New Directions in Modern Economics

FINANCIALISATION AND THE FINANCIAL AND ECONOMIC CRISES

Country Studies

Edited by

ECKHARD HEIN DANIEL DETZER NINA DODIG

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NEW DIRECTIONS IN MODERN ECONOMICS

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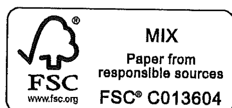

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12. Financialisation and the financial and economic crises: the case of Turkey*

Serdal Bahçe, Hasan Cömert, Nilgün Erdem, Elif Karaçimen, Ahmet Haşim Köse, Özgür Orhangazi, Gökçer Özgür and Galip L. Yalman

12.1 INTRODUCTION

Neoliberal economic policies have changed the structure of the Turkish economy since 1980.[1] Deregulation in labour markets and trade liberalisation have been integral parts of this process of structural adjustment. As a result of the liberalisation of cross-border capital movements and domestic financial markets, finance has gained considerable importance both at the national and international levels and the 1990s and early 2000s witnessed a series of financial crises in developing countries.[2] Although Western countries suffered from a major financial collapse in 2007, developing countries had been the main victims of a series of crises since the 1980s. Financial liberalisation seems to play a big role in these crises. In many developing countries, current account deficits and debt accumulation could be observed regularly, following financial liberalisation (Akyüz 2012). The volatility of many macroeconomic variables increased significantly. The Turkish economy demonstrates many traits of a typical developing country that has experienced such neoliberal transformation. High volatility in macroeconomic indicators and high frequency of crises have been among the characteristics of the economy since the 1980s.

Turkish current account liberalisation, which aimed to replace import-substitution industrialisation with export-oriented growth, started in 1980.

* This chapter is built upon Bahçe et al. (2015), 'Financialisation and the Financial Economic Crises: The Case of Turkey', *Country Report on Turkey, FESSUD Studies in Financial Systems No. 21*, Turkey Country Report. Henceforth this study will be referred to as FESSUD Turkey Country Report WP3.

By the mid-1980s import quotas were mostly removed, customs tariffs were reduced, and generous incentives were offered to exporters. Trade liberalisation was followed by the liberalisation of the capital account and the convertibility of the Turkish Lira (TL) in 1989. Foreign exchange controls on capital outflows were removed, and both current and capital accounts were completely liberalised. Capital account liberalisation was concomitant to domestic financial market liberalisation. Interest rate controls were abandoned in the 1980s and the Istanbul Stock Exchange Market was established in 1986. The weight of the public sector in financial markets gradually decreased and foreign entities were allowed to operate in Turkish financial markets. The importance of foreign investment in Turkish financial markets has increased considerably, especially since 2002.

Capital account liberalisation, accompanied by decreasing constraints on domestic financial markets, has transformed the Turkish economy considerably. However, Turkish financial markets remained shallow relative to those in developed countries. In other words, in Turkey, a classical domestic financialisation trend in the form of exponential growth in financial balance sheets, household debt and non-financial firms' financial activities was not as apparent as in the case of developed countries. As of 2010, the banking sector total assets to GDP ratio was around 90 per cent. Until 2001, government securities dominated banking sector assets. Similarly, many financial innovations such as derivatives, mortgages, and asset backed securities were only introduced after 2002. Until very recently, stock buybacks were not allowed and there has not been a significant shareholder activism forcing non-financial companies (NFCs) to change their behaviour. Besides, bank financing is still very important for NFCs and households. Households still hold their financial assets mostly in the form of deposits. Furthermore, although there has been an increase in the ratio of household debt to GDP, it stood at only about 22 per cent in 2012.[3]

Under these conditions, domestic financial markets have been very sensitive to movements of foreign financial flows. Although the symptoms of domestically driven classical financialisation are not very apparent, the Turkish economy has been greatly shaped by global financialisation trends. The Turkish economy has been suffering from chronic current account deficits and dependence on foreign capital for a long time. Stagnant and low investment has gone hand in hand with an increasing role of consumption. Furthermore, a declining labour share and increasing debt of households have been characteristics of the Turkish economy. All these developments in the Turkish economy seem to justify classifying the Turkish economy as a debt-led growth regime.

This study puts substantial emphasis on the role of financial flows in understanding macroeconomic developments in the era of neoliberalism.

To this end, we will first evaluate the growth pattern of the Turkish economy, as well as the role of financial flows. The second section investigates income distribution in Turkey focusing on the period after 2001. As debt-financed consumption has become a major issue in the Turkish economy in the last decade, these issues will be discussed in the third section. The implications of financialisation on real investment activities will be discussed in the fourth section. The fifth section attempts to document developments in the current account under the neoliberal regime. These discussions will be followed by a penultimate section on the implications of the recent crisis on the Turkish economy. We will conclude with some final remarks about how macroeconomic dynamics have changed in the Turkish economy since the 2000s.

12.2 THE GROWTH PATTERN AND FINANCIAL FLOWS DRIVEN CYCLES

In the early 1980s, liberalisation of foreign trade and the capital account was seen as the basis for economic growth in Turkey. The McKinnon-Shaw Hypothesis was the theoretical background of this policy change. McKinnon (1973) and Shaw (1973) suggested liberalisation of the financial markets and high returns on deposits particularly in developing countries, where the most valid saving method is bank deposits, would bring higher investment and growth. According to this view, financial liberalisation would restore growth and stability by raising savings and enhancing economic efficiency. Furthermore, many developing countries were lured by the export-led growth strategy with trade liberalisation, high subsidies to exports and increasing pressures on wages. Turkey was not an exception. However, neither the promises of financial liberalisation nor trade liberalisation were fulfilled in the Turkish case. An investigation of the main components of GDP can assist us to better understand the general picture.[4]

Turkey's economic growth and its demand decomposition in terms of main components of GDP is reported in Table 12.1. Since the liberalisation of the 1980s, the Turkish economy has aspired to achieve an export-driven growth model. However, even though the volume of trade has increased significantly, the contribution of net exports to growth has stayed negative. As discussed below, Turkish exports are highly dependent on imported energy, intermediate and capital goods. Therefore, an increase in exports has always been accompanied by an increase in imports, preventing net exports from being positive.

