POLITICAL ECONOMY RESEARCH INSTITUTE

Re-Making of the Turkish Crisis

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February 2020

WORKINGPAPER SERIES

Number 504

RE-MAKING OF THE TURKISH CRISIS

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Abstract: Turkey entered a new phase of recession-cum-real economy crisis starting in the last quarter of 2018. In contrast to the previous crisis episodes of 1994, 2001 or 2009, when the economy has abruptly shrunk with a spectacular collapse of asset values and a severe contraction of output, the 2018- crisis is characterized by a prolonged recession with persistent low (negative) rates of growth, dwindling investment performance, debt repayment problems, secularly rising open unemployment, a spiraling currency depreciation and high inflation. Popular explanations from the mainstream tradition attribute this dismal performance to a lack of "structural reforms" and/or exogenous factors. *Per contra*, our analysis shows that the underlying sources of the crisis are to be found not in the conjunctural cycles of *reform fatigue*, but rather in the post-2001 neoliberal speculative-led growth model with excessive reliance on hot money flows and foreign debt accumulation. We argue that following the post-2001 orthodox reforms, a foreign-capital-inflow-dependent, debt-led, and construction-centered economic growth model dominated the economy and caused a long buildup of imbalances and increased fragilities.

Keywords: economic crisis, financial crisis, emerging markets, financialization, Turkey

1. Introduction

Turkey was following an IMF-directed, exchange rate-based disinflation and austerity programme when the economy was hit by a financial-*cum*-real economic crisis in February 2001. The crisis has erupted at a point when the economy was seemingly at its zenith as the government had succeeded in implementing the *full directives* of the IMF's austerity package, including the verbatim administration of a pre-announced currency peg (the infamous *tablita*), as well as the conversion of the Turkish Central Bank (CBRT) to a *currency board, a la* Argentina 1991. Set across a regime of fully open financial account, admitting unregulated, free mobility of finance capital under the *tablita* of fixed exchange rate administration, Turkish markets could not endure the pressures of speculative attacks of short term hot finance. As widening of the current account deficits, fed through a series of IMF-narrated "success stories," led to episodes of *moral hazard*, the crisis erupted in February 2001 and quickly became one of the deepest crises of the Turkish economy.

All this had been narrated succinctly in poise, framed as the *making of the Turkish crisis*, by Akyüz and Boratav (2003). In less than two decades later, we are faced once again with a homemade crisis, *re-made*. Following the IMF-directed comprehensive structural reform program implemented after the 2001 financial crisis, Turkey was seen as a darling of international observers, financial institutions and investors in the 2000s and the early 2010s.[1] In fact, supported by record levels of foreign capital inflows and an unprecedented credit expansion, the economy grew rapidly. This growth was briefly interrupted in 2009 due to the global financial crisis that originated from the centers of high finance across the Atlantic. Turkey's recovery from the 2009 recession was rapid and seemingly buoyant. Yet, due to its excessive reliance on the whims and caprices of hot money finance, it was short-lived and with the second half of the 2010s the perception about Turkey began changing. As the country was struggling with a myriad of problems from ongoing instability in foreign exchange markets, debt repayment problems, accelerating inflation and unemployment rates with a slowing economy, credit rating agencies began sharply downgrading Turkey's ratings. The end result in August 2018 was an exchange rate crisis in which *Lira* significantly lost value, by as much as 35 percent against the US dollar, followed by rapid acceleration of inflation and a severe deterioration of the balance sheets of the debt-ridden corporate sector, as well as an abrupt rise in the rate of unemployment, especially among the youth and educated.

Why? What went wrong? While the government tried to put the blame on international speculators working against Turkey, allegedly envious of her successes, orthodox economists and popular critiques of the government claimed that the reason behind the woes of the Turkish economy lie in institutional decay leading to interventions to the free workings of the markets and a delay of "structural reforms" such as further labor

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

market flexibility, and broadening incentives for foreign direct investment. Contrary to popular and naïve orthodox explanations such as governance issues, delays in structural reforms, or institutional retreat, we argue that the Turkish economy's woes originate from the structural problems and intrinsic fragilities generated by the *speculative-led* economic growth model (Grabel 1995) of the post-2001-crisis era. This model depended on continuous foreign capital inflows and increased indebtedness; and was centered around a construction boom.[2] The economic growth that this model generated has also led to a long buildup of imbalances and increased fragilities in the economy. The external balance steadily worsened as the external debt of the banks and nonfinancial corporations reached to unprecedented levels and current account deficits widened. The credit expansion led to fragile balance sheets for both firms and households as economic growth increasingly took a debt-led character. The construction-centered economic growth, lack of a sound industrial policy together with an overvalued real exchange rate undermined the industrial base of the country, with the exception of a few industries that managed to insert themselves into the global value chains. Hence, an unbalanced growth path emerged for the economy. Income distribution remained highly unequal as the economy failed to generate sufficient employment even during the high-growth years. In the end, the expansion of the 2000s and the early 2010s prepared the conditions for the bust and the ensuing crisis through an accumulation of fundamental imbalances and financial fragilities. Misguided policies and the erosion of institutions in the second half of the 2010s contributed to the surfacing of these problems by increasing uncertainties. While the expansion of global liquidity in 2019 by the Federal Reserve, the European Central Bank and Bank of Japan ensured that capital inflows continued and the Turkish economy avoided, at least for now, the worst scenario, the analysis of the Turkish crisis presents a useful case to understand the fragilities generated by foreign-capital-inflow-dependent growth model.

We document this episode through an analysis of the buildup of economic imbalances and financial fragilities in the next section. Section 2.1 documents the increased fragilities in the external accounts, Section 2.2 discusses the unprecedented credit expansion, and Section 2.3 focuses on the economic imbalances generated by the construction-centered and increasingly import-dependent economic growth. Section 2.4 traces the impact of these imbalances on class dynamics and patterns of income distribution. We discuss the similarities as well as the differences of the 2018 crisis with the earlier crisis episodes in Section 3. Finally, in Section 4, we conclude by discussing the limitations of the proposed crisis-resolution policies with a specific focus on whether the so-called structural reforms can remedy the situation.

[2] This model has variously been characterized as dependent financialization (Akçay and Güngen 2019), deficit-led neoliberal populism (Güven 2016), or a mix of neoliberal developmentalism and authoritarian populism (Adaman *et al.* 2019).

2. Build-up of imbalances

2.1 External balance: capital inflows, current account deficit, and external debt accumulation

Turkey began liberalizing its external accounts in the early 1980s under a repressive military regime. Import substitution industrialization strategy of the pre-1980 era was abandoned and a comprehensive strategy of external liberalization began with the aim of switching to an export-oriented growth model through repression of labor costs. Full liberalization of the external account was completed in 1989 with the liberalization of capital movements, mostly to ease the financing pressures resulting from government budget deficits. Similar to the experiences of most other *emerging markets*, Turkey's post full-financial-account-liberalization history was followed by the boom-bust cycles of foreign capital flows, which, in turn, generated high volatility in interest and exchange rates, and unstable swings of economic growth. Periods of economic growth supported by capital inflows were followed by capital outflows and *Minsky-type* financial crises (Minsky 1982, Kindleberger 1996, Palma 1998, 2000, 2012). Following the 1998 crisis, mainly triggered by the contagion effects of the *Asian* and *Brazilian crises*, a stabilization program was prepared in 1999 together with the IMF and put into effect at the beginning of 2000. The poor design of the IMF-directed stabilization program led to a deep financial crisis at the beginning of 2001 (Akyüz and Boratav 2003, Ertuğrul and Yeldan 2003, Yeldan 2002, Boratav and Yeldan 2006, Orhangazi 2002, and Dufour and Orhangazi 2009). The 2001 crisis resulted in a 51 percent devaluation of the Turkish lira, 7.4 percent contraction of the GDP and a soaring inflation rate of 61.6 percent (Yeldan and Ünüvar 2015).

