Topics in Middle Eastern and African Economies
Proceedings of Middle East Economic Association
Vol. 23, Issue No. 1, May 2021

The Political Anatomy of Economic Crises –the case of Turkey

Hurşit Güneş[1]

Abstract

The foundations of economic and financial crises are conventionally attributed to the technicalities of macroeconomic fragilities. Yet political instability (caused by the deficiency of democracy and/or unfunctional political institutions) can also be considered as a major determinant of economic instability by deteriorating the debt dynamics through depreciation of the national currency or the ascent of interest rates. Analogously, political instability, for instance, disruption of cabinet durability, to a large extent depends on the economic performance of governments. Hence, though most economists conceive macroeconomic fragilities as *the mother of all* crises, the issue is rather complex and there is an intermingled relationship between political and economic crises.

Besides, as macroeconomic fragilities or structural imbalances are results of inappropriate policies, the political rationale and the social motives that lead to such policies should also be well comprehended. Such an elaboration will enable the negation of the dominant argument that it is only economic factors that instigate crises.

This study investigates the political background of eight economic crises in Turkey, since 1946. It is observed that in all of them, significant levels of devaluation are observed, and retraction of growth is experienced. All of the devaluations were indispensable, except the first one in 1946 which was discretionary and precautionary. The crises of 1978/9, 1994 and 2001 ended with drastic austerity programmes, albeit the others, where governments refrained with macroeconomic adjustment through fiscal and monetary measures. The 2001 twin crisis was so peculiar, as it was to a large extent a result of the design-defection of the programme which was recommended by the IMF. Yet, since the attempt of financial liberalization, all of the other economic crises were prompted by capital flights. The 2008/9 crisis was due to global contagion and the 2018 crisis was caused by the tensions in the bilateral relations with the US, amid high private sector foreign debt. In all economic crises, the profligate fiscal stance of governments has played a prominent role, as well as the maintenance of appreciated exchange rates, but such choices had a political rationale. Finally, in the background of all the economic crises in Turkey, we observe stern political instability, especially since financial liberalization.

Political instability not only restricts the rational decision-making capacity of the policymaker, especially if it converges into a political crisis, but also exacerbates economic sentiment, either by consumer confidence or by investor appetite, which subsequently results in economic decline. It also intensifies risks and causes exchange rate depreciation as well as interest rate hikes, both of which degenerates debt dynamics. Since the financial liberalization attempt, as portfolio investments have boosted, political stability has become imperative to sustain the stability of risk-sensitive financial markets. Both the experience of the 2008/9 and especially the 2018 financial crisis, have verified the importance of political instability as a determinant of economic crises. In short, economic crises cannot be analysed disregarding their political anatomy.

Keywords Political crises economic crises· emerging market democracy

[1] Marmara University, Department of Economics, İstanbul
E-mail: hursit@marmara.edu.tr.

1. **Introduction**

Economic crises have political implications as well as political crises having economic foundations. Furthermore, crises cannot be conceived as simple or uniform phenomena. They are complex and they are also intermingled with each other. The economic foundations of political crises have long been discussed in numerous academic studies, generally by political scientists. Yet the political implications of economic crises have seldom been analysed by economists[2]. Economists have rather focused on the macroeconomic fragilities as the principal causes of economic crises, disregarding all other factors as minutiae. The purpose of this study is thus to challenge this conventional, and in a sense parochial, approach and to elaborate the political and social implications of economic crises with a synopsis of the Turkish economy.

1. The Political Foundations of Economic Crises and their Consequences

The political background of economic crises can be conceptualized within two dimensions. Firstly, if macroeconomic fragilities, that are incurred by *misleading policies*, are the principal causes of economic crises, then the social and political factors that accrue those misleading policies should be investigated. Secondly, there are also direct mechanisms, like political instability, which may exacerbate economic crises. Let us start with the first dimension.

Nelson (1990) argues that the economic policy prescription of countries shows diversity depending on the social factors like the rate of population growth, the share of the urban population, the entity of agricultural population, life expectancy, infant mortality and the proportion of secondary education. Acemoglu et.al. (2003) attributes poor macroeconomic policies to weak (or extractive) institutions in the sense that they do not constrain politicians and political elites for enforcement of property rights for investors, combat widespread corruption, and finally alleviate the high degree of political instability. Furthermore, they contend that macroeconomic problems, just like volatility and the disappointing macroeconomic performance of several countries, are symptoms of deeper institutional causes. Van Rijckeghem and Weder (2008) refer to the importance of political institutions with respect to debt crises. They conclude their empirical analysis by arguing that political institutions matter in defaults on both external and domestic debt obligations. In democracies where there is a parliamentary system with sufficient checks and balances, there is a guarantee against the risk of default on external debt due to the sufficiently strong economic fundamentals or liquidity. In dictatorships, however, this only rests on high stability and tenure.

The relationship between economic crises and democracy as a political structure has been analysed earlier by Remmer (1990) vis-à-vis the Latin American experience. Remmer mainly questions whether democracies with appropriate policies are less likely than other regimes to address economic crises or tend to aggravate, rather than ameliorate, economic challenges for their survival. He especially examines the characteristics of the political regimes for explaining policy responses to common economic difficulties and concludes that debt crises establish no basis for asserting that authoritarian regimes outperform democracies in the management of economic crises. Remmer, confirming the position of Rijckeghem and Weder, contends that the supposedly delicate new Latin democracies perform as effective as their authoritarian counterparts in managing the debt crises.

---

[2] This does not imply that this study has the aim of being the frontier study in exposing the political dimension behind economic crises. As discussed below, there are quite a number of contributions in this sense in the literature. Öniş (2010) analyses the political repercussions (in his terms transformations) of crises in Turkey whereas our study looks at the political background of those crises.

Dornbusch and Edwards (1991) have analysed the relationship between populism and macroeconomic policies concerning the experiences of Peru and Chile and argued that macroeconomic populism emphasizes growth and income distribution but de-emphasizes deficit finance, inflation and external constraints. Needless to mention the preference of growth and income distribution to that of inflation and external balance is a rather political issue than a stark economic matter.

The comparative analysis of the macroeconomic performance of democracies is another essential issue. Gasiorowski (1995), for example, has analysed this relationship, using a data set of 75 countries through the 1950s and 1980s, and has found that although inflationary crises inhibited democratization from the 1950s through the early 1970s, they rather facilitated democratization in the late 1980s. Recessionary crises, on the other hand, facilitated democratic breakdown but did not affect democratic transition throughout this period. Thus, Gasiorowski concludes that economic crises do not simply undermine the legitimacy of whatever type of political regime is present in a country, but they incur a regime change in either direction. He also (2000) suggests that more democratic countries have higher inflation and slower growth, and ascribes this phenomenon to fiscal deficits and faster growth of wages. On the other hand, he observes no significant differences between the rates of growth and inflation of the new and mature democracies.

Policy differences are not only inferred by various types of political regimes, as the political dispositions of policy-makers and the behaviour of certain social classes are also instrumental. Weyland (1996) explores the "unexpected affinity" between neo-populism and neo-liberalism which emerged in the 1980s under President Menem of Argentina, President Collor of Brazil and President Fujimori of Peru. He observes that in Argentina, unlike the classical populists like Peron during the 1960s and 1970s (who attracted political support from the urban workers and provincial middle class), neo-populism during the 1970s and 1980s has attracted the political support of the urban informal sector and the rural poor, which have been politically uncommitted, alongside the preceding social groups. According to Weyland, it was democratic politics that stimulated the revival of populism, despite the economic constraints which appeared to condemn it to death. In other words, while democracy paved the way to populism, economic crises which were exacerbated by populist leaders could threaten democracy itself.

However, unlike Dornbusch and Edwards or Weyland, De Castro (2007) by referring to both the Latin American economic crises of the 1970s and 1980s, and the Asian financial crisis of the 1990s, argues that populism/neo-populism as a political aspiration has not been the *cause* of economic crises but has emerged as a *consequence* of economic and political instabilities or crises. Nevertheless, such an argument naturally underrates the importance of the non-economic or social background of populism.

Concerning the Asian crisis, Haggard (2000) argues that domestic political factors such as crony capitalism, weak leadership or autocratic governments have played significant roles at the onset of financial crises. By focusing on two countries, namely Thailand and Korea, Haggard contends that the institutional arrangements of these two countries rendered them vulnerable to public policy. In Thailand, for example, those peculiar and chronic problems which were ingrained in their parliamentary system had generated non-cohesive political parties and fragile coalition governments.

Similar to the line of Haggard, Feng (2003) argues that financial crises can be associated with political factors such as public governance, the relationship between bureaucracy and the business world. He then engages in a theoretical and empirical examination of three features of countries; political life, political freedom (which involves democratic institutions), and political stability (which is related to the likelihood of the survival of the government) and thus policy certainty (which concerns the shift of policies concerning the degree of income equality). Nevertheless, his main conclusion, in contrast to Weyland, is that democracy has no direct effect on the variables which are found to be associated with growth, but rather it appears as a contributor to political stability, human capital formation, income equality, economic freedom, etc.

Throughout the last century, economic crises have presented a dynamic nature concerning their motives and their progress. There has been a consensus that certain inappropriate policy choices are observed at the onset of crises, but once the crisis breaks, it engenders a chaotic milieu with massive uncertainty which impedes policy effectiveness. Finally, all economic crises have social and political consequences in a distinct manner.