Chronic current account deficits have meant accumulation of liabilities which should be sooner or later paid back. Unless the current account

Table 12.1 Basic economic indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP growth rate (%)	−5.70	6.16	5.27	9.36	8.40	6.89	4.67	0.66	−4.83	9.16	8.77	2.13	4.12
Growth contributions to GDP (%)[1]													
Consumption	−4.50	3.21	6.79	7.66	5.56	3.27	3.80	−0.22	−1.57	4.72	5.31	−0.32	3.41
Investment	−5.54	2.03	3.13	5.61	3.14	3.11	0.59	−1.97	−4.44	5.41	4.40	−1.09	0.08
Government spending	−1.11	1.01	−0.95	0.41	0.99	0.91	0.85	0.60	0.76	0.91	0.41	1.02	1.61
Change in inventories	−1.06	2.10	−0.43	−1.92	0.06	−0.09	0.65	0.35	−2.31	2.50	−0.25	−1.49	1.60
Net exports	6.52	−2.19	−3.27	−2.40	−1.35	−0.30	−1.21	1.90	2.74	−4.38	−1.09	4.01	−2.57
Financial balances (percentage of GDP)													
Government		−14.43	−10.44	−4.38	−0.81	−0.69	−1.95	−2.71	−6.08	−3.44	−0.63	−1.42	−1.52
Current account balance	1.92	-0.26	−2.49	−3.62	−4.44	−6.01	−5.84	−5.52	−1.97	−6.20	−9.69	−6.15	−7.94
Private sector[1]		14.17	7.95	0.76	−3.63	−5.32	−3.89	−2.81	4.11	−2.76	−9.06	−4.73	−6.42
Real interest rate on government borrowing[1]	41.80	18.83	19.71	15.08	6.75	8.64	10.04	8.82	6.41	−0.11	2.26	−0.06	0.17
Export/Import ratio[1]	1.13	1.03	0.96	0.90	0.86	0.82	0.82	0.84	0.96	0.80	0.73	0.83	0.79

Adjusted wage share (percentage of GDP)	46.21	43.32	42.28	37.20	35.08	33.86	33.83	32.98	34.58	34.07	30.14	31.79	32.66
Household debt statistics[1]													
Interest payments household disposable income ratio			0.02	0.03	0.04	0.04	0.05	0.06	0.05	0.05	0.04	0.05	
Household debt, GDP ratio			0.03	0.05	0.08	0.10	0.12	0.14	0.15	0.18	0.19	0.21	
Household debt, household disposable income ratio			0.08	0.13	0.20	0.25	0.30	0.37	0.36	0.44	0.47	0.49	

Note: [1] Authors' estimations.

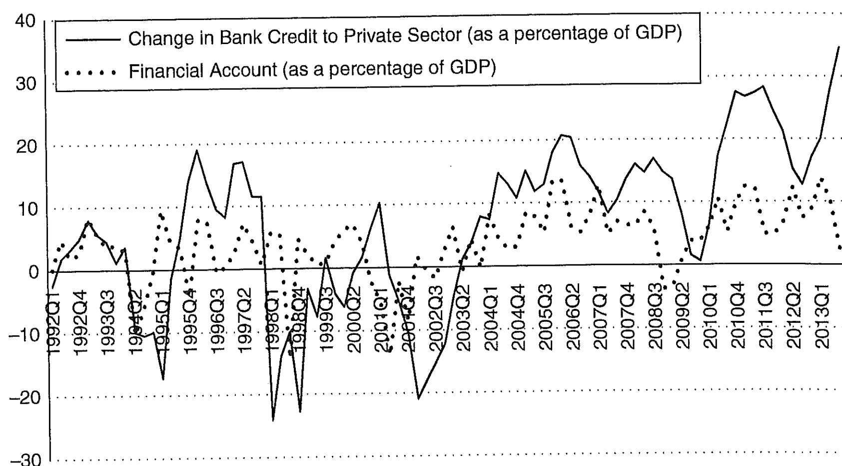
Sources: IMF (2014), TSI (2014), European Commission (2015) and CBRT (2006, 2008, 2010, 2011, 2013).

balance is improved, debt servicing capacity of developing countries would be vulnerable to sudden stops or reversals in financial flows. With declining demand from developed countries in a deep recession as in the case of the recent global crisis, the limitations of the export-led growth strategy become even more obvious.

Private consumption has been a major demand-generating force of the Turkish economy, with the exception of economic crises. The contribution of investment demand to the growth of Turkish GDP has been erratic and cannot be a match to that of private consumption. In the last three crises of 1994, 2001 and 2008–9, a sharp negative movement in investment expenditures is very apparent.

The contribution of government spending to economic growth has been limited. The high government debt stock and debt servicing have put an enormous burden on the government budget and forced the government to cut its expenditures significantly from time to time. The Turkish government followed tight budget policies especially in the midst of the crises of 1994 and 2001. Following the 2001 turmoil, due to the structural reform program implemented under the auspices of the IMF, contribution of government expenditures to GDP growth remained very low if not negative.[5] The government followed a relatively expansionary policy during the last crisis. However, this did not prevent the economy from experiencing one of the worst crises in its history. The contribution of consumption and investment to GDP growth turned negative in late 2008 and 2009; yet, the Turkish economy quickly recovered in 2010. Monetary and fiscal policy measures had limited impacts and the quick return of foreign capital in the form of short-term flows in 2010 was mainly responsible for this recovery.