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

In fact, a self-feeding success story was to emerge in the following years. As Turkey was going through the fundamental neoliberal structural reforms and re-structuring its banking sector, the global liquidity was increasing and a sizable amount of hot financial capital was set loose, looking for lucrative markets to invest. Turkey enjoyed this booming cycle via accelerating economic growth together with currency appreciation and

relatively rapid disinflation; which in turn led to further capital inflows. As a result, the ongoing structural reform program (and the new Justice and Development Party government's devotion to it) began to be hailed as a "success story." We document the main dynamics of this growth pattern in Figure 1, which shows the paths of foreign capital inflows and economic growth since the early 1990s. The figure reveals the following: First, the economy's growth performance since the 1990s, after the liberalization of capital flows in 1989, depended on the direction of capital flows. The economy grew during times of capital inflows and contracted during outflows. The same relationship continues into the 2000s yet, now the significant increase in foreign capital inflows does not necessarily lead to comparably strong responses in the growth path of the economy. Second, the capital outflows during the global financial crisis are quickly reversed by mid-2009 and a long period of large capital inflows follow. Of these capital inflows, foreign direct investment (FDI) constituted a significant share in the mid-2000s due to a wave of large privatizations. However, the bulk of foreign capital inflows took the form of portfolio investments and debt flows. After 2009, thanks to QE policies, portfolio investments and debt flows significantly increased and reached record levels.

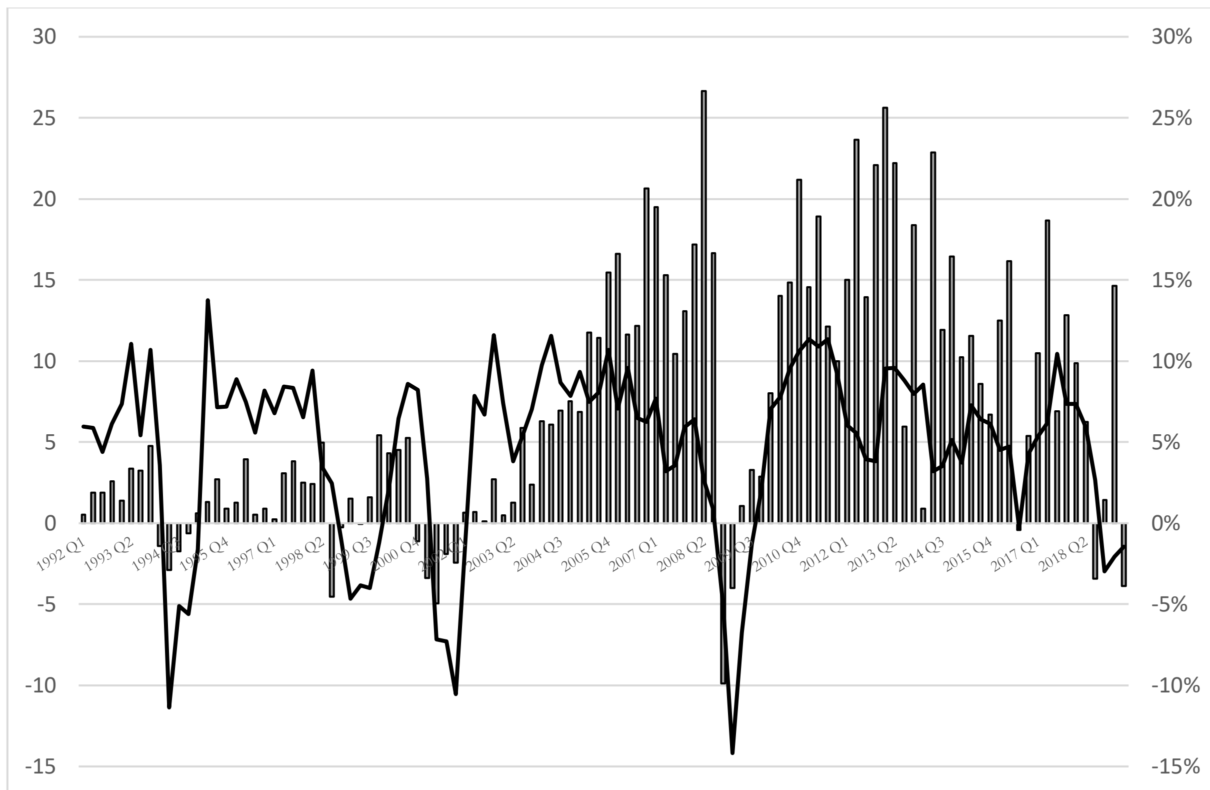

Figure 1: Foreign capital inflows in billion USD (bars, left axis) and rate of economic growth (line, right axis), quarterly data.

Source: CBRT EVDS

The mirror image of the increased foreign capital inflows after 2002 is seen in the widening current account deficit, displayed in Figure 2. While chronic current account deficits have been a characteristic of economic growth since the liberalization of capital flows, these deficits were usually small. However, current account deficits widened significantly throughout the 2000s and 2010s. As we discuss in detail below, the widening of the current account deficit was directly related to the increased foreign capital inflows and the concomitant currency appreciation, and reflect the increased import-dependency of the economy in this period. More than 85 percent of the total imports consisted of capital and intermediate goods.

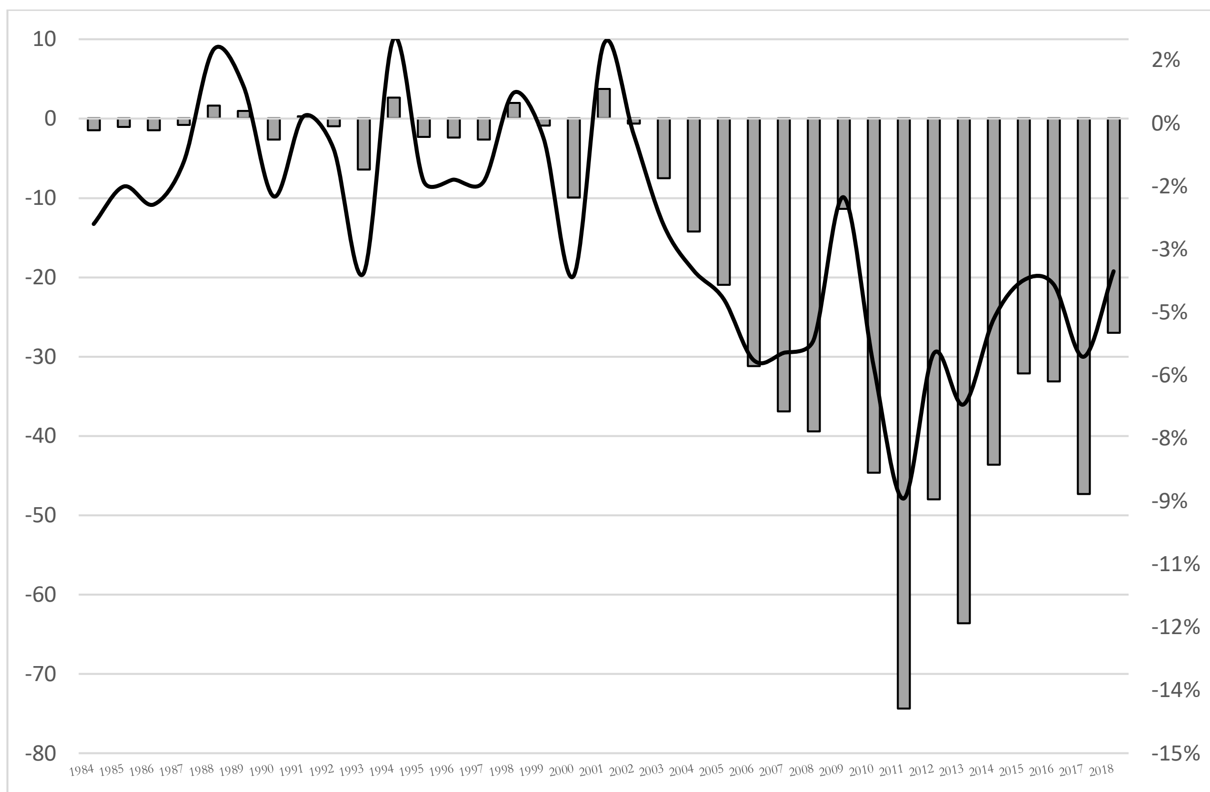

Figure 2: Current account balance in billion USD (bars, left axis) and as a percentage of GDP (line, right axis)
Source: CBRT EVDS

While the push factor in the increasing capital inflows after 2002 was the increase in global liquidity, the pull factor was the prevailing high domestic interest rates. Despite the rapid disinflation process, interest rates did not adjust immediately and all through the post-2001 expansion till the eruption of the global financial crisis of 2009 the real interest rates on government debt instruments remained above 10 percent. Between 2003 and 2008 the high real interest rates attracted speculative short-term capital inflows leading to speculative-led growth (as described in Grabel 1995). Relatively high interest rates compared with the global interest rates and rates in similar "emerging markets" continued into the 2010s after the global crisis brought

the interest rates in major economies down to very close to 0 percent. Even though the general plateau of the interest rates declined, they remained significantly higher than the prevailing interest rates in the world. Hence, the main supporter of economic growth in this period has been increased foreign capital inflows through the maintenance of relatively high real interest rates.