Regarding economic crises, first-generation models, for example, indicate that unstable monetary and fiscal policies violate or contradict the basic principles of economics, particularly regarding the fixed exchange rate regime, and pave the way to economic crises. Second-generation models are those that explain multiple equilibria crises that are caused by a shift in the exchange rate and the self-fulfilling expectations. The third-generation crisis models are developed as a result of the 1997 Asian Crisis. These recent models have examined the vulnerabilities or the new maladies of the financial sector such as moral hazard, balance sheet imbalances and financial contagion. Indeed, the rise of third-generation models of economic crises can rather be ascribed to the phenomenon of the globalization of short-term capital flows.

On the other hand, there are political factors that play a key role in the choice of policy.[3] For example, governments favour fixed exchange rate systems, at least in the short-run, since they aspire to economic growth alongside price stability. Besides, many governments perceive exchange rate volatility as a factor of instability and hence refrain from floating exchange rate regimes.[4] Truly, the volatility of the exchange rates that rise during the floating exchange rate regimes can pause political severities especially when political stability is very delicate. Thus, fixed exchange rates are favoured not only in cases where political stability is weaker but also when inflation is likely to be imported.[5]

Another noteworthy issue is the type of fiscal policy maintained by different types of governments. For example, first-generation models of economic crises focus on the public sector deficits and many authors ascribe such a policy choice to the populist or neo-populist political aspirations that surged in the developing world. It is also contended that weak governments cannot venture fiscal discipline or flexible exchange rates, both of which can generate the fundamentals of the first-generation model of economic crises.

The inability to finance the rapidly increasing public expenditures in industrialized economies and hence the subsequent budget constraints are attributed to the advance and spread of the social welfare state. Nevertheless, in developing countries, the motivation for high public expenditure is rather a different matter. The rapid demographic change (in terms of growing population and urbanization) has urged excessive increases in public expenditures despite the limitations of public revenue. Moreover, in democratic regimes, the demand for social justice has also

[3] Persson and Tabellini (2000) explain in detail the political economy of policy choice in their novel book. Again, Acemoglu et. Al (2003) elaborate on this issue historically by an empirical approach and address the fact that weak (extractive) institutions can even deteriorate the performance of appropriate macroeconomic policies.
[4] See Fischer (2001), McKinnon & Schnabl (2004) for a detailed elaboration of the fear of floating exchange rates
[5] Svensson (1994), Williamson (2000), Fischer (2001), Goldfajn and Olivares (2001) and McKinnon and Schabl (2004).

opted for increases in public expenditures. Once these social factors are considered, envisaging the excessive public expenditure patterns in developing countries as mere populism can hardly be justified.[6]

There are also domestic and foreign factors that improve or exacerbate the performance of economic policies. The domestic factors are either peculiar to the policy-makers or to the policy itself. The socio-political environment, for example, is particularly important as a domestic factor in the determination of the policy performance.

The behavioural pattern of the policy-executor is also one of the principal factors in overcoming potential economic crises, in the sense that the incumbent government should have the *political will* to tackle the social and economic problems that the country encounters. If politicians in a country are indifferent or irresponsible against emerging social problems, in time, these problems may become so acute that may even culminate in economic crises. Such an apathetic behavioural pattern can be termed *lethargy* which is exactly what economists refer to as the inner policy-lag of stabilization policies. Even when politicians feel responsible and act, any delay will reduce the effectiveness of the allocated public resources (just like the delayed medication of an oncological patient). Consequently, the political system or the democratic process may culminate in a complete deadlock. Thus, lethargy is not only peril of economic stability but also a threat to democratic stability.

The *expertise* of the policy-maker is another imperative in the performance of economic policy as incompetence may contribute to crises. That is why international organizations, which provide financial support to countries, also acquire credible figures with technical expertise, alongside the bureaucratic quality, especially about the requirements of the macroeconomic policy design.

Analogously, the *credibility* of the government is an important factor in policy implementation. Many governments that face economic crises suffer from credibility losses and the most commonly addressed factor that causes such credibility losses is the existence of cronyism an extreme version of nepotism. As Haggard (2000) notes, the Asian Crisis has shifted to become as much political as economic, either through policy predictability or through policy decisiveness. Haggard (2000) and McIntyre (1999) both address this issue that in the case of the Indonesian financial crisis the major political effect was those crony investments coupled with the authoritarian regime of President Suharto. The most conspicuous nepotism case was about the son of Suharto when some of the projects undertaken by him were cancelled for the sake of austerity but reinstated later. This reversion amplified the already existing policy unpredictability and overwhelmed the investor confidence. On the contrary in the case of Thailand, although an authoritarian government did not exist, the problem was the weakness of governments, due to political fragmentation. It was followed by several resignations which subsequent coalition governments intensified policy indecisiveness. Hence, the case of Thailand substantiated the institutionalist approach to macroeconomics, due to the inefficiencies in policy-making by the lack of autonomy, capacity and strength.

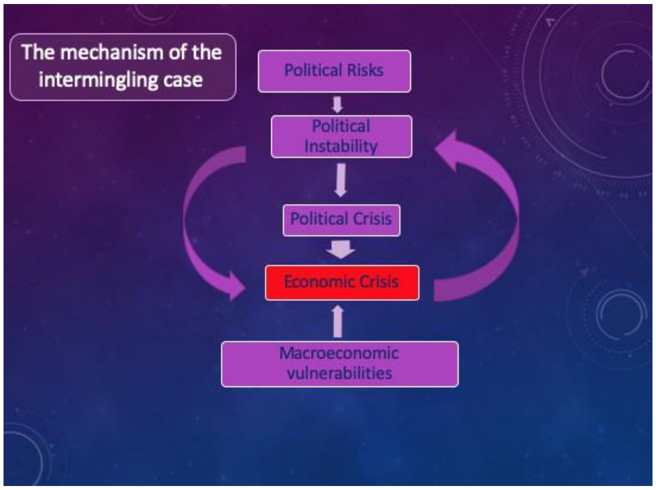
The case of the Asian financial crisis is so particular as it has shown political stability as a prerequisite of an appropriate and successful stabilization policy. In other words, political instability ensues to economic instability which may even accrue an economic crisis. Although political instability is analogously a consequence of economic instabilities, this relation is dependent on the existence of social cohesion and cooperation within the society. In countries where democracy is advanced and social cooperation is high, economic crises may not ensue political instability. Analogously, it is very difficult to pursue a successful stabilization policy in the absence of social cohesion.

[6] Roubini & Sachs (1989) contribute to the explanation of political and economic determinants of budget deficits in industrial democracies.

The nuisance of the Asian crisis showed us that, once a crisis emerges in a particular country, it spreads akin to another what is termed as *contagion,* due to the herded behaviour outflow of the portfolio investments. This kinship naturally depends on the similarities of economic fragilities -regionally or even globally. Furthermore, the foreign politico-economic environment of a country appears to be a critical factor of economic stability. As there is a need for foreign support -not only of international organizations but also of creditors, the neglect of such support would imply the impulsion of the problematic country to a prospective crisis.

2. Inextricable ties between crises: the relationship between political stability and economic crises

First of all, we should distinguish the difference between political instability and political crisis. Political instability is the changing nature of political power distribution and subsequently the weakening of government. Political crises, on the other hand, are the climax of political instability where there is total ambiguity about the destiny of the government, let alone the loss of its governing capacity. According to Bussière and Mulder (1999), political instability is caused by electoral indecision and thus political fragmentation, political polarization and loss of cohesion within the government.[7] Political crises can have several social outcomes; including unrest, tensions and even disorder within the society. Analogously, there may be various political repercussions such as the reshuffling of the cabinet, resignation and change of the incumbent government or call for early elections. In immature democratic regimes, if the prevailing government insists upon staying in power, this may pave the way for a (military or civil) coup. Naturally, the deterioration in the macroeconomic conditions also plays a key role in causing political crises. That is why we contend that political and economic crises are very much intermingled.[8]



[7] A seminal empirical study is undertaken by Bussière and Mulder which measures the impact of the causes of political instability on the economic vulnerabilities of 23 countries.
[8] Leblang & Satyanath (2008) in their extensive empirical analysis where they test political factors in three separate baseline models of Frankel & Rose; Kamin, Schindler & Samuel; and Bussière & Fratzscher, conclude that political economy models predict currency crises much more accurately. Their political economy model includes two major parameters; recent turnover in government (time left for elections) and the dividedness of the government (parliamentary majority).

Graph 1. The mechanism of the intermingling case between political and economic crises

Such a dual relationship or simultaneous determination is also confirmed by Chang (2003) where he addresses his axiomatic exercise by referring to the crisis experiences of Indonesia in 1998 and Argentina in 2001. Yet Chang strongly refutes the arguments that political disequilibria can cause financial crises per se. He argues that social uprising in Indonesia and Argentina appeared due to widespread anger about the adjustment measures to overcome financial difficulties. He maintains that arguing the unidirectional effect that political crises causing financial crises are a denial of the existing theories of crises. Chang relies his analysis on two factors; firstly, the self-fulling expectations of foreign lenders as any change in these would not only lead to a financial crisis but also the collapse of the government, and secondly on the information asymmetry between the government and the public concerning the public debt. Chang marks the issue of multiple equilibrium arguing that if foreign lenders are pessimistic about the country's stability, they demand high interest rate on the debt and exacerbate distortions which might even lead to a political crisis[9], and if foreign investors are optimistic, it may rule out political crises vice versa.