Domestic expenditures have traditionally been higher than total income in Turkey. This has caused an accumulation of external and internal liabilities in the balance sheets of the private sector. The financial balances of the private sector have been negative for a long time (Table 12.1). In other words, the growth of demand of households and firms depended on their borrowing activities. As it will be further evaluated in the next section, the adjusted wage share declined in the 2000s (Table 12.1). As a result, consumer debt increased in this era as discussed below. Similar to households, firms benefited from decreasing interest rates and bank loans became the major source of funding for NFCs after the crisis of 2001. The profitability of NFCs declined with the 2001 crisis. Even after the recovery, it could never reach the pre-crisis levels (Bahçe et al. 2015). And similarly, fixed investment expenditures and tangible fixed assets to total assets ratio of NFCs could never return back to the pre-2001 levels.

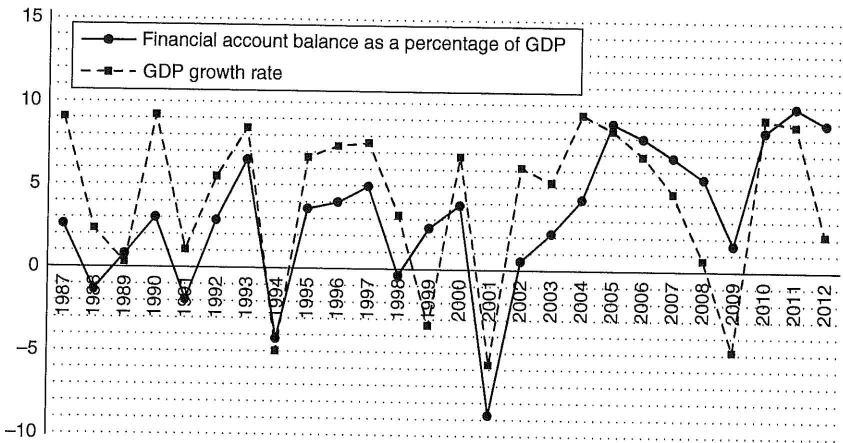


Source: Estimated from the Central Bank of the Republic of Turkey Statistics (2014).

Figure 12.1 Financial flows and domestic bank credit to private sector

The borrowing of the private sector increased considerably. Low interest rates due to capital inflows and a declining wage share strengthened this tendency. In this era, capital inflows have been a major driving force of credit expansion in the Turkish economy and as shown in Figure 12.1, there is a clear association between capital inflows and domestic credit expansion. Financial flows have dominated the course of the current account through their impacts on credit.

As a result of these developments, capital flows have dominated the growth process of the Turkish economy in the post-liberalisation period (Figure 12.2). Since the completion of external financial liberalisation in 1989, the Turkish economy has been subject to a series of financial shocks and crises, mostly associated with boom-bust cycles of the capital flows. Booms have generally been driven by an increase in capital flows; and when the flows declined, the process was reversed causing a parallel decline in domestic demand. In this sense, throughout the period, the correspondence between financial flows and growth of the economy has increased. The simple correlation between net financial flows and economic growth has been found to be 0.45, 0.66, and 0.75 for the periods of 1980–9, 1990–9, and 2000–12 respectively. The post-1990 years exhibit four downturns (1994, 1999, 2001 and 2009). In all these four crises, a sudden stop of capital inflows and/or a decline in export revenues triggered the collapse.[6]



Source: Estimated from the Central Bank of the Republic of Turkey Statistics.

Figure 12.2 Financial flows and economic growth (%)

12.3 INCOME DISTRIBUTION

The macroeconomic conditions and economic policies after 2002 had profound effects upon income distribution; and at first glance, according to household data, there seems an improvement in income inequality in the early 2000s. However, the share of wages in total income has decreased in the same era. Beside this, increases in consumption especially among lower income groups could not be matched by increases in their incomes. As a result of this, lower income groups in particular have relied on borrowing (Bahçe et al. 2011).

Table 12.2 indicates that the share of the highest quintile decreased from 2002 to 2007, then rose in 2008 and 2009.[7] The losses of the highest quintile seem to be the gain for all the remaining quintiles. Without any exception, the shares of the other four quintiles increased between 2002 and 2007. Nevertheless, in 2008 (the year of global crisis) and 2009 (the year in which contagion effects of the global crisis were felt to the utmost degree in Turkey), this trend was reversed. The share of the highest quintile rose again while the shares of the others decreased.

The last two columns in Table 12.2 show the change in Gini coefficients.[8] Both Gini coefficients declined until 2007, and then increased between 2007 and 2009; after this year they both declined again. Our estimation of the Gini coefficient has always been higher than the official one except for 2006. The highest values for the coefficients were observed at the beginning

Table 12.2 The distribution of household disposable income by quintiles (per cent)

	Quintiles							
	1	2	3	4	5	P5/P1	Gini	Gini_TSI
2002	6.46	11.12	14.83	20.35	47.24	7.32	0.46	0.44
2003	7.13	11.68	15.36	20.63	45.19	6.34	0.43	0.42
2004	7.26	11.98	16.34	21.43	42.99	5.92	0.41	0.40
2005	7.27	12.78	16.74	22.24	40.96	5.63	0.40	0.38
2006	7.80	13.27	16.66	21.88	40.40	5.18	0.39	0.40
2007	8.03	13.16	16.86	21.85	40.10	4.99	0.38	0.39
2008	7.73	12.60	16.72	22.09	40.86	5.28	0.39	0.39
2009	7.09	12.61	16.54	21.49	42.27	5.96	0.41	0.39
2010	7.85	13.03	16.45	21.65	41.02	5.22	0.40	0.38
2011	7.66	12.75	16.53	21.88	41.18	5.38	0.40	0.38

Sources: Authors' calculations from HBSs, except for Gini_TSI. It is the official estimate of the Turkish Statistical Institute. The figures for Gini_TSI are from two different surveys. The figures for the period 2006–2011 are the results from *Income and Living Conditions Surveys, 2006–2011*. The figures for the period 2002–2005 are from *Household Budget Surveys, 2002–2005*.

of the period, as these were the years of slow recovery from one of the worst crises of Turkey. According to our calculations, the Gini coefficient dropped from 0.45 in 2002 to 0.39 in 2011. However, despite the improvement in the period, Turkey has the third worst income distribution among OECD members (following Chile and Mexico) (OECD 2013).