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

$$\frac{1+R}{1+\Delta\varepsilon}-1$$

Thus, during the course of this operation, financial speculators would gain the domestic rate of *R*, and lose at the rate of depreciation of the Lira, $\Delta\varepsilon$. The net difference between the two prices would give us the net financial arbitrage gain. We calculate the evolution of such gains in Figure 3. Here, the main hypothesis is that the financial *arbitrageurs* would invest their foreign monies at the domestic instrument that would bring the highest rate of return in the domestic asset markets (in most cases government debt instruments). According to the calculations portrayed in Figure 4, Turkey has offered a speculative arbitrage rate above 30% in the aftermath of the 2001 crisis well into the beginning of 2004 and became one of the leading emerging markets in the world of financial speculation! While the US and the OECD interest rates were at 2.5 – 4 % levels, Turkey continued to offer quite high arbitrage gains over dollar-denominated assets. Such returns enabled Turkey to attract huge sums of speculative finance capital with a significant “hot” component during especially over 2003-2004 and then again in 2007. While these speculative arbitrage rates seem to be lower in the post-2009 period, compared with the near-zero interest rates in advanced economies, Turkey was still continuing to offer quite high speculative rates. However, following 2012, the rate of arbitrage dwindled significantly, and geopolitics, rather than financial calculus, started to play a more important role in setting the patterns of hot money flows.

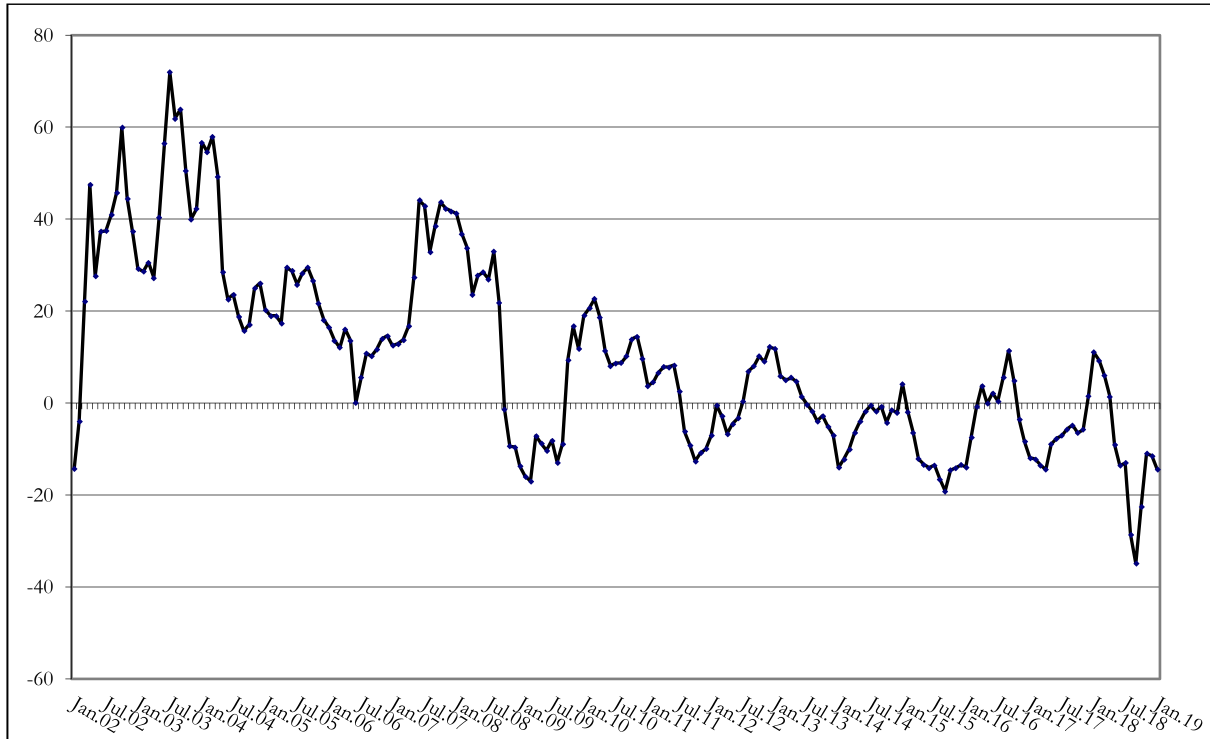

Figure 3: Speculative arbitrage in the 2000s (%)

Source: Authors' calculations from CBRT EVDS data

Note: Speculative arbitrage is calculated as one plus the interest rate divided by one plus the change in the exchange rate minus one.

The immediate result of increased foreign capital inflows in the aftermath of 2003 has been a significant appreciation of the real exchange rate. As the high interest rates attracted capital inflows, the abundance of foreign exchange led to an overvaluation of the Turkish lira. As the Central Bank focused *exclusively* on maintaining price stability, currency appreciation helped to keep inflation under control via cheapening of imported consumer products, but more importantly, intermediate goods. Figure 5 shows the path of the real exchange rate over an extended period and is also narrative of the three main episodes of financial-*cum*-real crises of the Turkish economy, *viz*. April 1994, February 2001, and the ongoing August 2018, with the adjustments therein set against the background of January 1982 as the benchmark year. The export promotion era of the post 1980s is visible with real exchange depreciation. Following the capital account liberalization of 1989, *Lira* appreciated significantly as a result of the inflow of abundant foreign exchange. The consequent widening of the current account deficits was no longer sustainable by late 1993, and the Turkish economy entered a severe crisis in April 1994.

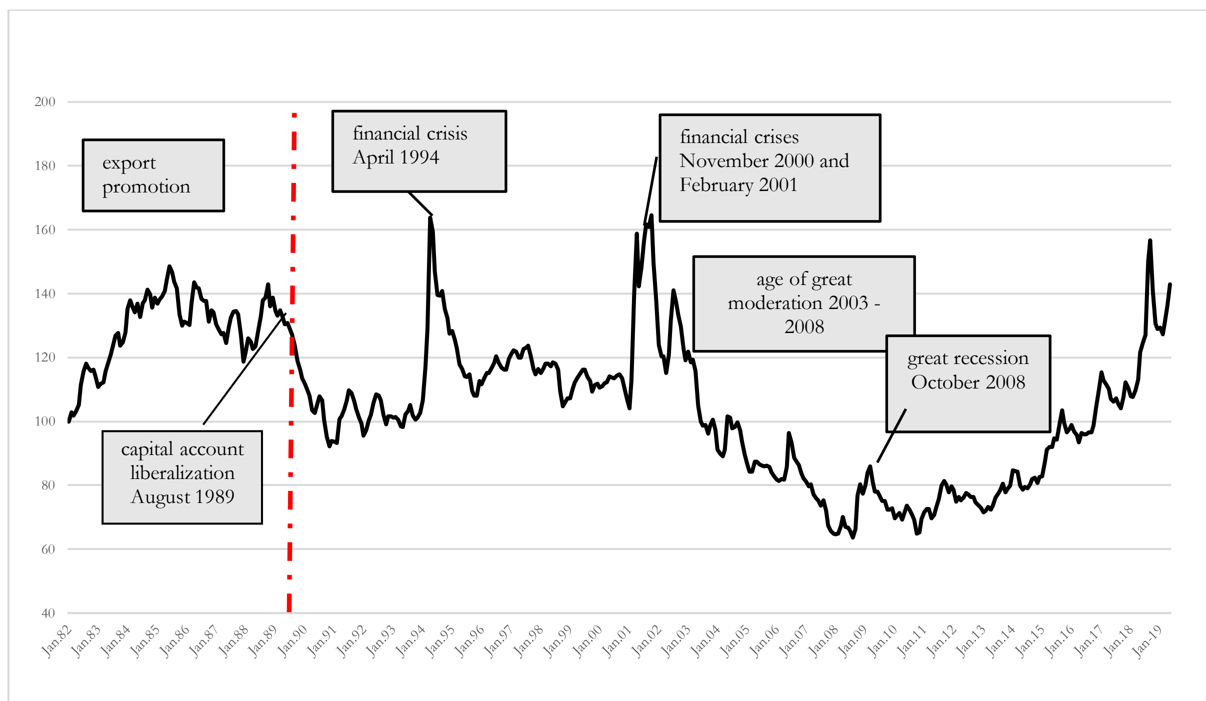

Figure 4: Real exchange rate index (TL/$) PPP in consumer prices (1982=100)

Source: Authors' calculations from CBRT EVDS data

Note: Real exchange rate in PPP terms with producer prices as the deflator.