Financial and political crises are also related to social psychology. In the narrow sense, political or economic crisis are *unexpected* or unforeseeable *events*. The main characteristics of political crises are the loss of governmental power and subsequently the loss of social credibility. Likewise, the most important feature of economic crises is that markets come to a cessation. This loss of functionality of either markets or governments is the main mechanism that intertwines political and economic crises. When markets do not function, governments cannot perform, and when the governmental system is in crisis, markets soon oblique towards instability.

There are two main determinants of this intermingled relationship between crises; the first, as noted above, is uncertainty, and the second is higher costs due to higher risks. Uncertainty is the main and foremost feature of crises, whether economic or political. Accordingly, when a political crisis outbreaks, it may generate an economic crisis through deteriorated expectations of market agents (firms and consumers). Once expectations deteriorate, the subsequent uncertainty due to higher risks causes the faltering of both the investor appetite and consumer confidence. Foreign capital starts to exit and domestic investors revert or at least postpone their investment plans. Similarly, consumers postpone their expenditure especially on durable goods which are not among immediate needs.

The second mechanism of political uncertainty that instigates an economic crisis is again through escalated risks. Higher risks, as economic theory predicts, causes domestic interest rates to rise and thus not only discourage investment but also pose a major threat to public debt dynamics. Moreover, most developing countries, suffer from current account imbalances and chronic inflation which entail currency substitution as a precautionary instrument. Higher risks also hasten such a substitution mechanism and cause the exchange rate to rise further. This would not only cause a pass-through to consumer prices but also impose a serious threat on the foreign debt dynamics.

Jianping (1999) has undertaken an empirical study to test the role of political uncertainty on financial crises with the usage of a combination of probit and switching regression analysis where he incorporated 22 emerging countries for the period 1994-1997 (panel data). He mainly looked at the political election cycles and witnessed that 8 out 9 financial crises happened during periods of political election and transition. He argued that the main mechanism that political instability affected financial crises through increased market volatility.

[9] One can hardly understand why such a state would not cause any economic instability but only cause political instability. Besides, political instability could easily accrue economic instability, if not a crisis.

3. The political foundations of economic crises in Turkey: a historical perspective

Political instability is more significant in provoking a crisis when macroeconomic fragilities are predominant and severe. Nevertheless, as discussed above, even in the case of Turkey, the poor macroeconomic policies that accrue financial crises are also due to certain political and social factors. The presence of political stability, on the other hand, has gained prominence since financial liberalization, when the economy became more prone to foreign capital, especially since the rise of the public debt ratio.

3.1. The political background of the devaluations during the period 1946-1971

From 1945 until 1970 there had been three major devaluations which can be considered as major economic instabilities. The first one occurred on 7th September 1946, 2.5 months after the general elections of 21st July 1946. The election results were quite surprising, besides being contentious. Nonetheless, despite the spectacular performance of the opposition during the elections, there was no governmental change. The immediacy of this devaluation (as it was right after the elections) shows that the government has long necessitated and planned such an action but has postponed it until the elections. At the first sight, this devaluation might seem unnecessary as, until 1947, there were repetitive trade surpluses throughout the war years. Nonetheless, due to consecutive inflation rates, there was an accumulated real appreciation of TL. Furthermore, during the War years, there was an accumulated stock of goods that could only be cleared by exports, if a devaluation stimulus could be provided. There was also an augmented level of public debt alongside some gold reserves. It was conceived that a devaluation would make better use of gold reserves in the repayment of public debt. Finally, the country was at the doorstep of the membership of the IMF which would restrict its capacity to devalue and curb imports. Hence it aspired to undertake a contingency devaluation in advance.

The second major devaluation happened in 1958. The timely elections were in 1958, yet the incumbent government of the Democrat Party called for early elections on 27th September 1957 to hinder the possible electoral losses that would be caused by the adverse economic conditions and subsequently rising political instability. This time devaluation was postponed to August 4th, 1958, 10 months after the general election.

The period of 1954-1960 is quite peculiar as it shows the intermingled relationship between economics and politics very vividly. There was an economic necessity for the devaluation of 1946 due to the global economic conditions of World War II, although its timing was politically arranged. The 1958 devaluation case was also of economic necessity but (unlike the previous one which had been a result of global economic conditions) it had stemmed from the socio-political implications of those policies pursued by the Democrat Party. In other words, those economic policies (which consequently led to a devaluation) had certain political implications.

The year 1954, marked a milestone, as the sudden drought caused a 20 per cent fall in agricultural output at a time when world prices began to falter. As a result, Turkey started to import wheat. When the purchased tractors broke down due to lack of maintenance, and soil-erosion emerged to be a serious issue in the new arable areas, the deficit started rising, but more importantly, the external deficit started to spin out of control causing gold reserves to decline remarkably. Most importantly, national income declined by 3 per cent in 1954. The external deficit surged and social reactions spread rapidly. Consequently, the DP government, amid the economic slowdown, called for early elections in 1957 to retain its power. After the elections, it recanted resisting an agreement with the IMF and (in 1958) initiated an IMF-supported stabilization programme which included a devaluation from 1 US =2.80 TL to 9.00 TL.

At this point, one would naturally inquire about the socio-political motives of those policies that incurred economic instability and thus the devaluation. Firstly, as noted above, the peasantry was the main political base of DP. The DP government conceived *populism* as the "provision of the welfare demands of peasants" and *nepotism* as "political loyalty" to its political clientele. Moreover, the failure of the DP government to contemplate an urgent strategy against forthcoming economic problems ascertained its *lethargy* as it postponed the stabilization programme for more than 10 months, after the elections.

Following the spectacular economic performance of the period 1963-1968, the devaluation attempt of 10th August 1970 is a rather intricate matter, in the sense that, at the first glance, there seems no urgent necessity for such an action. The average rate of inflation between 1965-1970 was 6.6 per cent. The budget deficit was less than 1 per cent of GDP in 1969 and 1970 and the growth rate was positive.

Yet, there were some anxieties besides some expectancies in the country. The first anxiety was the continued faltering of export performance in 1968, mounting the chronic trade deficit due to the import substitution strategy of the 1960s. Moreover, the persistent inflation rate had accrued an appreciation of the exchange rate in real terms which was evident from the shadow exchange rates[10]. As a result, the government was in the pursuit of encouraging exports by the readjustment of the real exchange rate. There was also anxiety about the transition to the Common Market which might deteriorate the trade deficit. To offset such an effect, the government intended an upfront devaluation. Yet, this expectancy was over-optimistic as the structure of the economy did not have a competitive structure due to the import substitution strategy. On the other hand, there was an expectation of fostering workers' remittances by a depreciated TL. Despite the high trade deficit, the current account of the country, for a long time, was much lower due to these remittances, which were thus of vital importance.

Nonetheless, the prominent reason for the 1970 devaluation was again the pressures of the IMF as the foreign indebtedness queries had mounted once again. The government eventually consented and implemented a drastic devaluation by depreciating TL against USD from 9 TL to 14.85 TL. Since a major part of the year had already bygone, the impact of this devaluation was not felt in 1970. Moreover, the trade deficit did neither decline in 1971 nor 1972.

In sum, the 1946 devaluation was due to a presumed economic necessity of accumulated real exchange rate appreciation, the 1957 devaluation can be conceived as an obligation to restore the trade deficit which was caused by the fiscal consequences of agrarian populism and the 1971 devaluation was undertaken at a time when the foreign debt had surged. Both of the last two devaluations were by the conviction of the IMF.

3.2. The Crises Years of 1978/9: oil prices, the crisis of import substitution strategy or political polarization?

The 1970s have been years of stagflation globally due to sharp rises in the oil prices provided by the new international cartel; OPEC. The Turkish economy, like all import-dependent countries, was immensely affected by these rises.

During the period between 1968-1973, the average annual trade deficit of Turkey was 2.3 per cent of GNP, but since the first phase of the Oil Crisis in 1974, this deficit immediately soared and reached an average of 6.6 per cent during 1974-1976. Then onwards, during 1977-1980 the trade deficit remained at a level of 5.3 per cent of GNP on

[10] There was a large discrepancy between the official and the black-market rates exchange rates.

average.[11] The Oil Crisis came into effect at a time when there was a coalition government of two dissimilar parties (CHP and MSP).

At the start of the oil price escalation, the government was unable to recognize the imminent risk of external deficit due to two fortunate factors; firstly, at that time foreign exchange reserves were relatively strong, and secondly, workers' remittances in foreign currencies had boosted (almost 5 per cent of GNP) levelling the export performance.

During the period 1971-1976, the average growth rate was 8.1 per cent, budget deficits were limited and inflation was on average 18.3 per cent. Due to these economic advantages, the macroeconomic balances did not deteriorate instantly, albeit the limited resilience of the economic structure incurred by the import substitution strategy of the 1960s. With the relief of the two advantages, the government was reluctant to reflect the higher costs of imported oil to consumers and provided excessive price supports to farmers which amassed budget deficits.

One can naturally inquire about the policy prospect of a presumed single-party government after the general elections of 1973. If such a government had longer durability[12], would it be similarly populistic or would it venture fiscal prudence which might avoid the imminent crises? Our immediate answer would be that the rapid urbanization of the 1960s and 1970s had stipulated higher public expenditure. Besides, macroeconomic balances deteriorated particularly by the second phase of the Oil Crisis in 1979. [13]

The budget deficit was at a peak in 1977 (4.6 per cent of GNP), but since the IMF-led stabilization policy of 1978, it was reduced to 1.7 per cent in 1978 and 2.7 per cent in 1979. The stabilization policy also included a significant devaluation, the adjustment of public enterprise prices and the restructuring of short-term debts. Yet, such an effort was not rewarded as the government was soon replaced by a patched coalition of 4 political parties. In other words, political instability had become the principal trait of the period. However, this new right-wing coalition government, in less than 2.5 months announced the most radical economic transformation decree of the Turkish economy on January 24th, 1980.