These Gini coefficients are estimated from household surveys; but macro level data, e.g. functional income distribution, can give different information on inequality. GDP figures estimated through an income approach are more likely to provide a complete view of the functional income distribution since this measure also incorporates retained profits.[9] The changes in the adjusted wage share are reported in Table 12.1, and as the figures indicate the wage share decreased throughout the 2000s until Turkey was hit by the financial crisis in 2009.[10]

12.4 FINANCIALISATION AND CONSUMPTION

Private consumption has become a key driver of Turkish economic growth over the last decade, and household borrowing played an important role in this process. Accordingly, the share of private consumption in GDP

rose from an average of 68 per cent in the 1990s to 71 per cent in the post-2001 crisis era. Between 2002 and 2007, private consumption contributed 5.2 per cent to Turkey's average GDP growth rate of 6.8 per cent. Like many East Asian and Latin American countries, in Turkey, consumer credit stimulated consumption in the late 1990s and early 2000s (IMF 2006; Hanson 2005). According to Banking Sector Regulation and Supervision Agency (BRSA) statistics, the ratio of consumer loans and credit card expenditures to consumption of resident households increased from 3 per cent in 2002 to 31 per cent in 2013, demonstrating the increasing penetration of credit into the daily lives of people.[11]

This rising use of credit to finance consumption has been accompanied by a remarkable decline in private savings, which has reached its lowest level since 1998. According to the data from the Ministry of Development, the private saving ratio as a share of GDP declined from 25.7 per cent in 1998 to 12 per cent in 2012 (Karacimen 2014). The data breakdown of private savings by corporate and household sectors is not available. Nevertheless, according to the estimations of Van Rijckeghem and Üçer (2009), household savings as a percentage of household disposable income fell from 17 per cent in 2004 to 8 per cent in 2008. More recent data from the Central Bank shows that from 2008 to 2012, household savings fell further to 7.3 per cent in 2012 (CBRT 2013). As a result, consumption grew faster than income, and households, especially from low income groups, resorted to borrowing for further consumption (Bahçe et al. 2015). However, increases in borrowing activities were not limited to consumption, as housing loans also increased in this era (Karacimen 2014).

Although household debt levels increased, they are still low in comparison with that of developed countries. As argued throughout this chapter, financial markets are relatively shallow in Turkey, a phenomenon that is also valid for the consumer credit market. Household debt, as a percentage of GDP, increased from 3 per cent in 2002 to 21 per cent in 2012 (Table 12.1). Strikingly, household debt reached 49 per cent of disposable personal income in 2012, implying a seven-fold increase since the end of 2003.[12] Along with the rising debt, the burden of debt servicing increased as well. The share of interest payments in the disposable income of households increased from 2.2 per cent in 2003 to 5 per cent in 2012 (Table 12.1), indicating increasing transfers of household income to the financial sector. Higher interest rates on consumer debt relative to other debt instruments, especially on credit cards, were important determinants of the rise in Turkey's consumer debt service burden. In response to rising public discontent against high interest rates on credit cards, there were significant interest rate cuts after 2006. Although the interest rates fell, the rising debt levels led to a rise in the debt service burden in the upcoming years.

Throughout this period, banks have increasingly turned towards providing consumer credit as an alternative way of making profit. The share of consumer loans in total banking sector loans increased remarkably, rising from 13 per cent in 2003 to 34 per cent in 2012 (Karacimen 2014). One of the key questions that needs to be addressed related to the rising usage of consumer credit is whether this increased access is accompanied by a rise in asset holdings of households. However, the rise in financial wealth is rather weak. Indeed, in Turkey the rise in household financial assets is well below the rise in household liabilities as evident in the sharp increase in the household leverage ratio, as seen in Table 12.3 below.

The table shows that households hold their financial assets mostly in deposits. It is striking to see that while the importance of deposits has declined in many countries in the age of financialisation, the opposite has been the case in Turkey. The total share of domestic and foreign currency deposits increased from 64.3 per cent in 2003 to 70.8 per cent in 2012. Another important observation is that, together with the introduction of the private pension system in 2003, there has been a steady, albeit small, increase in the share of private pension funds in household portfolios. On the other hand, there has been a decline in the share of government

Table 12.3 Composition of household financial assets in Turkey (per cent)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
TL deposits	29.1	33.3	41.2	40.6	45.5	51.2	49.9	52.7	51.9	50.7
FX deposits	35.2	32.2	27.2	26.8	25.0	24.2	23.3	20.1	20.6	20.1
Currency in circulation	6.4	6.5	8.3	8.8	8.4	8.3	8.4	9.3	9.1	9.0
Government securities and Eurobond	22.4	20.5	14.8	10.1	6.3	5.3	3.3	2.0	1.9	1.0
Mutual funds	n.a	n.a	n.a	6.3	7.2	5.6	6.2	5.9	4.7	4.3
Stocks	5.1	6.5	7.1	5.6	5.6	2.9	5.9	6.8	5.5	6.3
Private pension funds	0.0	0.2	0.5	1.0	1.5	1.7	2.1	2.5	2.6	3.4
Repos	1.78	0.8	0.7	0.7	0.6	0.6	0.5	0.3	0.3	0.6
Precious metal deposits	n.a	n.a	n.a	n.a	0.0	0.1	0.3	0.5	2.5	2.9
Total assets (billion TL)	157.6	190.5	219.5	279.7	313.6	368.3	420.4	481.7	543.2	605.1
Household liabilities / assets (per cent)	8.5	14.8	22.2	26.3	33.2	35.0	35.1	39.7	46.3	49.4