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

developing, lost control over all instruments of austerity leaving the fate of capital investments and employment generation to the *caprices* of finance.

Focusing onto the period of our analysis, data reveal that following 2001 the Turkish Lira has appreciated by as much as 70% till September 2008, when the conditions of the global asset markets had completely changed. It remained overvalued in the next decade. All of these meant a build-up of external debt. Despite the rapid increase of the *level* of external debt, its ratio to GDP appeared salient at around 45 percent as a result of growth, but more importantly due to the appreciation of the Lira, which overstated the GDP in dollars. In fact, the appreciation of the Lira hid much of the fragility associated with the increase in external debt and the attendant increase in the current account deficit. After 2008, the total increase in external debt was higher than the increase in national income. A significant portion of the external debt was of short-term structure. Figure 5 shows the rise in the private sector's external debt, where, in addition to the banks and financial institutions, the nonfinancial corporations also rapidly borrowed from abroad.

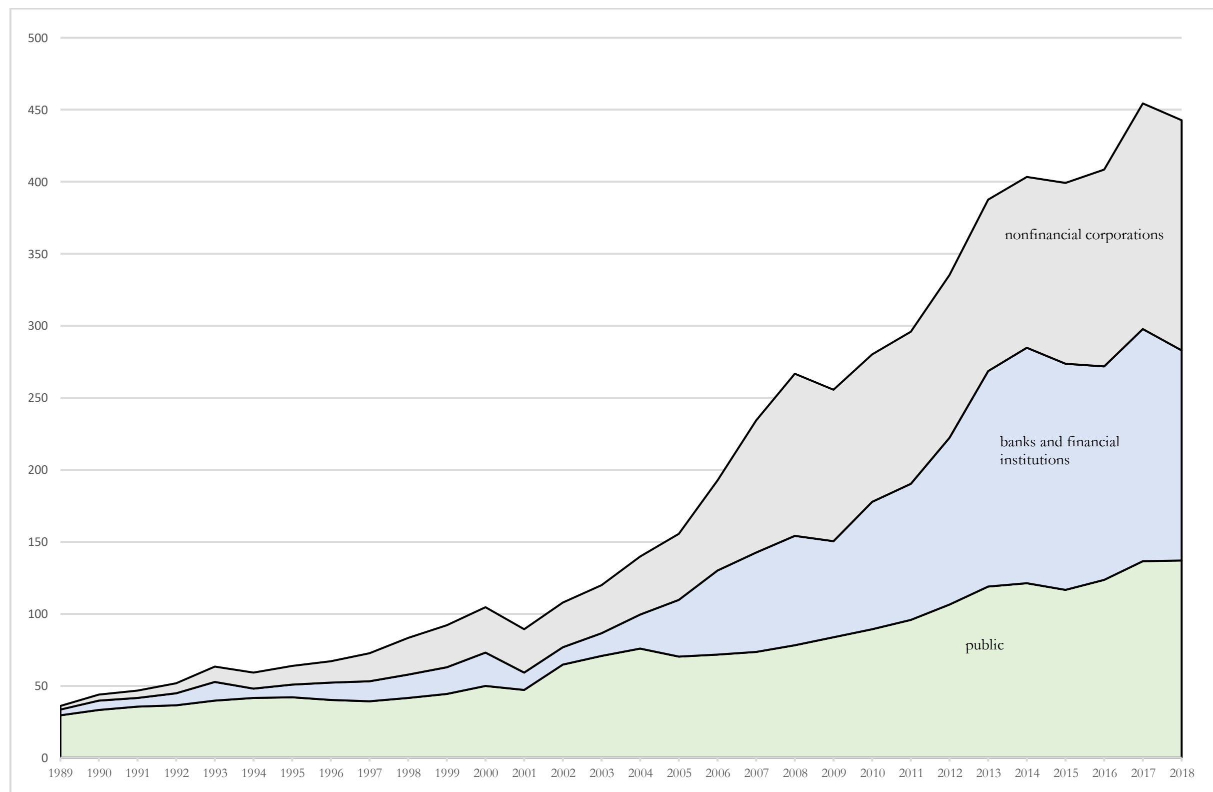

Figure 5: External debt accumulation, billion USD.
Source: CBRT EVDS

In short, Turkey was faced with a deteriorating external balance due to increased capital inflows leading to wide current account deficits and a rapid accumulation of external debt, which rendered the economy

extremely fragile to a reversal or even a slowdown of capital inflows. This buildup of external fragilities occurred alongside a rapid domestic credit expansion, as we examine in the next section.

2.2 Domestic credit boom

Turkey's successful adherence to the era of "great moderation", supported by increased capital inflows and lower inflation rates, led to a decline in the domestic interest rates and encouraged an unprecedented increase in the volume of domestic credit. Most of the debt in the 1990s was due to the government's borrowing needs. Government budget deficits were seen as responsible for the economic problems prior to the 2000s, and through widespread privatizations and primary budget surpluses, they were brought under control. While the government borrowing needs declined, a steady expansion of credit to the private sector followed. The increase in capital inflows supported the domestic credit boom in two main ways. First, capital inflows into financial markets led to an increase in financial asset prices and hence an increase in the net worth in the economy that can be used as collateral and as a result a decline in leverage ratios. In the same process, capital flows also contributed to the decline in the interest rates, enabling firms and households to borrow more. Second, a significant portion of the capital flows went directly into the banking sector to be converted into domestic credit. These processes are not peculiar to Turkey as capital flows to "emerging markets" led to credit and asset bubbles after QE policies as domestic banks borrowed from abroad to fund domestic lending (Akyüz 2012, 2015; Orhangazi 2014, Orhangazi and Özgür 2015). Furthermore, expansion of the credit contributed to the widening of the current account deficit through its expansionary impact on demand by increasing imports of consumption goods and intermediate and capital goods, exacerbating the import dependence of domestic production.