The decree had two major dimensions: The first dimension was the austerity measures towards price stabilization, and the second dimension was the departure from the long-standing import-substitution industrialization strategy towards export orientation.

For price stabilization; subsidies to public enterprises, fertilizers, energy consumption and transportation were abandoned, agricultural support was curbed and the Central Bank advances to the Treasury was controlled. On the other hand, for export orientation foreign trade was liberalized, daily determination of the exchange rate was put in effect following a 33 per cent devaluation.

[11] As a result of the higher burden of oil imports, throughout the 1970's the trade deficit rose; in 1973 it was 769 million USD, in 1977 it exceeded 4 billion USD but then reclined back to 2.3 billion in 1978 due to the stabilization efforts.
[12] Lijphart (1984) attempts to measure those political and economic factors which determine cabinet durability
[13] Needless to add that the Cyprus Peace Operation of Turkey met fierce international reaction and some economic, as well as military, sanctions were imposed against Turkey. Furthermore, the intensity of domestic political instability supplemented all these detrimental factors.

The instability of the macroeconomic structure since 1977, which ended up in an economic crisis in 1979, can be attributed to several social, political, economic and global factors. First and foremost, the energy crisis has been the principal factor that dilapidated the macroeconomic balances, especially through higher costs and widened trade deficit. The longstanding import substitution strategy had failed to provide an efficient industrial structure that could compete in international markets. Hence with the occurrence of the Oil Crisis, the import-substitution development strategy has become almost obsolete.

In the meantime, political fragmentation hampered the establishment of a government with sufficient duration which could commit itself to undertake several reforms regarding the restructuring of the economy. Consequently, prescriptions changed from one government to another creating inconsistencies and invoking unpredictability. Furthermore, coalition governments required arduous reconciliation efforts on the policy choice, but many times, these efforts were inconclusive. Due to the prevalent public disorder, there was also a lack of social cohesion or social support for the stabilization efforts.

The adverse global environment was not solely confined to the Oil Crisis. As noted above, the military sanctions imposed on Turkey due to the Cyprus Intervention, the politically hostile treatment of foreign investments alongside the reluctance of governments to collaborate with the IMF, exacerbated the economic instability and subsequently led to the economic crisis of 1978/9.

It is no coincidence that the coups of May 27th 1960, March 12th 1971 and September 12th 1980 were all followed by massive devaluations.[14] The common economic cause of these devaluations was the foreign debt-service problem whilst massive foreign deficits. These deficits were caused by both the lax nature of fiscal and monetary policies, and the real appreciation of the exchange rate. Naturally, all those policies had a socio-political rationale; the pursuit of real exchange rate appreciation and the populist trait in public spending were political choices and without understanding the motives of these choices, an analysis of the 1978/1979 economic crisis would be incomplete.

3.3. The 1994 Economic Crisis: hasty financial liberalization or contra-market intervention?

Since the implementation of trade and financial liberalization, the first major economic crisis broke up in 1994. To a large extent, this crisis can be attributed to the failures of the liberalization attempts. For a better understanding of the background of this crisis, the social and political background of those economic policies should be comprehended.

In 1989 (August 11th) Turkey initiated its financial liberalization attempt amid an inconvenient economic environment where there was a lax fiscal stance with high public sector borrowing requirement (in 1987 PSBR was 5.7 per cent of GNP). As a result, a high level of public debt (23 per cent of GNP) was accrued, albeit moderately high price inflation of 38.9 per cent. By the liberalization challenge, average nominal interest rates immediately hiked to 83.9 per cent from 58 per cent, whilst the price inflation surged from 38.9 per cent to 73.7 per cent, and then the growth rate slumped from 9.8 per cent to 1.5 per cent in 1989. Hence under such economic conditions (high PSBR, high public debt with short maturity, alongside high and volatile inflation rates and consequently very high interest rates), one can hardly justify the rationale behind such an attempt, as it would naturally encounter excessive rises in interest rates. For example, whilst the interest payments of domestic debt had made 10 per cent of budgetary

[14] Öniş (2010) analyses the political results of these early economic crises as well as the others.

expenses in 1987, in 1988 it surged to 15.1 per cent and at the onset of the crisis, in 1993, the ratio had reached 18.8 per cent![15]

Although the 1994 economic crisis cannot be entirely attributed to the hasty and thus misleading financial liberalization endeavour[16], it certainly constituted the main economic backdrop of the crisis. It is contended that financial liberalization is the complementary stage of trade liberalization and thus the government felt that it should undertake such an endeavour. Another explanation is the influence of market-led liberal policies which had become widespread globally, including financial markets. However, if a one-party government had not prevailed while enjoying a solid parliamentary majority, such an audacious attempt would be beyond imagination. Besides, the economic results of the financial liberalization were so unfavourable and costly for the incumbent ANAP government that it lost most of the major municipalities in the 1989 local elections.

Alongside the inanity and hastiness of financial liberalization, there were major economic and political influences that contributed to the emergence of the crisis. First of all, the Gulf Crisis of 1990 should be mentioned as the major geopolitical instability factor in the region. On August 2nd Iraq invaded Kuwait and as a result, 37 countries initiated a military intervention, led by the US, on January 17th, which took more than 6 weeks. Although Turkey refrained from this military operation, its markets were distressed.

A consensus argument[17] for the occurrence of economic crises during the 1990s is the existing political instability due to incoherent coalition governments which suffered a short duration. Such governments, let alone tackling a prospective fiscal discipline, on the contrary, created a profligate behaviour in the pursuit of fiscal policy.

A political example is the incidence of the 1987 general elections. When the votes of ANAP declined to 36 per cent, (from its previous level of 45 per cent) it was alarmed by the impending political risks of the next elections. The Prime Minister reacted immediately unleashing the fiscal discipline to such an extent that the ratio of public expenditures in GDP surged from 17.1 per cent in 1987 to 20.9 per cent in 1991. This policy coincided with the financial liberalization attempt and put the budget in a dual strain: on the one hand, there was the burden of rising interest payments caused by financial liberalization, and on the other hand, there was the populist behaviour of the government.

In 1991 a new government was established by a coalition between centre-ring (DYP) and centre-left (SHP) political parties. Yet, the pace of populist spending policy did not change due to the fragmented structure of the political system. In 1987 PSBR was 5.7 per cent of GDP, but had surged to 7.3 per cent in 1990 and then further to 10 per cent in 1991. The new government did nothing to curb this borrowing and maintained its level until 1993. This huge deficit naturally distorted the budgetary composition to such an extent that interest payments comprised 25.8 per cent of the public expenditure. At that time, Prime Minister Çiller aspired to reduce this burden by discretion. She attempted to intervene in the auctions of the Treasury by limiting its borrowing requirement and replacing it with

[15] One can imagine the immense income distribution repercussion (from taxpayers to interest-earning rentiers) of this budgetary deformation.
[16] Rodrik (1990) qualifies this liberalization attempt as disastrous for inflation and macroeconomic stability. He furthermore notes that the external finance which was due to this attempt, replaced domestic borrowing at times highly disadvantageous for the public sector.
[17] See Cömert and Yeldan (2018) and Öniş (2010). Largely, coalition governments that have been largely unsuccessful should not necessarily imply that they are always prone to economic and political instability. During 1961-1965 three separate coalition governments were maintained with political difficulties but without incurring any consequential economic instability.

Central bank advances. The financial markets were so exasperated that a currency attack became inevitable immediately in January 1994 which resulted in repetitive and massive devaluations, as the efforts of the Central Bank to defend the exchange rate until exhausted the foreign reserves. Eventually, the Decrees of April 5 was announced as an austerity policy prescription which included the temporary floating of the exchange rate, fixing the wages and adjusting the public enterprise prices with respect to the targeted (future) inflation. Some further steps were also taken regarding the Central Bank autonomy, the restructuring of the public funds by reducing their number and allocating more resources to the Treasury. Despite the painful social cost aspects of these decrees, they were inconclusive due to the lack of political stability.

In the case of the 1994 economic crisis, the inexistence of fiscal discipline can be attributed to durability problems of governments and the profligate fiscal stance can be attributed to political fragmentation. Yet, the regional geopolitical instability and the frequency of domestic terrorist activities should also be reminded as significant non-economic contributors to the crisis.[18] In this sense, Prime Minister Çiller's contra-market intervention can only be considered as the triggering of the crisis.[19] This incidence also demonstrates, as was noted above, that the expertise of the policy operator is imperative in the pursuit of economic stability. It was senseless, if not incompetence, to attempt to manipulate the market interest rates in the borrowing auctions of the Treasury, especially since financial liberalization.

3.4. The Economic Crisis of 2001: the result of the political crisis or the design flaw of the IMF programme?

3.4.1. The background

Although the timely general elections were in 1996, the current DYP-CHP coalition agreed on calling for early elections in December 1995. The first runner, though by a small margin, was the fundamentalist Welfare Party which traumatized, even exasperated some social quarters and institutions, including the Army. Under such taut conditions, a coalition was established between RP and DYP, but it was under the immense strain of annulation by these social sectors (i.e. main NGOs declared such a demand publicly). The strain was so excessive that it provoked a post-modern coup of the Army on February 28th,1997, delegating the President to announce their request.[20] After the collapse of this coalition, by the resignation of the Prime Minister, several other coalition trials were undertaken but all of them were inconclusive. Political instability in this period (due to short cabinet durability) was so elevated that since the general elections of 1995, four separate coalitions were formed until the timely elections of 1999.