Sources: CBRT (2006, 2008, 2010, 2011, 2013).

securities and Eurobonds, due to their declining yields. Overall, it can be seen that the remarkable increase in financial liabilities is not matched by a corresponding increase in the asset holdings of households in Turkey. Furthermore, there is no major shift in household portfolios towards riskier asset types, suggesting that the financialisation of household balance sheets has mainly taken place through a rise in liabilities. As a result, the household leverage ratio increased from 8.5 per cent in 2003 to 49.4 per cent in 2012, as can be seen from Table 12.3.

In sum, the analysis of the household dynamics in Turkey indicates that financialisation of household balance sheets is not comparable with that of developed countries. The most outstanding observation is the rapid rise in household debt levels over the last decade, albeit from a low basis. However, it is unquestionable that the rising debt levels put a considerable burden on households through a rise in their debt stock and debt service burden. As the rise in financial assets does not show a similar increase, the burden of increased debt levels does not seem to be compensated by a rise in gains from asset acquisition.

12.5 FINANCIALISATION AND INVESTMENT IN CAPITAL STOCK[13]

In the financialisation literature, most of the studies focused on advanced economies, looking at the changing relationship between NFCs and financial markets in the last couple of decades. These changes are twofold: On the one hand, nonfinancial corporations began increasing their acquisition of financial assets and deriving an increasing share of their income from financial sources. On the other hand, the management of nonfinancial corporations came under increased pressure from financial markets to maximise shareholder value, which led to increased payments to financial markets in the forms of interest payments, dividend payments and stock buybacks (Crotty 2003; Stockhammer 2004; Orhangazi 2008). These studies argue that the changes in the relationship between financial markets and NFCs had a negative impact on the levels of investment.

A number of recent studies examined similar issues for the case of Turkey. Demir (2007) in a cross-country study including Turkey suggested that financial liberalisation led to a channelling of nonfinancial sector savings to speculative short-term investments instead of long-term investment projects and this has changed the pattern of nonfinancial corporate sectors' capital accumulation. In a study on the investment and saving behaviour of nonfinancial corporations, Özmen et al. (2012) argued that in Turkey the financial sector remains limited in mobilising funds for firms

that are dependent on external financing for investment. However, they have not analyzed to what extent corporations use their internal savings for investment in fixed capital as opposed to financial investments. Gezici (2007) examined the effects of financial liberalisation on the investment decisions of manufacturing firms in Turkey. She contended that:

> (the) negative impact of uncertainty on investment is worsened under financial liberalisation, while there is no evidence of declining importance of liquidity. Overall, results suggests that financial reform policies did not lead to expected benefits for the investment of real sector firms while producing increased uncertainty that impedes investment further.

Akkemik and Özen (2014) observed that nonfinancial corporations in Turkey have shifted significant amounts of working capital from productive activities to the acquisition of high-yield interest bearing assets in an effort to gain short-term interest revenues and argued that they have done so as a response to highly uncertain macroeconomic conditions.

In terms of financialisation, it should be mentioned that stock market capitalism is relatively undeveloped in Turkey, since shareholder activism is very limited, corporations are still controlled by large groups, stock buybacks were not allowed (until very recently), and most corporations are organised as holding companies which also include affiliated banks (Demirag and Serter 2003).

The Company Accounts of Turkey (CBRT 2014) covers the aggregate data on NFCs for the period 1997–2012 and this data set is used in order to evaluate the impacts of financialisation in Turkey.[14] Gross fixed capital formation as a percentage of GDP, in this era, has oscillated around 20 per cent except during recessions and the following years. The profitability of NFCs experienced a decline in the 2001 crisis, it recovered in the following years but could not reach pre-crisis levels, and the profit before tax to equity ratio oscillated around 11 per cent. On the liability side, the leverage ratio, defined as total loans as a percentage of total assets, declined significantly following the 2001 crisis; and bank loans have constituted more than 40 per cent of total loans to the NFCs at the end of the period, showing that bank finance is an important channel for NFCs. In terms of financial activities, financial incomes as a percentage of operating profits significantly declined starting in 2000; it had reached a remarkable rate of 74 per cent by 1999, yet levelled around 25 per cent after the decline. During the 1990s, government bonds used to be the main sources of financial income for NFCs as the yields on these bonds were very high. However, as interest rates of these assets declined this type of financial revenue source dried up.

In conclusion, we make a couple of complementary observations about NFCs in Turkey. First, a hallmark of financialisation in advanced

economies has been the increase in payments to the financial markets, especially in the form of dividends and stock buybacks. For the Turkish NFCs, dividend data is limited in our database. However, due to the institutional differences, stock buybacks were not possible until very recently. Shareholder pressure was also not visible as shareholder activism has been limited. This is a major institutional difference. Second, bank financing is still a very important channel. Third, there is an increase in financial asset holdings, although financial incomes are declining in the post-2001 era. This is partly due to declining interest rates especially on government bonds. In the pre-2001 era, Turkish NFCs were earning high short-term interest revenues through investments in government bonds. Overall, the framework based on classical financialisation literature derived from the experiences of advanced countries would not easily account for the stagnant nature of investment in Turkey, though high volatility in financial flows might contribute to this trend by increasing uncertainty in the economy.