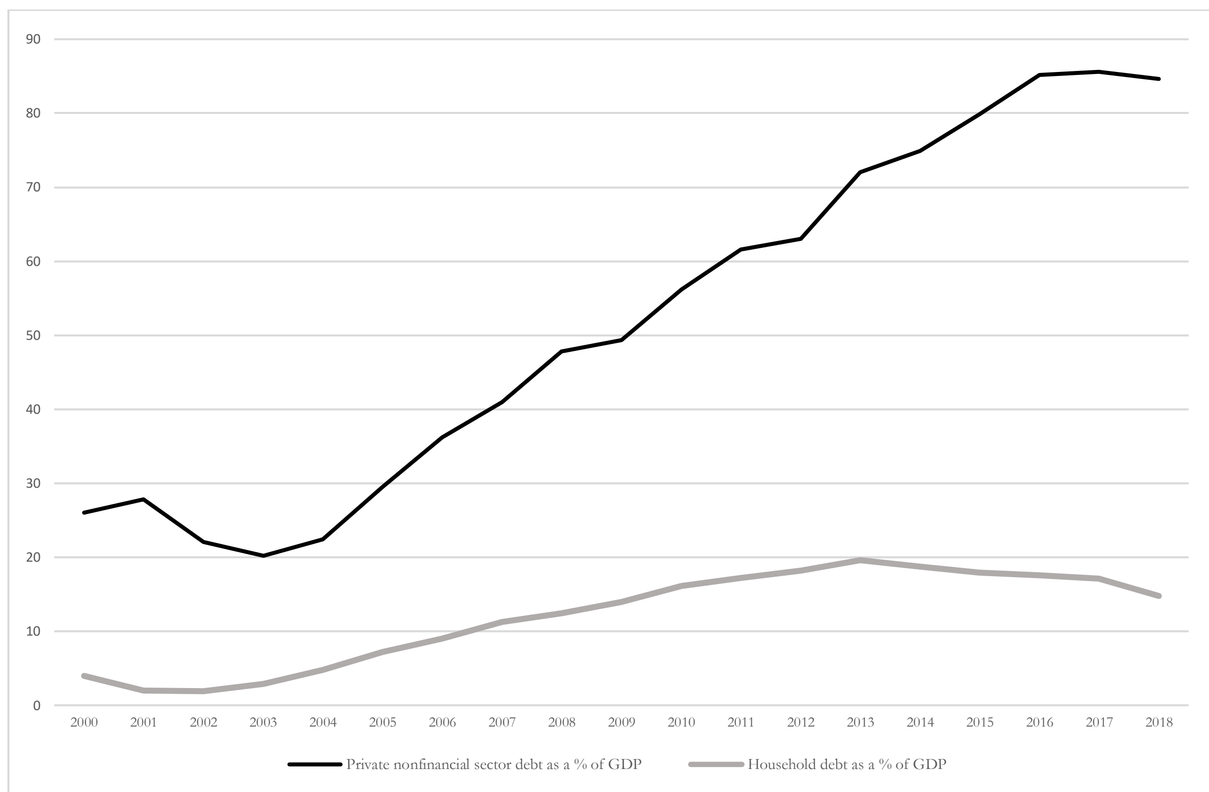

Figure 6: Credit expansion in the 2000s

Source: Bank for International Settlements

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

As the credit boom continued, debt dynamics were usually ignored and Turkey, in comparison with advanced economies that had higher debt ratios, was declared safe. However, as Minsky (and others) showed, credit booms are often followed by financial crises through similar structural dynamics. At the beginning of the boom, the expanding credit volume contributes to economic growth by supporting increased production and consumption. This economic expansion is usually accompanied by soaring stock and/or real estate prices

as credit growth also supports and enables more investment in these assets by investors and speculators. Inflation-targeting Central Banks refrain from intervening to the credit boom as long as inflation rates remain stable and economic expansion continues, allowing the credit boom to take a life of its own. As the growth rate of credit exceeds the rate of growth of the economy, the debt repayment capacity of the economy starts to falter and macroeconomic fragility increases. Once credit growth, for whatever reason, slows down and is reversed, dynamics of deleveraging take over. In the case of Turkey, comparisons were usually made with advanced economies with higher debt-to-GDP ratios and these debt dynamics were ignored. However, when in 2018 the Central Bank was forced to increase the interest rates to stabilize the foreign exchange markets, credit expansion came to an abrupt halt and debt repayment problems emerged with both small and large corporations declaring bankruptcy.

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

2.3 Unbalanced growth: Import-dependent, construction-centered growth

The accumulation of domestic and external financial fragilities in the 2000s was accompanied by an unbalanced economic growth. A prolonged period of overvalued real exchange rates (see Figure 4 above) due to increased foreign capital inflows promoted increased use of imported intermediate goods in many sectors, while, at the same time, resulted in a loss of export competitiveness in some sectors. The overall impact has been slow industrial growth which led to concerns of *premature de-industrialization* as the share of industrial production within the GDP declined.

At the same time, construction activities rapidly increased, due to three main reasons: First, as the share of agriculture in total production declined, the 2000s witnessed a significant migration towards cities and rapid urbanization, leading to an increased need for housing as well as other types of structures including hotels, malls and various types of infrastructure. In addition, the 1999 earthquake had revealed the need for updating some of the current housing stock that was deemed unsafe, contributing to an increase in construction activity. Second, the relatively lower and stable inflation rates coupled with the financial expansion enabled the banks to introduce long-term housing loans, which generated an expanding demand for housing. In the process, a classical speculative wave also emerged, where the housing price increases due to increases in the demand generated further increases in the demand, financed by credit, with the expectation of further

increases in housing prices. Yet, the third and most important factor behind construction-centered growth was the government's deliberate policy choices. The government began a massive construction spree including the building of new public buildings, new public universities, highways, subways and airports. At the same time Public Housing Authority (PHA), initially established to provide low-cost housing to the low-income households, was granted special privileges in 2004 such as utilization of idle public land and engage in construction through subcontracting, and effectively turned to a contracting agency of the government.

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

Figure 7 shows the increase in the significance of construction within the economy over the 2000s and 2010s. The acceleration began around 2004 after the decline following the 2001 crisis. The share of construction spending within the GDP increased from a low of 7.5% in 2004 to 17.2% by 2017. Meanwhile, the employment in construction sector constituted around 7.4% of all employment by 2017. As Figure 8 shows, this increase was enabled by the credit boom as construction, real estate and mortgage credits increased rapidly after 2004. By 2006 the construction companies also began increasing their external borrowing, which increased from a low of around 1.5 billion USD to over 26 billion USD by 2018.

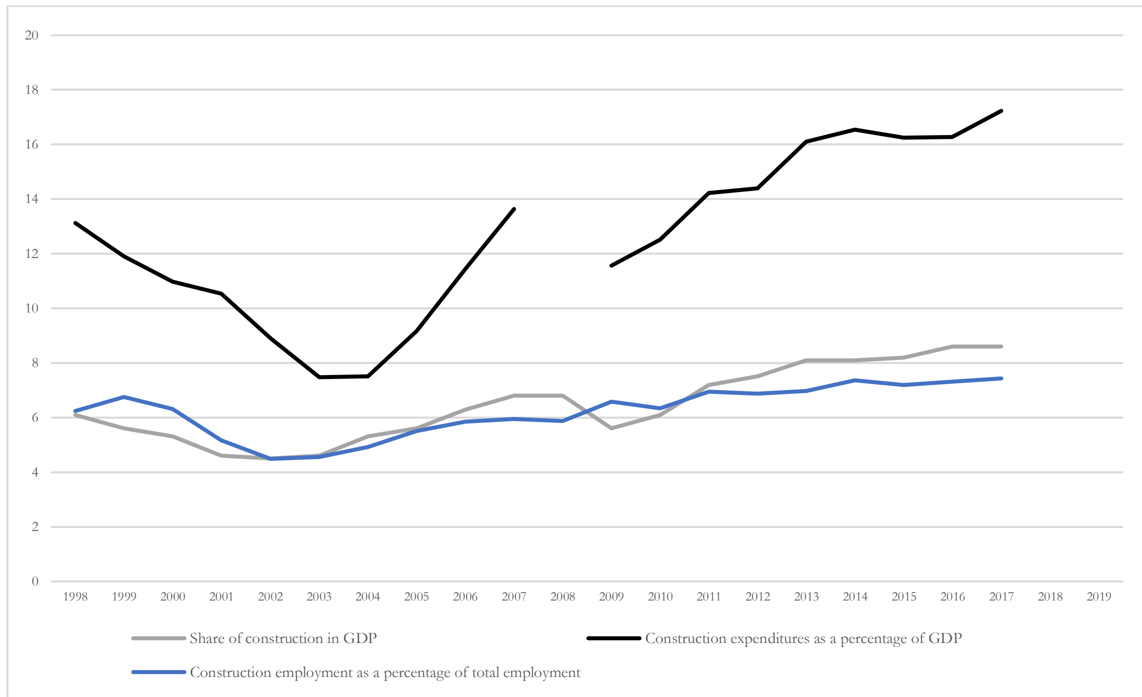

Figure 7: The share of construction within the economy

Source: TurkStat

Note: The construction expenditures as a percentage of GDP series is broken due to a change in the national accounts.