In 1997 the Asian financial crisis broke out. Although the Asian crisis was rather regional, it had some contagious effects on the Turkish economy as well as other emerging economies.[21] For example, the growth rate in the Turkish

[18] Cömert and Yeldan also remind the coincidence of the rise of the FED funds rate that constituted an unfortunate major disadvantage for foreign debt balances.

[19] Özatay (2007) contends that the Turkish episode of 1994 had little relations to models of self-fulfilling crises as it was a case of a policy mistake. We would agree with this argument if only such the policy mistake of auction manipulation was conceived as the *triggering* effect of the crisis, as the budgetary structure was already in a serious mess. Celasun (1998) objects to the sole contribution of the crisis to mistakes at the monetary front, suggesting that if several steps had been taken, as some had argued, the crisis could not be hindered. She argues that the fragilities in the fundamentals, especially fiscal discipline, were the main reasons of the crisis.

[20] Öniş (2010) analyses the political transformations caused by the economic crisis of 1994 in a very vivid way.

[21] Celasun (2002) shows substantial influences of the Asian crisis that contributed to the economic background for the 2001 crisis.

economy declined from 7.6 per cent in 1997 to 3.2 per cent in 1998. The growth performance of the Turkish economy continued to deter by a decline from 3.2 per cent to a contraction of - 4.7 per cent in 1999. There may be two effects in the background of this contraction: firstly, as we keep emphasizing, political instability not only hindered fiscal frugality but also, caused a profligate fiscal stance, deterring macroeconomic balances. Indeed, there was not even a mention of *stabilization strategy* in any of the coalition protocols. Secondly, it was quite unfortunate that the Russian economic crisis broke out in August 1998, following the Asian crisis.[22]

In January 1999 a minority government was established by Prime Minister Ecevit which was also aided by the arrest of Öcalan (leader of the terrorist organization PKK) in February 1999. Ecevit instead of holding the elections in December 2000 called for early general elections in April 1999. This time his party, DSP became the first, albeit another fragmented political outcome. A new three-party coalition was formed again, led by Ecevit, but this time, the government was very unfortunate, due to the occurrence of a calamitous earthquake in Gölcük in August 1999 which not only destructed thousands of buildings and caused 18,400 lives to be lost, but also dilapidated the economy via regressed sentiments. As a result of this multidimensional devastation, the government was enforced to send a letter of intent to the IMF, within 4 months, requiring a stabilization programme.

IMF, then, recommended an innovative architecture for stabilizing the price inflation in Turkey. The essence of this stabilization strategy was primarily to restrain the *price expectations* with the presumption that the public sector deficit, the balance of payments problems and even the instability of growth performance were all by-products of this phenomenon. In other words, the new strategy conceived inflationary expectations (inertia) very much dependent on the exchange rate changes and thus expected that if the Central Bank had declared the range of exchange rates in advance, it could also manage price expectations as they would converge into these declared values. Consequently, if price inflation could be controlled, interest rates could be expected to decline and as a result, the fiscal deficit would drop too. The fiscal deficit would contract because interest payments had become the main determinant of the public expenditure. For example, in 1999 interest payments of the public domestic debt had become 35 per cent of the budget.[23] Before the implementation of the programme, an upfront partial devaluation was undertaken to cushion the possible real appreciation of the national currency. The programme also required the attainment of a primary surplus in the budget as well as certain monetary targets for the Central Bank which were anchored to the level of international reserves.

3.4.2. The crisis

Such a policy design of the IMF had major political and economic fault lines: First of all, an exchange-rate based stabilization programme was design-defective due to the very existence of the fragile coalition government. Under such conditions of political instability, technically a perseverant stability programme could not be instigated or pursued. In other words, the political assumptions of the programme on the onset were erroneous. The second fault-line was on the impacts of the designed exchange rate regime. One should bear in mind that pegging the future exchange rates at predetermined levels, would not only lure enormous amounts of portfolio investments but also induce imports excessively. Considering the negative growth rate of 1999, the natural rebound of growth would also cause the current account deficit to surge to higher levels. Thirdly, such an exchange-rate based stabilization

[22] Although the negative impact of the 1999 earthquake also contributed to this economic contraction, its role had been relatively limited on the annual figures, since the earthquake occurred in the third quarter of the year.
[23] Indeed, when the Financial Crisis of 2000/2001 broke-out, the interest payments ratio also peaked at almost 47 per cent of the budget. Cömert and Yeldan (2018) qualified this crisis as finance-led and finance-driven similar to that of 1994.

programme would require full-flexibility of interest rates, and in a country where domestic public debt is too high, this would entail the further rise of interest rates and deter the public sector financial accounts.

The 2000/2001 economic crisis occurred as a full-fledged financial crisis.[24] As it is briefed above, both political and economic risks were effective in the instigation of this crisis. The programme had accrued an excess current account deficit beyond the calculations of the IMF. (In 1999 current account deficit was 0.4 per cent of GNP. In 2000 the deficit rose to 3.7 per cent of GNP) Secondly, an immediate structural accommodation was expected, but such an adjustment did not follow. At first, the certainty on the future exchange rates accompanied by high real interest rates attracted portfolio capital, but when investors were distressed by the political crisis, they hurried to exit in herd behaviour. The programme also presumed that the banking system was prudent. Nonetheless, this presumption was unfounded as public banks were in duty-losses, and private banks were both in high exchange-rate risks due to their open positions and in interest rate risks due to the high allocation of Treasury bills in their assets.

2000/2001 was a typical twin-crisis case as the crisis in the banking system was coupled with a currency attack.[25] The first stage occurred in November 2000 as a banking commotion. One major bank suddenly ceased its provision of excess liquidity in the overnight market. Another medium-sized bank, with its assets loaded with fixed interest Treasury bills, was addictively financing these bills by borrowing from the overnight market, showing a huge maturity mismatch. When this bank failed to meet its liquidity obligations from the money market, it applied to the lender-of the-last resort mechanism or the discount window of the Central Bank. The Central Bank intervened accordingly, despite its requirements of net foreign assets[26] set by the IMF programme, it was far from being satisfactory to extinguish the furore in markets. As a result, the problematic bank had to be seized by the banking authority (Savings Account Insurance Fund). Furthermore, the IMF moved, in return for a new letter of intent by the government, enhancing the foreign reserves with an amount of SDR 5,8 billion under its Supplemental Reserve Facility. This new financial support was of utmost vitality because at this first stage the foreign reserves of the Central Bank had plummeted by 5.2 billion USD. Although most scholars generally focus on the problems of the banking sector of the first stage, the subsequent capital flight was no less important in the instigation of the twin crisis.[27]

The most interesting stage of this twin crisis is its second stage. On February 19th, Prime Minister Ecevit at the exit of the National Security Council declared that there was a *state crisis* between the President and himself. The reaction of the market was horrific, and on that day, there was a capital flight of 7.6 billion USD. Although the Central bank intervened in the money markets, the repo rates hiked to 315.9 per cent. The next day the Central Bank altered some of its monetary obligations as there were funding problems in the interbank money market due to a secondary capital outflow of 6.1 billion USD. The repo rates this time soared to 1107 per cent overnight. The capital flight continued on February 21st (4 billion USD) and repo rates hiked to 4474 per cent overnight. By then, there

---

[24] Cömert and Yeldan (2018) qualifies this crisis as finance-led and finance-driven similar to that of 1994. Öniş (2010), on the other hand, contends that the 2001 incidence was a fiscal and balance of payments crisis coupled with major structural problems in the banking sector.
[25] Kaminsky and Reinhart (1999) qualify the coexistence of banking and currency crises as twin crises.
[26] The Central Bank could only inject liquidity into the system within the limits of foreign reserves. That is why the system in operation resembled that of a currency board.
[27] Alper (2001) in his article published right after the crisis contends that policies in maintaining the stream of good news were necessary to sustain capital inflows. He also argues that there was inadequate backing for the programme by the IMF, especially to ensure the exchange rate. Nevertheless, we doubt if such an assurance could be justified. Finally, he asserts that there was a design flaw in the sense that there was no *sterilization rule* to alleviate the interest rate undershooting at the start. Besides these factors, he also considers the fragile banking system and unfavourable external conditions as major causes of the crisis.

were no exchange rate quotations in the market as the forex market operations had come to a halt. In short, the second stage is a conspicuous currency attack case triggered by a political crisis announced straight by the Prime Minister! At a time when macroeconomic fragilities were at their apex and the banking crisis was already recent, such an announcement was more than enough to trigger the currency attack.

There is a criticism that IMF preferred banking crisis against currency crisis and insisted on the seizure of troubled banks. This criticism can hardly be justified because the first stage of the crisis was truly due to the weakness of the financial system. The plausible criticism against the IMF should be on its advice of an exchange-rate based stabilization policy under the conditional weaknesses of the political and economic system. As noted above, such a stabilization strategy could not be undertaken during political instability, particularly in the presence of a fragile and inconsistent coalition government. Furthermore, there was no dedicated political will behind the programme. Again, there was no social support or any kind of coordination, as such a strategy was particularly dependent on expectations. Secondly, although limited, there existed a current account deficit (almost 1 per cent of GDP) before the enactment of the programme and it would naturally deteriorate by the managed exchange rates. (The current account deficit soared to almost 10 per cent of GDP in 2000 whilst the foreign debt of the country was 41 per cent of its GDP. Thirdly, despite the experience of the Asian crisis IMF failed to inspect the prudence of the banking sector in advance. Thus, in the first stage, it was the fragile banking system that drove the economy into a crisis. Last but not least, the programme was designed for interest rates to conform with reduced price expectations, but on the contrary high public debt and the strain on the exchange rate was drifting real interest rates.