12.6 CURRENT ACCOUNT BALANCE OF TURKISH ECONOMY

The Turkish economy has been suffering from chronic current account deficits for decades, and these deficits have grown in size in the 2000s and 2010s. The recession of 2009 led to a contraction in the current account deficit, however, unlike previous recessions, the current account still remained in deficit. The current account deficit as a percentage of GDP reached a record level of 9.7 per cent in 2011 and 7.9 per cent by the end of 2013 (Table 12.1). Chronic and large current account deficits render the economy vulnerable to slowdowns in capital inflows, which could create problems in terms of financial stability and economic growth.

Various explanations have been put forward to explain the chronic and large current account deficit of the Turkish economy. Two dynamics behind those deficits can be identified (Bahçe et al. 2015). The first one is the structure of Turkey's trade with the rest of the world and the composition of exports and imports. Turkey imports large amounts of energy items, intermediary and capital goods, while it exports, to a large extent, relatively low-value added products. The second one is the impact of capital inflows. Capital inflows have direct and indirect effects on the current account deficit. The direct effect is through the exchange rate. Periods of large capital inflows coincide with the appreciation of the domestic currency, which leads to increasing imports while holding back export growth. If the opposite was true, that is if a current account deficit

was the cause of capital account inflows, then rising deficits should lead to a depreciation of the local currency and/or rising interest rates. Yet, the Turkish economy experienced both currency appreciation and declining interest rates in this era of widening current account deficits. The indirect effect of capital inflows on the current account deficit works through the domestic dynamics of the economy. Large capital inflows lead to an expansion of domestic credit, increased asset prices, and decreased interest rates. As a result, domestic economic activity increases and, given the high import content of domestic production, this leads to an increase in imports of both consumption goods and investment goods (energy, intermediary goods, and capital goods) imports.[15]

For the first dynamic, the details of the current account balance provide very insightful information. First of all, even though the volume of foreign trade has increased since 2001, the export-import ratio declined to its lowest level (79 per cent) by 2013 (Table 12.1, and TSI 2014). Secondly, contrary to common fallacy, intermediate and capital goods, not consumption goods, have the largest share in Turkish imports. Intermediate goods and capital goods have constituted 70 per cent and 20 per cent of all imports, respectively, on average since 1989 (TSI 2014). In a different classification of total imports, energy items such as oil and natural gas accounted for 25 per cent of all imports on average in the 2000s and 2010s (TSI 2014). Thirdly, as regards the export side of the economy, Turkey has managed to update its product variety so as to adapt itself to changes in the product composition of developing economies. However, the rank of the Turkish economy in the global production value-chain has not changed since the 1950s; Turkey could not improve its rank in international markets, yet it could keep its position (Taymaz et al. 2011). Even though Turkey managed to transform its production base, the export sector specialised in mid-level technology products with relatively low market growth potential (Taymaz et al. 2011).

The structure and composition of exports and imports can explain why the Turkish economy has experienced chronic current account deficits for a long time, but to explain the growing deficit in the 2000s and 2010s we need a further elaboration of the second dynamic; i.e. the role of capital flows. The dynamics of capital inflows to Turkey are related to changes in the global economy. According to Boratav (2010, p. 24), as US current account deficits started to grow in the late 1990s, many developing economies benefited from rising current account surpluses. However, a small group of developing countries took a different path and benefited from rapid growth through foreign capital inflows in the 2000s; these economies were Eastern European economies, Turkey, South Africa and some of the Latin American economies. In this respect, financial liberalisation changed the causality between current account deficits and capital flows (Boratav

2010, p. 25). Before liberalisation, economic growth was responsible for the rise in imports and current account deficits, and thus the need for foreign capital inflows through foreign debt. However, in the era of financial liberalisation, capital flows have become *autonomous* from the current account as these flows are determined by the international financial system. It can be argued that these flows are determined by global liquidity and search for yield not by the size of Turkish current account deficit.

Capital flows lead to economic growth mainly through three channels in the Turkish economy:[16] First, capital inflows lead to credit expansion, which increases demand, consumption and imports (and hence contribute to the current account deficit). Second, capital inflows lead to appreciation of assets, especially the stock market index. Third, periods of surges in capital inflows are associated with appreciating currency and thus by making imported capital goods cheaper contributes to increased investment. As a result domestic economic activity increases. Moreover, lower interest rates also gave a further stimulus to overall economy. Thus, a surge in foreign capital boosts domestic demand and economic growth (of excess capacity), and these developments give way to a rise in imports and current account deficits (Boratav 2010, p. 25).

As foreign debt constituted most of the capital inflows to the Turkish economy (Bahçe et al. 2015), a chain-reaction emerges out of these developments: greater capital inflows will be needed for further economic growth in the following years (BSB 2008, pp. 131–132). Thus, the fate of the Turkish economy, similar to other fragile economies, is directly linked to global interest rates and credit conditions. A stress in these areas can send shockwaves to the Turkish economy as experienced in 2009 and again briefly in the summer of 2013. The main fragility here is that the Turkish economy not only needs uninterrupted capital inflows but also greater amounts compared with previous years for economic growth (BSB 2008, p. 132).

12.7 THE RECENT CRISIS AND THE TURKISH ECONOMY

Along with massive financial flows related to the mainly positive global outlook, the Turkish economy experienced its Great Moderation from 2002–8 with high growth and low inflation, although the problem of high unemployment could not be addressed. However, the global financial crisis ended this honeymoon, and the Turkish economy fell into a significant recession.