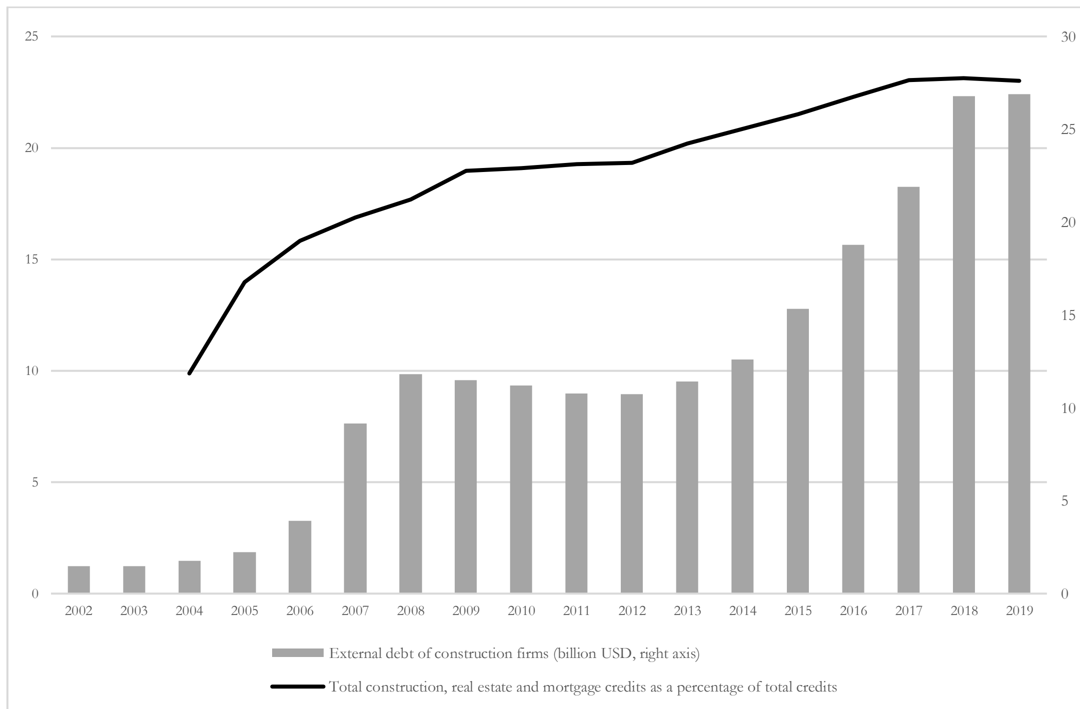

Figure 8: Construction, real estate and mortgage credits and external borrowing of the construction firms

Source: CBRT EVDS

The construction-centered growth model generated three main problems. First, these investments were not productive as such as a significant portion of them came to depend on continued flows of aggregate demand and on price appreciation. Second, growth depended on the availability of cheap credit and proved fragile against any shocks to credit growth or to the rate of interest, as it became evident in 2019. Third, in parallel to the import dependence of the whole economy, the construction sector also became more import-dependent and hence costs of production started to be sensitive to volatilities of the exchange rate.

All in all, when we take into account the fragilities presented in the previous sections, the economy began suffering from a malign mix of currency and maturity mismatch risks, interest rate risks as well as overproduction and underconsumption risks as the economic growth increasingly depended on capital inflows, credit expansion and construction growth. The reflection of this model on class dynamics and patterns of income distribution is briefly examined in the next section.

2.4 Class dynamics and patterns of income distribution

2.4.1 Current account deficit and structural unemployment in the 2000s

"Jobless growth" has been a major characteristic of the 2000s and 2010s as the unemployment rate rose above 10 percent after the 2001 crisis, and despite a long expansion has not returned to pre-2001-crisis levels. As narrated above, the structural overvaluation of the Turkish lira, not surprisingly, manifested itself in ever-expanding deficits on the trade and current account balances. As traditional Turkish exports lost their competitiveness, new export lines emerged. Yet, these proved to be mostly import-dependent, assembly-line industries, such as automotive parts and consumer durables. They utilized cheap imported materials, assembled in Turkey with low value-added, and were re-directed for export. Thus, being mostly import-dependent, they had a low capacity to generate value added and employment. As traditional exports dwindled, the newly emerging export industries had not been vigorous enough to close the trade gap.

The close relationship between meager job creation and the foreign deficits are portrayed succinctly in Figure 9. In order to isolate the effect of non-energy imports, the trade deficit is taken as non-oil trade deficit and due to the presence of high seasonality and structural factors, the rural economy is also taken out and non-agricultural unemployment ratio is portrayed. Thereby, we follow the close relationship of the *non-oil trade deficit* together with the *non-agricultural unemployment*. To emphasize the initial conditions of the ensuing persistence in unemployment, we exclusively focus on the pre-2009 global crisis period. The portrayal of the rising non-agricultural unemployment along with an expanding (non-oil) trade deficit is no surprise to students of development economics. As Turkey consumed more and more of value added produced *abroad*, and found it profitable to do so with an appreciated currency financed by speculative financial inflows, external deficit widened and foreign debt accumulated. The costs of this *speculative-led growth*, however, were realized as losses in jobs, deepening informalization, and decline of real wage income.

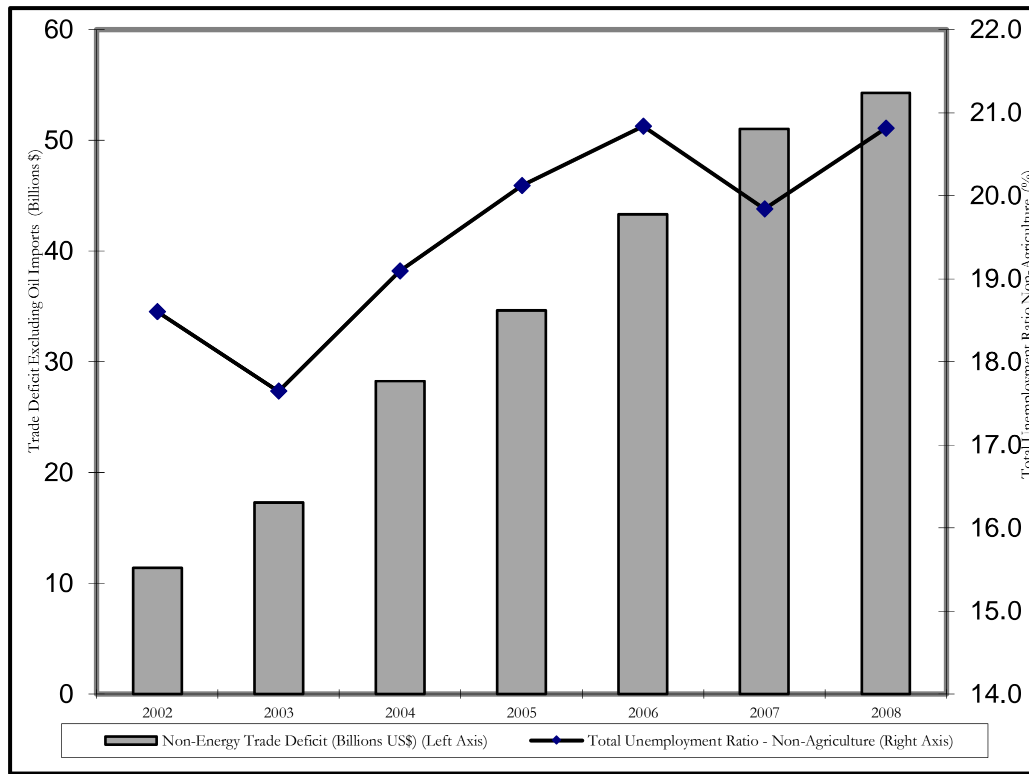

Figure 9: Non-oil trade deficit and non-agricultural unemployment rate

Source: TURKSTAT Household Labor Force Statistics and CBRT Balance of Payments data

2.4.2 Developments in the wage remunerations of labor

The post 2001 period had also witnessed a pattern of first *contraction*, and then *stabilization* of the manufacturing wages. Such a transfer of financial returns through very high real interest rates offered to the financial system would, no doubt, call for repercussions on the primary categories of income distribution. It is clear that creation of such a financial surplus would directly necessitate a squeeze of the wage fund and a transfer of the surplus away from wage-labor towards capital incomes, in general. It is possible to find evidence to the extent of this surplus transfer from the path of the manufacturing real wages. Figure 10 portrays the dynamics of the manufacturing real wages and offers contrasts against productivity of labor over a broad time horizon to give the basic turning points of the wage path.

The wage rate in private manufacturing was typically following the business cycle with a lag all over the post-1990 reform age. Clearly, the most important observation is the opening gap between productivity of labor and its real wage remunerations.