Even though the 2001 crisis was mainly caused by the design error of the IMF stabilization strategy[28], the blame of the crisis was laid solely on the government, mounting its disreputability. Some economists, by then, even argued that if a conflict had not occurred between the prime minister and the president, the crisis would not occur. Although a simple logical exercise might contemplate such a conclusion, the macroeconomic fragilities, which have been neglected by the IMF, cannot be disregarded. Ironically, though the IMF was largely responsible for the crisis, it was encountered as a saviour and a new IMF programme was put into effect with the support of the media and the business world. This time, a different exchange rate regime was implemented and the political coordination of the programme was commissioned to a non-political figure Kemal Derviş, who was a senior officer of the World Bank. The new programme received the support of the media and the business world and contained some important structural reforms as well as macroeconomic adjustment. The prominent structural reform was the abandonment of the losses of the public banks by a prolonged monetization process alongside budgetary constraint to restrain its inflationary impacts. In short, the 2000/2001 program had stemmed on false political grounds and was inappropriate for the macroeconomic fundamentals of the Turkish economy.

3.5. The 2008/2009 Crisis: the first crisis without domestic implications

The economic crisis of 2008/2009 was distinct by its causes.[29] First and foremost, unlike its predecessors, it was, to a large extent, a globally-induced economic crisis.

The global liquidity crisis in 2008 which was ignited from the US economy is a commonly known incidence. Before the crisis, the economic climate in Turkey had two major features: on the one hand, the labour-intensive exports,

[28] The design flaw of the stabilization programme recommended by the IMF was so obvious that since then the IMF never recommended such a programme to any other country.
[29] This crisis had salient political consequences rather than political effects. Besides, the political milieu was rather stable until the 2008/2009 crisis.

like textiles, had started to falter, especially due to the Chinese competition, and secondly, monetary policy had been tightened due to the inflationary hike in 2006. (The inflationary hike was stimulated by higher food prices and the depreciation of the exchange rate) The average growth rate of the economy during 2002-2005 was 7.3 per cent but had moderated to 4.7 per cent in 2007 before the global crisis.

The global crisis spread to the Turkish economy through two main channels: firstly, there were net financial outflows for at least 3 quarters, and secondly, there were export shocks due to the slump in the foreign demand albeit the exchange-rate depreciation. Considering the fall in domestic consumer confidence, this implied a more dramatic decline in aggregate demand.[30] When the crisis hit the Turkish economy through these channels, the exchange rate reacted immediately, with depreciation from 1.24 TL/$ to 1.69 TL within a month in October 2008.[31]

The Bloomberg-HT Consumer Confidence Index slumped to 54.5 in April 2008 from a level of 105 in August 2008 and did not recover until the end of the year. (It retrieved back to its original level by June 2009) This decline was caused by several factors: there was the roll-over risk of private sector foreign debt, especially during the liquidity squeeze (credit crunch) caused by the falling risk appetite and overcautious banks. There were also concerns about fiscal discipline since the IMF Stand-By agreement was due to expire by May 2008. Finally, the memories of past crises were still fresh and vivid reviving anxieties.

In sum, the main impacts of the global economic crisis on the Turkish economy should be attributed to the global shock and subsequent uncertainties, and the deterioration of domestic confidence. Nevertheless, except for the Asian economies, most emerging economies were hit worse than Turkey. Although the Turkish economy, unlike its peers, showed minimal growth performance in 2008 (0.65 per cent), it slumped relatively less (-4.7 per cent) in 2009. The major disadvantage of the Turkish economy was the very high private sector foreign debt. The ratio of total private sector foreign debt in GDP had doubled from 8.3 per cent in 2002 to 19 per cent in 2008. That is why Öniş (2010) terms the 2008/2009 crisis as the *crisis of the real sector*.[32]

The relatively limited contraction of the Turkish economy was due to some resiliencies. First of all, this time the ratio of public debt to GDP was much lower than in the past; below 40 per cent. Furthermore, in 2007 consumer price inflation was at a moderate one-digit level, 8.4 per cent and unlike its predecessors, interest rates did not surge upwards as the floating exchange rate regime had replaced the role of offsetting. The global crisis was quickly ameliorated, by the US Federal Reserve and other major central banks, through immense quantitative easing measures. Many emerging countries, including Turkey, benefited from this policy choice of advanced economies by increased foreign investments. Another, important advantage of the Turkish economy was the immediacy of its counter-cyclical policies, both by fiscal and monetary expansion. Furthermore, the banking sector had become prudent due to strict financial regulations and the macroeconomic balances were already relatively healthier due to sound monetary and fiscal policies and most importantly due to political stability.

Although it is mentioned that the emergence of the 2008/2009 crisis cannot be ascribed to political instability per se, this does not imply that financial markets were insusceptible to political events. For example, on April 27th, 2007 there was an e-memorandum by the Army through its official website which called for attentiveness about

[30] In all past crises of the Turkish economy, there was a period of current account surplus due to the contraction of import demand and the rise of exports induced by currency depreciation. Yet, in this crisis, such a surplus never appeared.
[31] In March 2009, TL was as low as 1.80 TL/$, but then onwards it appreciated back to 1.50 TL/$
[32] Öniş also argues that there had been frequent political crises before the 2008/9 economic crisis but they had no role in its creation.

secularism. The major ramification of the e-memorandum in 2008 was the legal case for closure against the ruling AKP with the allegation of *misconduct against the secular nature of the state*.

At the same time, the arrest of some members of the intelligentsia and army officers intensified in 2009 (which had started in 2007 by allegations of attempting to overthrow the democratic government). Nonetheless, it must be reiterated that despite these adverse political conditions, the termination of the global crisis in 2010 and the existence of the one-party (and being recently re-elected) government provided the overriding favourable factors which procured the resilience of the Turkish economy. As for economic fortunes, the role of foreign support[33] and the abundance of international liquidity should also be reminded as a factor of quick recovery. Furthermore, the low public debt ratio and the moderate rate of inflation provided the opportunity for fiscal and monetary expansion. Finally, and perhaps most importantly, the prevalence of flexible exchange rates was the main economic advantage when compared to the past economic crises.

3.6. The 2018 economic crisis: tension in foreign relations, domestic political instability or contra-market intervention?

The instigation of the 2018 economic crisis is a contentious issue. Although there was no net negative growth in 2018 or 2019 when figures are observed on an annual basis, the substantial economic decline can be detected by quarterly observation. The economic decline started in Q3 of 2018 (2.5 per cent) and turned into a net contraction in Q4 of 2018 (-2.7 per cent). The negative growth continued in Q1 (-2.6 per cent) and Q2 of 2019 (-1.7 per cent). As the recovery in Q2 of 2019 was lean and as there was a continuous contraction for 3 consecutive quarters, the performance of the economy can be specified as a crisis. In 2017, the aggregate demand was quite buoyant which provoked the rise of inflation from 8.5 per cent to 11.9 per cent and the 15.7 per cent rise of imports from 192.6 billion USD to 222.8 billion USD. As a result, the current account deficit surged from 26.9 billion USD to 40.8 billion USD. Yet, due to the immense exchange rate shock in 2018, the consumer inflation hiked to 20.3 per cent by a significant pass-through and the current account deficit contracted to 20.7 billion USD.[34]

Foreign debt was one of the major burdens of the 2018 crisis. As a ratio of national income, it was 47.5 per cent in 2016, but increased to 53.5 in 2017 and then further to 56.7 per cent in 2018. This debt was primarily due to the private sector. Whilst the portfolio investments were flowing in and stabilizing the exchange rate, the private sector (both financial and non-financial), was continuously borrowing from foreign markets. The private sector external debt was 18.1 per cent of GDP in 2002. At the onset of 2008, this ratio had risen to 23.5 per cent, and in 2017 it hiked to 36.8 per cent of GDP.

The second but more important economic issue in the background of the 2018 economic crisis was the rapid and dramatic deterioration of the fiscal discipline. Although the ratio of public debt to GDP (by the EU format) was rather stable (27.4 per cent in 2015 and 28 per cent both in 2016 and 2017), the primary surplus declined very rapidly since 2015. In 2015 primary surplus weakened to 2.2 per cent in 2016, declined further to 0.63 per cent and

[33] Relations with the EU and US was rather amicable by then, and tensions in the region had not started. Furthermore, the government very wisely applied to the IMF (for SDR) in 2009 and received an equivalent of 1.5 billion USD as a cushion to offset the reserve losses of the Central Bank.
[34] Once the crisis broke out, the current account deficit retracted to 21.7 billion USD in 2019, similar to past economic crises.

almost diminished to less than 0.1 per cent in 2017.[35] In short, the *twin deficits* were effective in the economic background of the crisis.

