unemployment Ratio (%)	18.3	23.4	23.9
Macroeconomic Prices			
GDP Deflator	10.8	16.4	14.1
Inflation (CPI, end of year)	11.9	20.3	11.5
Exchange Rate (TL / US$) Annual Rate of Depreciation	20.0	30.2	21.9
Domestic Rate of Interest on Commercial Credit (%)	17.7	27.4	17.7
Public Sector (Central Administration) Budget Balance, as a Ratio to GDP (%)			
Expenditures	21.8	22.3	23.4
Non-interest Expenditures	20.00	20.3	21.0
Interest Expenditures	1.8	2.0	2.3
Revenues	20.3	20.4	20.4
Budget Balance	−1.5	−2.0	−2.9
Non-interest (Primary) Budget Balance	0.3	0.0	−0.5
Domestic Debt Stock	28.3	31.1	32.1
Rate of Turnover of Domestic Debt (%)	127.5	95.6	132.4

Sources: TurkStat, CBRT Central Bank of the Republic of Turkey, Electronic Data Dissemination System; https://evds2.tcmb.gov.tr; www.hmb.gov.tr/ekonomik-programlar-arastirmalar-yeni-ekonomi-programi (accessed 1 November 2020).

of April 2020 reveals that industrial activity shrank by 30.4 per cent monthly and by 31.4 per cent on an annualized basis. There was significant decline in the consumer durables industries (–49.3 per cent) and capital goods (–42.9 per cent) (see Figure 16). Studies conducted by Taymaz (2020) and Yeldan and Voyvoda (2020) show that the five sectors projected to experience the highest contractions in real production relative to 2019 were: accommodation and food services (55.6 per cent); tourism (51.5 per cent); construction (48.7 per cent); air transport (47.7 per cent); and iron and steel (40.5 per cent). Thus, the early days of the Covid-19 crisis clearly underscored the

Figure 16. Rate of Change in Industrial Production, April 2020



Source: Turkstat, Industrial Production Indexes. https://data.tuik.gov.tr/Kategori/GetKategori?p=gelir-yasam-tuketim-ve-yoksulluk-107&dil=1 (accessed 1 November 2020).

deep-seated contradictions and fragilities of the domestic economy and laid bare its imbalances. The government's response to date has mainly involved a significant push of credit engineered through public banks — a somewhat dubious and threatening manoeuvre, with echoes of the ad hoc policy actions of the 1990s.

CONCLUDING REMARKS

A popular argument made by orthodox economists regarding the Turkish economy has been that the neoliberal institutional and policy framework established after the 2001 crisis generated high economic growth, while the political and institutional changes after 2017 led to a worsening of the economic performance and increased instability, especially in foreign exchange markets (see, for example, İmamoğlu, 2020; Özel, 2015; World Bank, 2019). Hence, the 2018 currency crisis is often explained by referring to the misguided policies of the government, and a call for further neoliberal structural reforms usually follows. In this article, we argue — and document evidence — that the same factors that generated high economic growth (increased foreign capital inflows, overvalued exchange rates, credit expansion and increased share of construction) were responsible for the increased fragilities and imbalances in the economy, and prepared the ground for the 2018 crisis. The Covid-19 pandemic further exposed these fragilities and imbalances, particularly the country's economic dependence on foreign capital inflows and on credit stimulus.