Although the crisis began in advanced economies, it quickly spread all

over the world and caused negative GDP growth and significant increases in the unemployment rate in Turkey and in many other developing countries. Turkish GDP growth began to decline in the third quarter in 2008 and the fall continued until the third quarter of 2009. The Turkish economy experienced 0.7 per cent annual real GDP growth in 2008. In 2009, GDP shrank by −4.8 per cent. Indeed, the Turkish economic performance was one of the worst in the world in this period. Excluding small economies from the sample, Turkish economic performance was better than just a few ex-Eastern bloc countries and raw material exporters. The negative growth performance of the economy deteriorated the already weakened employment conditions further. As a result, the unemployment rate rose to record levels of 15.0 per cent in April 2009. The capacity utilisation rate in the manufacturing sector declined from 80 per cent to about 60 per cent in 2009. Overall, economic growth significantly deteriorated and the economy experienced one of its worst recessions since the Second World War.

The initial impact of the crisis took place through declines in consumption and investment spending due to the worsening expectations of investors and consumers. The contraction of consumption was larger compared to the 2001 crisis (Cömert and Çolak 2014). The negative growth of investments lasted for seven consecutive quarters. This investment shock was as large as the shock during the 2001 crisis. Similar to consumption and investment, exports also declined during the global crisis as demand from the EU largely stopped. While exports had increased during the 1994 and 2001 crises due to large depreciations of the Turkish Lira, export earnings in 2009 declined by 20 per cent (Cömert and Çolak 2014). The contribution of the fall in exports to the negative GDP growth of 2009 was around 25 per cent and the fall in exports to Europe explains directly about 20 per cent of the recession in 2009. Similar to many other developing countries, Turkey did not experience a financial system collapse during the global crisis. And, relative to the 1994 and 2001 crises, the financial system of Turkey recovered from the global crisis very quickly. While 18 banks went bankrupt during the crisis of 2001, no single bank collapsed during the global crisis. Moreover, the profitability of the banking sector did not even decline and their capital to asset ratios further increased during the global crisis (Uygur 2010).

According to the literature, developing countries owe the resilience of their financial systems to large accumulated reserves, flexible exchange rate regimes, financial stability policies, and banking reforms (Ammer et al. 2011; Llaudes et al. 2010; Alvarez and Gregorio 2013). Although these factors might have mitigating roles, we believe that the Turkish financial system was not substantially tested in the global crisis. Since

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Turkish financial markets were not exposed to toxic assets of the advanced countries, there was no direct deterioration of balance sheets. Even though financial flows declined in 2008 and 2009, in comparison to earlier crises, there was no reversal of capital flows and they returned quickly to pre-crisis levels after 2009 (Cömert and Çolak 2015).

The authorities adopted a wide range of policy measures in order to mitigate the impact of the financial crisis, despite criticisms that they were too late to respond.[17] These measures might be grouped into three categories: monetary responses, fiscal policy measures, and financial sector measures.

The Turkish monetary responses to the crisis preceded the fiscal actions starting in the first half of 2008. The primary objectives of monetary policy during this period were to stabilise inflation and to meet the FX demand (to ease the pressure on the exchange rates) and TL liquidity needs of the private sector. In the initial phase of the crisis, the Central Bank of the Republic of Turkey (CBRT) did not adapt an expansionary stance until November 2008. In this period, the measures taken by the Central Bank were mostly concerned with inflation and financial stability without much emphasis on growth and unemployment issues. When Lehman collapsed in the third quarter of 2007, it was apparent that a plunge in aggregate demand and recession was looming for advanced countries. Hence, these countries significantly cut their policy rates. In contrast, the CBRT took a tightening stance in this period and did not cut its rates. Indeed, it even increased the policy rates further in the second quarter of 2008. Nevertheless, when the inflation pressure abated in the last quarter of 2008, monetary policy was relaxed significantly with a cutting of policy rates by 10.5 basis points in 11 months from November 2008. Moreover, considering the threat of short-term volatile cross border flows, the Turkish monetary authorities started implementing a nonconventional monetary policy in 2009. In addition to the conventional inflation targeting regime, the CBRT targeted financial stability as another objective and utilised nonconventional policy instruments with particular emphasis on credit expansion and exchange rate volatility (Kara 2011). Several macro prudential measures have been taken as well.

Compared with advanced countries and many other emerging market countries, the Turkish government was slow and reluctant in its fiscal response to the crisis. For example, while the advanced countries decided to implement huge stimulus packages in the second quarter of 2008, the first significant fiscal measures by the Turkish government were only taken in the first quarter of 2009, when the crisis had already affected the Turkish economy.[18]

Besides fiscal and monetary authorities, BRSA adapted measures specifically geared towards financial sector stability and the health of bank

balance sheets. In order to tighten liquidity conditions some balance sheet adjustments were made. In particular, the amount of provisions set aside for loans was reduced and the calculation of liquidity adequacy ratio was adjusted downward. Furthermore, in order to strengthen the capital structure of the banking sector, profit distributions to shareholders were limited and only allowed under the control of BRSA. Also, to decrease the amount of risky assets, the risk weights on credit card usage were raised. Finally, in coordination with the Central Bank, a wide range of debt relief regulations were put into practice.

12.8 CONCLUSION

Capital account and domestic financial liberalisation of earlier decades increased the importance of financial markets, yet the Turkish financial markets still remain shallow relative to those in developed countries. Financialisation in the form of non-financial firms' activities in financial markets did not take place, and domestic financial markets are still dominated by the banking sector. However, the financialisation process is not non-existent, and it is dominated by international financial flows; and economic growth has been very erratic under the influence of such flows.