The political aspect of the 2018 economic crisis dates back to the general elections of June 7th, 2015. As there was no parliamentary majority to form a one-party government, the two major parties AKP and CHP looked for the prospect of a coalition. Yet, soon it was recognized that such a coalition was impossible and the newly elected President Erdoğan called for the repeat of elections on November, 1st. Nonetheless, the temporary search for a coalition caused more than 5 months of uncertainty, and hence incurred significant political instability, which indicated that the absolute political power of AKP was eroding. Moreover, the terrorist activities in the South-East of the country had already aggravated political instability. On July 15th 2016, a coup was attempted by a faction within the Army to overthrow the incumbent and democratically elected government, but it failed due to civil resistance supported by all political parties. This incidence was the milestone of political stability as consumer confidence started to falter by then onwards. The exchange rate did not respond immediately, but by the second half of the year, it depreciated by 34 per cent. Despite some partial and temporary political stability in 2017, the referendum for constitutional change from parliamentary to presidential system created a divided society and polarized the political system. On April 19th, 2018 US officials demanded the release of a US citizen and consulate officer Pastor Brunson who was convicted of being involved in the coup attempt. By the plea of the court order, the Turkish government at first rejected such a demand. The consequent diplomatic tension was so stern that it triggered a currency attack[36] (impacted by portfolio capital flight and domestic demand for foreign currency) and subsequently the exchange rate depreciated by 76 per cent until September 2018.[37] The gross international reserves of the Central Bank were 116.1 billion USD in February 2018 but by October 2018 they were drained down to 84.4 billion USD demonstrating the enormous extent of the demand for foreign currency and short-term capital flight. Consumer confidence also collapsed by 39 per cent (from a level of 87.5 in January to 57.6 in September) regarding the rapid depreciation of the exchange rate.

As a result of this crisis, the government called for early elections on June 24th, 2018. The results of the elections did not provide a parliamentary majority for AKP alone, but it was in an alliance with the nationalist MHP. Besides Erdoğan was elected as the president of the country anyway. Although the economic crisis did not ease until the elections, two factors contributed to the de-escalation of the crisis: firstly, three weeks before the elections the president gave his consent to the increase of policy rate of the Central Bank (which had long been obstructed by him) from 8.0 per cent to 16.5 per cent (a rise of 850 basis points). As this rise was insufficient to impede the depreciation of the TL, within a week the policy rate was raised again by 125 basis points to 17.75 per cent. Nonetheless, that rise was also inadequate to extinguish the furore in the financial markets and the Central Bank this time raised its policy rate[38] by 625 basis points to 24 per cent. The second factor was rather a political change; the Turkish government recanted from its insistence to retain Pastor Brunson in prison and extricated him.

Dates	**CB O/N Borrowing**	**CB O/N Lending**	**1-Week Repo**	**T-Bill Compound**

[35] In 2018, there was a net primary deficit of 0.25 per cent of GDP.
[36] On August 10th, 2018 US President posted a tweet 'I have just authorized a doubling of Tariffs on Steel and Aluminum with respect to Turkey as their currency, the Turkish Lira, slides rapidly downward against our very strong Dollar! Aluminium will now be 20% and Steel 50%. Our relations with Turkey are not good at this time!' By next Friday, he posted a second tweet 'We will pay nothing for the release of an innocent man, but we are cutting back on Turkey!'
[37] Boratav (2018) showed that in August 2018 the total foreign exchange demand of foreign investors and domestic residents was equivalent to 14 billion USD which was financed by Central Bank reserves and the current account surplus of 2.6 billion USD procured by the drastic economic contraction.
[38] The weekly repo rate of the Central Bank policy rate is considered as the policy rate.

25 Jan. 2017	7.25	9.25	8.00	11.00
1 June 2017	15.00	16.50	**8.00**	**11.25**
1 June 2018	16.25	19.25	**16.50**	**16.60**
8 June 2018	22.50	24.00	17.75	**19.00**
14 Sept. 2018	22.50	25.50	24.00	**25.00**
21 Sept. 2018	18.25	21.25	19.75	25.00
26 July 2019	15.00	18.00	16.50	20.30
25 Oct. 2019	12.50	15.50	14.00	14.18
13 Dec. 2019	10.50	13.50	12.00	11.64

Table 1. Presidential intrusion in the determination of the CB Policy Rate

The above table contains crucial data that depicts President Erdoğan's intrusion into Central Bank (CB) in the determination of its policy rate independently. The first column of the table shows the meeting dates of the Monetary Policy Committee when policy rate changes were announced. The second and third columns show the overnight (O/N) borrowing and lending rates of the CB. The fourth column displays one-weekly repo rates of the CB, which is also accepted as its policy rate. In the last column, the compound interest rates of the corresponding auctions of Treasury bills are displayed. They correspond to the values of the nearest auction date before the policy-rate change, to show the market interest rate just before the policy change of the CB. It is so obvious that for one year (from June 1st, 2017 until June 1st, 2018) the CB was under an immense political strain to refrain from adjusting its policy rate, despite the escalation of interest rates in the market. Eventually, the CB on June 1st 2018 raised its lending rate by 725 basis points but kept its weekly repo rate (policy rate) intact. Indeed, the CB had effectively raised its interest rate but officially it was still indicating a lower policy rate to markets (and to the President!). Analogously, the interest rates in the bond markets had risen in line with the CB O/N lending rate (lender-of-the last resort window) showing that due to the intrusion and pressure of the President, the official policy rates of the CB had derailed from markets. This disruption remained and the CB had to raise interest rates twice again for the realignment of market and policy rates. Yet such a loss of policy transparency and the complication of the use of policy instruments naturally resulted in the loss of confidence and the erosion of consumer sentiment in markets.

What is of interest is whether the crisis is incurred by the long political instability due to polarization, or by the tensions between the US and Turkey due to Pastor Brunson crisis, or by the obstruction of the President of the adjustment of the Central Bank policy rates following price stabilization.[39] Whichever is overriding, the 2018 economic crisis had substantial political impacts. Although both the fiscal deficit and the subsequent foreign deficit were effective in the background of the departure from fiscal discipline, the loss of the absolute power of the government and rising political instability have also been significant factors.

[39] On October 7th, 2019 when there was a conflict over Northern Syria between the US and Turkey, President Trump threatened again to inflict the Turkish economy by posting a tweet 'As I have stated strongly before, and just to reiterate, if Turkey does anything that I, in my great and unmatched wisdom, consider to be off-limits, I will totally destroy and obliterate the Economy of Turkey (I've done before!). They must, with Europe and others, watch over...' But this time effects of this threat on the financial markets were limited due to the attentiveness of the Central Bank.

	Consumer Confidence (Bloomberg)	**Exchange Rate ($/TL)**	**Commercial Lending rate**	**Treasury Bill rates**	**Intern. Reserves**	**Capital Flight[40]**	**% Change in Total Investment[41]**
Sept. 2007	105.2	1.25	21.9	20.0	108.3	2008(6) = $ -3 bn.	2009 (Q1) = -35.1
Nov. 2008	55.09	1.61	24.4	22.8	112.3		
Jan. 2018	87.5	3.76	20.1	13.5	116.1	2018 (3) = $ -2.3 bn.	2019 (Q2) = -21.0
Sept. 2018	57.6	6.26	38.5	25.1	84.2		

Table 2. The Comparison of the processes of the 2008/9 and 2018 crises

As noted above, since the financial liberalization attempt in 1989, Turkey faced four financial crises. In all of them, capital flight or currency attack was effective. In all of these crises, interest rates hiked and exchange rate depreciated, but each of them had different features. In 1994, both the exchange rate and interest rates hiked. In 2001 the interest rate effect was enormous due to the fixed exchange rate regime. Although in the 2008/9 crisis, consumer confidence plunged drastically by 91 per cent from its peak level in 2007, its impacts on the interest rates were limited, thanks to fiscal discipline, IMF aid and flexible exchange rates. In the 2018 crisis, consumer confidence declined by 52 per cent, interest rates were almost doubled and the national currency depreciated by 66.5 per cent despite the heavy losses of international reserves.

4. Conclusion

Economic crises in Turkey have been changing concerning their origin and nature. The devaluation of 1946 was distinct amongst all of the early devaluations, as it was held by the discretion of the government as a contingency against an imminent external deficit. Since then, all devaluations involved some degree of political instability and were technically unavoidable. The 1958 devaluation was an inevitable obligation due to the external deficit. The 1970 devaluation, like its predecessors, followed rising political instability (this time the anarchic environment) albeit a debilitated one-party government. All of these devaluations had political consequences, in the sense that in the first two the incumbent governments lost elections but in the final one, it was pulled down by a military coup.

The 1978/9 crisis was the first foreign-induced crisis that was engendered by the surge in oil prices. Yet, one must bear in mind that it was not just the subsequent external deficit that incurred the 1978/9 crisis. The prevalent political instability, which was affected by the fragmented political structure and political polarization, not only had an impact on the short-living coalition governments but also played a major role in the instigation of crises.

The 1994 economic crisis was also distinct. First of all, there was a mistake in the policy strategy, as the crisis rested on an immature financial liberalization attempt, which mounted the interest burden on the budget. The second mistake was in macroeconomic management. The crisis was indeed triggered by the contra-market intervention of the Prime Minister in financial markets and was the first which involved a portfolio capital flight.

[40] Peak figures are shown. In August 2018 there was another wave of capital flight of 1.5 billion USD mostly from the stock market.
[41] Peak figures are presented with their corresponding dates.