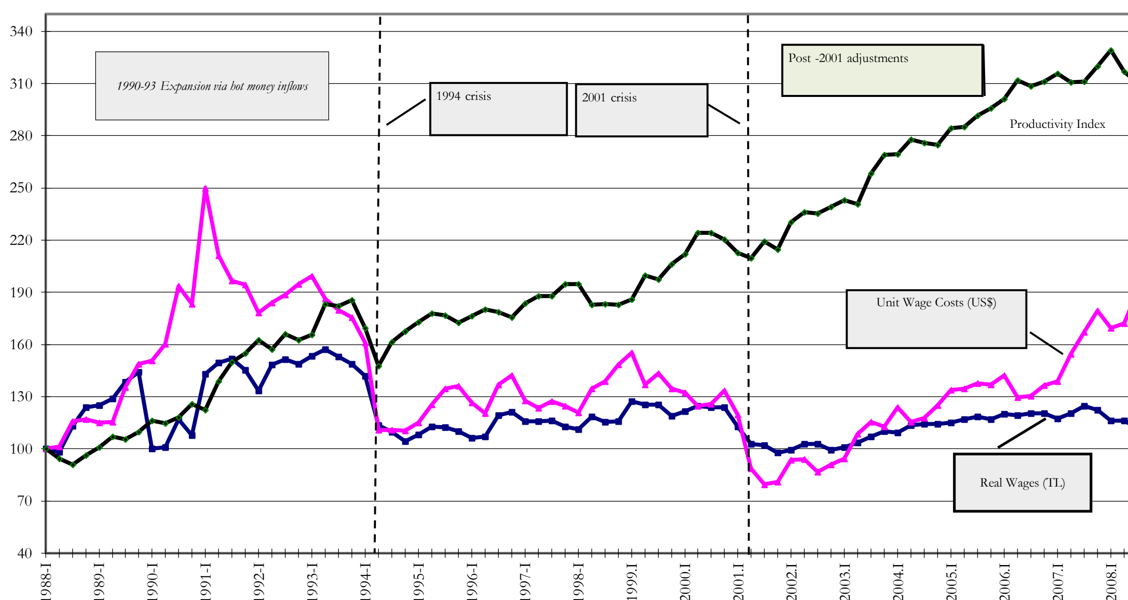

Figure 10: Productivity and real wages in private manufacturing (1988=100)

Source: TURKSTAT Manufacturing Sector Annual Reports

Unfortunately, detailed wage data is quite scarce in Turkish statistics and we have to rely on alternate sources for a full grasp of the picture. Data from the Ministry of Development on the *new* series date from 2007 to 2017[3], and we portray it in Figure 11. Post-2007 data reveal that, at least in the case of manufacturing sector, real wages continued to follow productivity gains up until 2013; the series moved roughly in order till 2016. In what-follows, Turkey entered a severe political debacle with frequent elections and a referendum over the governance regime. That period coincided with a brief episode of wage support reflecting a panicky concern aimed at purchasing votes of the middle classes by the ruling government. Deceleration of labor productivity, coupled with an acceleration of inflation, started to choke *real* wage rates, and labor remunerations once again seemed to fall behind the rate of growth of productivity. Unfortunately, our data series come to an official close by 2018 and we have to rely on independent studies to come to a conclusion on this issue.

[3] Ministry of Development has been shut down under the new presidential government regime put into effect in 2018.

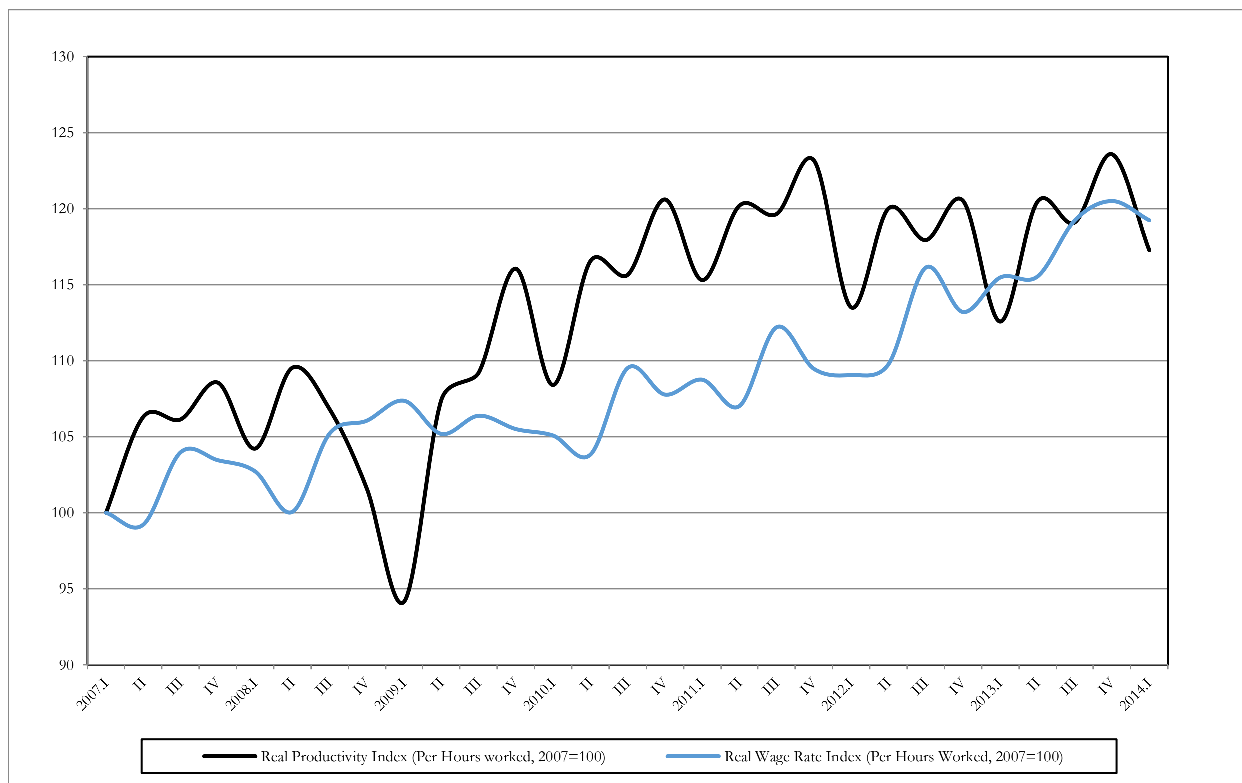

Figure 11: Real productivity and wages in manufacturing (2007=100)

Source: Ministry of Development (formerly State Planning Organization) Main Economic Indicators

We follow these evidence by directly looking at the wage income shares. All of the above naturally led to a falling share of labor income in aggregate value added and a worsening of the (functional) distribution of national income. Concomitant to the *financialization* process, wage shares all around the world had been on a declining trend over the last three decades. According to the Ameco data of the European Commission, this fall was particularly pronounced in Europe from a high of 73% of national income to less than 65% in 2005; and from 70% to 58% in Japan. Similar developments were also at work in other parts of the OECD as well (see Figure 12).

Furthermore, the post-2001 crisis period was also characterized by authoritarian practices in terms of labor relations and regulations as maintaining competitiveness mostly depended on keeping the productivity-wage gap large, and as Bozkurt-Güngen (2018) succinctly narrates, intensification of labor exploitation through high working hours became a basis to generate absolute surplus value. In short, in an economy characterized by relatively low labor force participation rates, high unemployment, and mostly stagnating real wages, expansion of credit became quite important for household as discussed above.

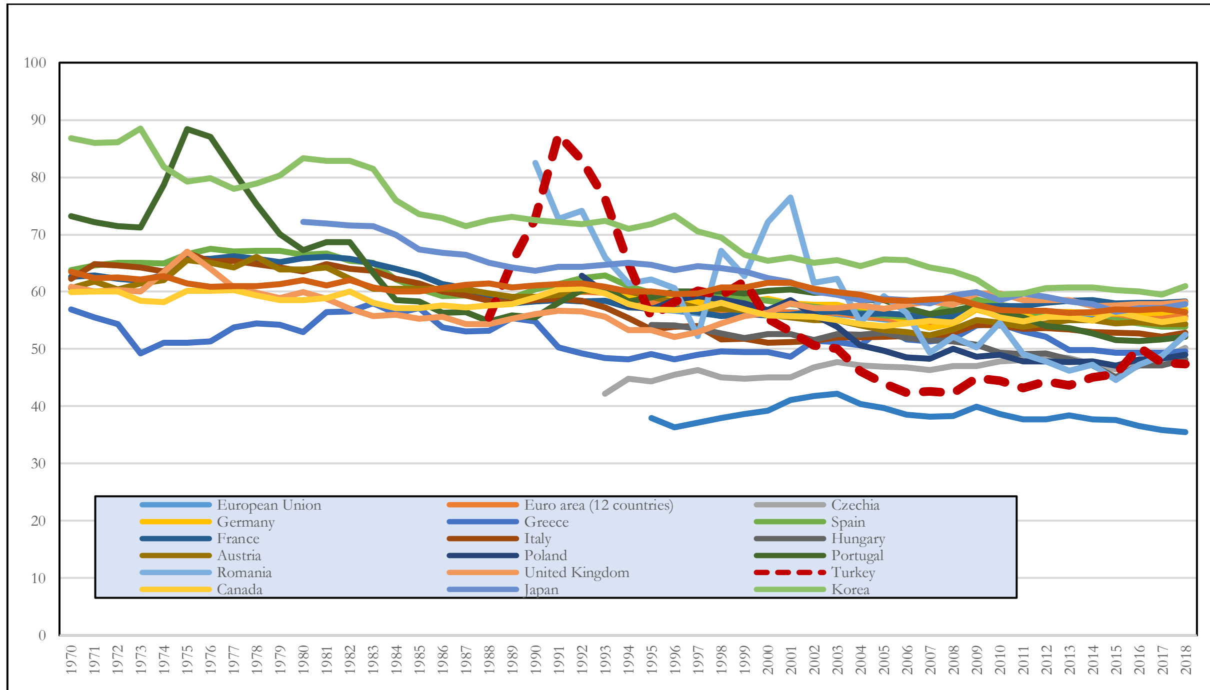

Figure 12: Adjusted wage share (compensation per employee as percentage of GDP at market prices per person employed)