The AKP, which has been in power uninterrupted since the end of 2002, has taken a pragmatic approach and exploited opportunities for short-term economic and political gain throughout this period. The early years were characterized by a strict adherence to the IMF programme and the high interest rate policy attracted capital inflows which supported growth in these years. After the 2008 global financial crisis, the quantitative easing policies of the leading central banks and declining global interest rates led to unprecedented sums of capital inflows. While globally the low interest rate environment helped interest rates to come down both in Turkey and in many other countries, and made the rapid expansion of credit possible, a construction-centred growth model emerged as a result of the government's prioritization of the sector. A rapidly appreciating currency, widening current account deficits, a worsening international investment position and increasing indebtedness of both firms and households slowly led to more and more fragile balance sheets. As the quantitative easing policies gradually came to an end in the second half of the 2010s, the volatility of the exchange rate increased and Turkey was faced with the infamous trilemma: with completely free capital flows, the volatility of the exchange rate could only be curbed by raising interest rates, which in turn would create risks for the increasingly fragile balance sheets and the credit-driven economic growth. As this process culminated in a currency crisis in 2018, in keeping with its pragmatic approach, the government began introducing a series of capital controls. Though they were never declared as such, these capital controls included strict limits on currency swap operations involving the Turkish lira, a gradually increased tax on the purchase of foreign currency, reversal of the 2009 deregulation that allowed non-financial corporations that do not have foreign exchange earnings to borrow in foreign exchange, and increases in import tariffs on a wide array of products (CBRT, 2018: 6–8). The absence of a coherent programme led to a patchwork of policies that focused on short-run gains. In 2020, the Covid-19 crisis showed the contradictions and fragilities of the economic model as rapid capital outflows once again threatened the stability of the exchange rate. The government's response involved tightening some capital controls and a significant push, using public banks and changes in the regulations of the banking sector, to increase credit expansion to tackle the slowdown. Yet, the future of the economy still depends on the movement of capital flows, and how the balance sheet fragilities will play out in the near term due to excessive credit expansions.

While the government preferred to follow a seemingly new path, the low employment-generation capacity, stagnant wages, persistence of inequalities and the incidence of poverty necessitated expansionary social inclusion mechanisms. Financial inclusion through credit expansion provided one such mechanism. Social policy was also extensively used, although within a neoliberal framework (Akça et al., 2014; Akçay, 2018; Akçay and Güngen, 2019; Buğra, 2020). While transformations in labour market regulations, social security provision and health and pension systems followed the logic of neoliberal marketization, at the same time social spending has increased, new social assistance programmes have been put in place and the coverage of social security expanded (Buğra, 2020). A variety of irregular in-kind and cash benefits emerged in addition to the regular transfers. Both these irregular benefits and the expansion of social spending were highlighted by the AKP, and were extensively used in electoral politics (Buğra, 2020; Eder, 2010; Powell and Yörük, 2017; Yentürk, 2018a, 2018b). All in all, the social inclusion policies were not designed as collective rights but as 'non-labour market interfering forms' that relied on political discretion (Güven, 2016: 1015) in an environment of de-radicalization of organized labour (Doğan, 2014), and helped the formation of a successful convergence between neoliberal macroeconomic policies and populist and authoritarian politics (Akça et al., 2014). As noted by some scholars, economic growth together with some form of clientelist redistribution and social inclusion policies contributed to the electoral success of the AKP together with polarizing identity politics and gradually increasing authoritarian repression (Buğra and Savaşkan, 2014; Esen and Gümüşçü, 2016; Öniş, 2019; Öniş and Kutlay, 2020). Faith-based, charitable, non-governmental organizations closely linked to the AKP have also become significant in this process as the government outsourced some of its social policy to these organizations which commanded large funds (Özden, 2014).

This period also witnessed increased cronyism on the part of the government, which resulted in the rise of new elites that have accumulated capital thanks to lucrative government projects especially in construction, mining and energy sectors, while the so-called middle class of the small and medium-sized enterprises took advantage of persistent informalization in labour markets. This was done through a regulatory framework, which has been continuously modified to ensure space for the intervention of the government in favour of its preferred 'entrepreneurs' (Buğra and Savaşkan, 2014). However, the way these interventions were made was, in general, in line with a broader neoliberal framework in which regulatory agencies were pacified and government power was used to abolish social, economic and environmental barriers constraining capital accumulation (ibid.). And when these have proved inadequate or insufficient, authoritarian repression of dissent has increased (Adaman et al., 2019). The faltering of growth and increased economic instability in the second half of the 2010s, together with heightened social discontent and increasing contradictions within the ruling bloc, have resulted in the government having to use progressively more repression to secure its hegemonic project.

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