CRISES	POLITICAL BACKGROUND	ECONOMIC CAUSE	TRIGGER	RESULT
1946	Political Stability	Precautionary	Discretionary	Devaluation by discretion
1958	Agricultural Populism + Political Instability	External Deficit	By Obligation	Devaluation by obligation
1970	Political Instability	External Deficit	By the conviction of the IMF	Devaluation
1978/9	Political Instability	Oil Crisis: external deficit	Indispensable	Austerity package of 1980
1994	Political Instability	High-interest burden on budget	Counter-market intervention by PM	Portfolio flight
2001	Political Instability	Design error of IMF	Banking Problems + Currency attack	Portfolio flight
2008/9	Political Instability	Global Crisis	Portfolio flight	Exchange rate Depreciation
2018	Tension in foreign relations	High private sector debt	Intrusion in CB Policy + Portfolio flight	Exchange Rate Depreciation

Table 3. The political background of economic crises in Turkey

Although in the aftermath of this crisis, fragmentation of the political system deteriorated further, the 2001 economic crisis should primarily be attributed to the design-defective stabilization policy of the IMF. This is because an exchange-rate based stabilization policy, towards the management of expectations, could not be implemented in political instability or within a fragmented political system.

According to Öniş (2010), poor governance was effective in all crises as they were products of populist cycles. As noted above, the incompetence in public debt management in 1994, the design-defect of the IMF programme in 2001 and the stubborn and inane political obstruction of the Central Bank to raise its policy rate in 2018 contributed to the instigation of crises. The only exception was the 2008/9 crisis, where relative macroeconomic prudence and expertise in the countercyclical policy provided quick recovery.

In all economic crises, there is a loss of fiscal discipline and subsequently a higher external deficit. The longstanding foreign deficit has caused an accumulation of foreign debt of the private sector, and this has constituted the conventional economic background of crises. Since financial liberalization, but especially in the last decade, foreign debt dynamics have become vital due to the high risk of a sudden capital flight or a currency attack. Though the loss of political stability has a limited role to impair financial stability on its own, it has become an imperative since financial liberalization. By the potential to affect both the consumer sentiment and the investor appetite adversely, political instability can have detrimental effects on macroeconomic balances through the interest rates (domestic debt dynamics) and the exchange rates (foreign debt dynamics). In this sense, the Asian crisis has been a very illuminating example for the comprehension of the role of political instability (besides other political factors) in the emergence of economic crises. Our analysis here is naturally confined to the Turkish experience. Yet the recent crises history of Turkey since financial liberalization resembles very much the Asian crisis. We tried to show that *some political instabilities* (although *not all*) led to macroeconomic imbalances. We also showed that *all political crises* led to macroeconomic imbalances whilst *some* of them have even instigated economic crises.

The influence of political instability on macroeconomic balances depends on the existence and extent of macroeconomic fragilities. Depending on the types of policies pursued these fragilities differ from one country to another, such as; the entity of current account deficit and subsequently the extent of foreign debt, and/or the entity of budget deficit and subsequently the size of the public debt and/or the shortage of international reserves. Once these fragilities become dominant, political instability can become instrumental in instigating an economic crisis. Finally, it must be contended that those macroeconomic fragilities caused by the flawed policy preferences of governments also have certain socio-political implications.

References

Akyüz, Y. & Boratav, K. (2003) The Making of the Turkish Financial Crisis
World Development, 2003

Alper, C. E. (2001) The Turkish Liquidity Crisis of 2000 -what went wrong
Russian and East European Finance and Trade, Vol.37, No. 6

Alper, E., & Öniş, Z. (2003). Financial globalization, the democratic deficit, and recurrent crises in emerging markets: the Turkish experience in the aftermath of capital account liberalization.
Emerging Markets, Finance and Trade, 39, 5-26.

Acemoglu, D., Johnson, S., Robinson, R., & Thaicharoen, Y. (2003). Institutional causes, macroeconomic symptoms; volatility, crisis and growth.
Journal of Monetary Economics, 50, 49-123.

Acemoglu, D., & Robinson, J. A. (2008). *Economic origins of dictatorship and democracy*. Palgrave.

Boratav, K. (2018) March-August 2018: capital movements that triggered the crisis (neo-liberalism creates a crisis in the South) *(in Turkish)* 19 October 2018, SOL

Bussière, M. & Mulder, C. (2000) Political Instability and Economic vulnerability
International Journal of Finance and Economics, Nov. Vol.5

Celasun, M. (2002) Before and After the 2001 Crisis: a macroeconomic and financial evaluation
(in Turkish, unpublished)

Celasun, O. (1999) The 1994 Crisis in Turkey
Policy Research Working Papers, No: 1913.

Chang, R. (2005) Financial Crises and Political Crises
NBER

Cömert, H. & Yeldan E. (2018) A Tale of Three Crises in Turkey: 1994, 2002 ,2008-2009
ERC Working Papers in Economics, 18/09, June

De Castro, R.C. (2007) The 1997 Asian Financial Crisis and the revival of populism/neopopulism in the 21st century Philippines politics
Asian Survey, 2007

Dornbusch, R., & Edwards S. (1991). The macroeconomics of populism.
in: Dornbusch, R., & Edwards S. (Eds.). *The macroeconomics of populism in Latin America.*
University of Chicago Press, Chicago, IL.

Ertuğrul, A. & Selçuk, F. (2001) A Brief Account of the Turkish Economy -1980-2000
East European Finance and Trade, November 2001

Feng, Y. (2003). *Democracy, governance and economic performance: theory and evidence*.

MIT Press, Cambridge, MA.

Fischer, S. (2001). Exchange rate regimes: is the bipolar view correct?
Journal of Economic Perspectives, 15, 3-24.

Gasiorowski, M. J. (1995). Economic crisis and political regime change: an event history analysis.
American Political Science Review, 89, 882-97.

Gasiorowski, M.J. (2000) Democracy and macroeconomic performance in underdeveloped countries: an empirical analysis.
Comparative Political Studies, 33, 319-49.

Goldfajn, I., & Olivares, G. (2001). Can flexible exchange rates still "work" in financially open economies?
G-24 Discussion Paper, No. 8.

Haggard, S. (2000). The Politics of Asian financial crisis.
Journal of Democracy, 11, 130-44.

Haggard, S. & McIntyre A. (2000) The Political Economy of the Asian Financial crisis: Korea and Thailand compared in Noble G.W. & Ravenhill J. (Eds.) The Asian Financial Crisis of Global Finance
Cambridge Univesity Press, 2000

Kaminsky, G. L. and Reinhart, C. M. (1999). The Twin Crises: The Causes of Banking and Balance of Payments Problems.
American Economic Review, Vol. 89 No. 3, 473–500.

Leblang D. & Satyanath S. (2008) Politically generated uncertainty and currency crises: theory, test and forecasts
Journal of International Money and Finance, Vol.27, No. 3, pp.480-497

Lijphart, A. (1984) Measures of cabinet durability: a conceptual and empirical evaluation
Comparative Political Studies, Vo.17, No.2

Macpherson, C. B. (1973). *Democratic Theory*, Clarendon Press.

McIntyre A. Political Institutions and the economic crisis in Thailand and Indonesia
in Pempel T.J. (Ed.) The Politics of Asian Financial Crisis.
Cornell University Press. Pp.143-162

McKinnon, R., & Schnabl G. (2004). The Asian dollar, standard, fear of floating and original sin.
Review of Development Economics, 8, 331-60.

Mei, Jianping (1999) Political risk, financial crisis and market volatility
NYU Working Paper.

Nelson, J. M. (Ed.) (1990). *Economic crisis and policy choice: the politics of adjustment in the Third world*, Princeton University Press, Princeton, NJ.

Öniş, Z (2003) Domestic Politics versus Global Dynamics: Towards a Political Economy of the 2000 and 2001 Financial Crises in Turkey
in Öniş, Z & Rubin B (Eds.) The Turkish Economy in Crisis. Cass. London

Öniş, Z (2010) Crisis and Transformation in Turkish Political Economy
Turkish Political Quarterly, Vol.5, No:3

Özatay, F. (2007) The 1994 Currency Crisis in Turkey
The Journal of Policy Reform

Özatay, F. (2020) Paving the way for an economic crisis with high leverage and currency mismatches:2018-2019 crisis in Turkey
Working Paper Series, TEPAV

Pamper, T. J. (1999) The Politics of Asian Economic Crisis
Cornell University Press

Persson T. & Tabellini G. (2000) Political Economics: explaining economic policy
Cambridge, MIT Press

Porhal, N. (2008) The economic consequences of political crises
The East African Review, No.38

Powell, A. (2002) Argentina's avoidable crisis: bad luck, bad economics, bad politics, bad advice
Brookings Trade Conference, Washington

Randanowitz, L. (2010) 2008-2009 Crisis in Turkey: performance, policy responses and challenges for sustaining recovery
OECD Economics Department Working Paper

Remmer, K. L. (1990). Democracy and economic crisis: the Latin American experience
World Politics, 42, 315-35.

Remmer, K.L. (1991) The Political Impact of Economic Crises in Latin America in the 1980s
American Political Science Review. Vol.85, No:3

Rodrik, D. (1990) Premature Liberalization, Incomplete Stabilization: The Özal decade
NBER Working Paper, No: 3300; Massachusetts

Roubini N. & Sachs J.D. (1989) Political and Economic determinants budget deficit in industrial democracies
European Economic Review, Vol.33, pp.903-933

Svensson, L. (1994). Fixed exchange rates as a means to price stability: what have we learned? *European Economic Review*, 38, 447-68.

Uygur, E. (2010) The Global Crisis and the Turkish Economy
Turkish Economic Association. *Discussion Paper*

Van Rijckegem & Weder B. (2008) Political Institutions and debt crises
Public Choice, Vol.138

Weyland, K. (1996). Neo-populism and liberalism in Latin America: unexpected affinities. *Studies in Comparative International Development*, 31, 3-31.

Williamson, J. (2000). Exchange-rate regimes for emerging markets: reviving the intermediate option.
Institute for International Economics, Washington D.C.