During the 2000s and 2010s, private consumption has been the main contributor to economic growth. Although investment has partially contributed to the growth of the economy, investment expenditures have been much more volatile than consumption, as expected, aggravating the size of the growth cycles. Since 2005 the government budget showed a primary surplus (Hazine 2015) and the financial balance of the government sector remained less than 3 per cent of GDP with the exception of 2009. And together with chronic current account deficits, this development meant rising liabilities, usually in the form of debt accumulation, for the private sector. Benign conditions in the international capital markets reinforced this trend again with the exception of 2009. In the light of these developments, a declining labour share and increasing debt of households justify labelling the structure of the Turkish economy as a debt-led growth regime based on the classification of Hein (2013) and Dodig et al. (2016).

These developments also had implications on the income distribution in Turkey after 2001. Even though an initial analysis shows a decline in income inequality between 2002 and 2011, an analysis of the functional income distribution indicates a reduction of the wage share throughout the period. Consumption spending rose while the wage share declined and income inequality worsened; these developments might also have reinforced households' indebtedness.

The global economic crisis hit Turkey in late 2008 and 2009, yet the economy returned to pre-crisis patterns as capital flows resumed after 2009. Unlike in many developed economies, the banking sector was not seriously affected as banks did not have US or European toxic assets in their balance sheets. Beside this, there was no reversal of capital flows and they returned quickly to pre-crisis levels. The crisis hit Turkey through deteriorations in expectations, trade and financial activities.

Declining wage share, household indebtedness, the importance of consumption for economic growth and chronic current account deficits have been major points of weakness for the Turkish economy throughout this era. And the availability of foreign capital only exacerbated these problems as policy-makers and their voter constituents did not have incentives for any major economic changes. As Akyüz (2012, p. 89) has noted, financial flows to developing countries 'has been creating or adding to macroeconomic imbalances and financial fragility in several recipient countries in large part because they have been shy in applying brakes on them'. Our analysis suggests that Turkey is a case in point. The biggest concern is the large current account deficit and the short-term and volatile nature of capital inflows; and if these flows are ever reversed in the future, the Turkish economy has no cover or limited countercyclical policy tools against such events.

NOTES

1. Bedirhanoğlu et al. (2013). Comparative Perspective on Financial System in the EU: Country Report on Turkey, FESSUD Studies in Financial Systems No. 11, http://fessud.eu/deliverables/, provides an overview of the economic and social developments in general, and the financial system in particular since 1980. Henceforth this study will be referred to as FESSUD Turkey Country Report WP2.
2. The Turkish and the Mexican Tequila crises of 1994, the East Asian crisis of 1997, the Brazilian and Russian crises of 1998, the Turkish crisis of 2001 and Argentinian crisis of 2001–2002 can be counted among the major crises in developing countries.
3. Although a growing problem of household indebtedness is evident from the rising ratio of household obligations to household disposable income, which increased from 7.5 per cent in 2003 to 51.7 per cent in 2011, the indebtedness is still low relative to that of advanced countries.
4. One should be careful in investigating the contributions of different demand components to GDP growth. Since each of these components can be considered as endogenous variables, the determination of direct and indirect contributions of each demand component to GDP is much more complicated.
5. For details see FESSUD Turkey Country Report WP2.
6. For details see FESSUD Turkey Country Report WP2.
7. The data set is obtained from the Household Budget Surveys (HBSs), which have been annually conducted by the Turkish Statistics Institute (TSI) since 2002. Household Survey Data is only available after 2002.
8. There are two different Gini coefficients here. One is from our own calculations;

the second one is the official Gini estimate by the TSI. We included these two measures as there is an important difference between these two. The official one assumes homeowners have an extra income called *imputed rent*. This is the amount of rent they would have paid if they did not own a house or apartment. And thus TSI adds the amount of *imputed rent* to the homeowners' income and then estimates the income distribution. In our own Gini estimations we omitted this *imputed rent*.

9. The former covers only the household income and does not include undistributed profits of firms. On the other hand, the denominator in the wage share incorporates undistributed profits. When this last item is included, the course of the wage share radically changes. This change casts doubt upon the analytical validity of the size distribution analysis.
10. The wage share is defined as the ratio of total compensation of employees – adjusted with the wage component of self-employment income – to GDP. TSI stopped providing GDP at income approach series in 2006. In order to fill the gap we used the data provided by the Annual Macro-Economic Database (AMECO) of the European Commission.
11. https://www.bddk.org.tr/websitesi/English.aspx.
12. It is important to insert a caveat here. Private disposable income data is estimated either through macro aggregates or Household Budget Surveys released by the TSI. It is well known that there is a discrepancy between the two data sets. This mainly derives from an implicit tendency of households to under-declare their incomes. Disposable income data in Table 12.1 comes from the Household Budget Surveys. Therefore household debt to disposable income ratios in the figure might be higher than actual ones. Nevertheless, the ratios are still important in showing the remarkable increase over a short period of time.
13. For an extensive version of the debate on financialisation in Turkey, see FESSUD Turkey Country Report WP3.
14. For details see FESSUD Turkey Country Report WP3.
15. For details see FESSUD Turkey Country Report WP3.
16. For details see FESSUD Turkey Country Report WP3.
17. A relatively detailed analysis of the policy responses can be found in Bahçe et al. (2015).
18. Several reports by the OECD and the IMF reveal that Turkey was among the slowest respondents in terms of fiscal stimulus compared with other countries. Besides the slow response, costs comparisons reveal that the costs of adopted fiscal measures as a ratio of GDP were among the lowest among countries. An OECD report (2009) identifies Turkey and Greece as the only two OECD economies having no fiscal stimulus package until March 2009. An IMF report (2009) on G20 economies' fiscal measures in crisis demonstrates that while the average cost of fiscal measures already amounted to 0.5 per cent of G20 GDP, Turkey did not announce any measure in 2008. And the costs of discretionary fiscal measures enacted in 2009 in Turkey were among the lowest in G20 economies and far below the G20 emerging markets average.

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