Source: European Commission Economic and Financial Affairs, AMECO data base

Moving from *functional* to the *size distribution* of income, a relevant popular metric is comparison of the income shares of the upper-most 1 percent rich, against that of the bottom half. Data disclose two different Turkish realities, separated by the eruption of the global crisis. Before 2007, taking advantage of an appreciated currency and modest inflation rates, incidence of poverty seems to decline along with improvements in income distribution. Post 2008 adjustments to the global crisis, however, openly fall over the poor; and the upper-most 1% rich income groups are observed to expand their income shares by as much as 8 percentage points (Figure 13).

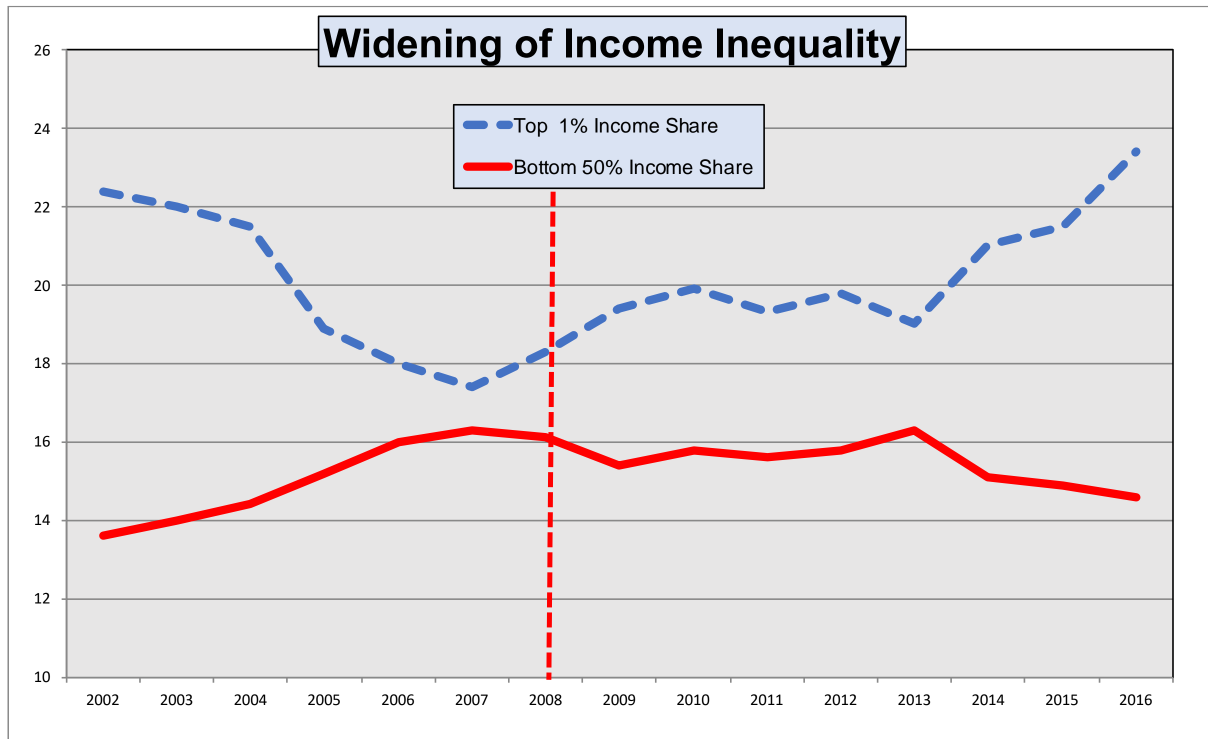

Figure 13: Income inequality- top 1% vs. bottom 50%

Source: TURKSTAT, Household Income Surveys

Household level income distribution, on the other hand, seems to be very little affected over the course of events. Poor stayed poor, while rich got richer. According to Turkstat data, a direct comparison over 2007 to 2017 reveals that almost 75% of the household population could have received less than the mean income. Measured in Turkish Lira units, these data have the advantage that it is not distorted by currency movements; and gives a direct estimate of the household disposable income. (Table 1)

Distribution of Household Disposable Income

		Cumulative percentage groups (TL)					Mean Income (TL)
	No of households ('000)	%10	%25	%50	%75	%90	
2006	17,284.2	4,555.0	7,140.0	11,387.0	18,474.0	28,054.0	15,102.0
2017	23,096.0	15,584.0	22,192.0	34,709.0	53,906.0	82,694.0	46,131.0

Source: TURKSTAT, Household Income Surveys

Table 1: Distribution of household disposable income

Source: Turkstat, Household Income Surveys

3. “THIS TIME IS DIFFERENT!”

In the words of Akyüz and Boratav (2003), once again all the reasons for a crisis were ready. A combination of push-factors (global liquidity in the 2000s and QE policies after 2008) and pull-factors (high domestic interest rates, currency appreciation and the “success story” of IMF-led structural reforms starting in 2002) resulted in a prolonged period of net private capital inflows into the Turkish economy, resulting in increased vulnerability and external fragility against a sudden stop or reversal. External debt of both financial and nonfinancial corporations reached to unprecedented levels, rendering them fragile against a change in global lending conditions as well as to currency shocks. The capital inflows led to a long period of overvalued real exchange rate, increasing the import dependency of the whole economy, widening the current account deficit and rendering it more vulnerable to exchange rate movements. The capital inflows contributed to the credit expansion, which, in a Minskian fashion, continuously increased the financial fragility of the economy. As the government policy favored construction as the leading economic activity, an unbalanced growth period emerged. Figure 14 summarizes the growth dynamics and the concomitant accumulation of fragilities.

The early signs came during the 2013-15 period, beginning with the Fed’s tampering decision around mid-2013. The Fed’s announcement signaled that the global liquidity conditions were to change, which led to a slow-down in capital flows towards the emerging markets. In January 2014, in the midst of a rapidly declining currency due to negative global conditions coupled with political instability in Turkey, the Central Bank had to increase the interest rates in a midnight emergency meeting to stabilize the currency. As the “taper tantrum” faded away and capital flows continued into 2014 and 2015, economic growth has also continued. However, a major policy dilemma began forcing itself. While low interest rates were important for construction-centered economic growth, the global conditions that made low interest rates possible were disappearing. After the failed coup attempt in 2016 and the following one-quarter decline in the GDP, the government decided to support credit growth full force and not let the economy go into a recession. This choice was partly due to political reasons as in mid-2017 a regime change away from parliamentary democracy towards a presidential system was to be voted in a referendum and the government did not want to take the risk of going to a vote during an economic contraction. Government sponsored Credit Guarantee Fund, which was initially established to support small and medium sized businesses, was the preferred tool to be used to support the credit growth. The main contradiction of this policy was that the increase in credit supported economic growth and contributed to the current account deficit, making the Turkish lira more vulnerable. Following the regime change in 2017, the government decided to go for early elections in 2018 and again with the same logic used all available tools not to allow a contraction before the election. However, the TL started sliding towards the election and in the summer of 2018 a political rift between the US and Turkey caused a sudden outflow of both foreign and domestic capital and resulted in a sharp depreciation of the currency. The foreign exchange crisis rapidly evolved into a debt crisis as many firms applied for bankruptcy protection and banks were forced

to restructure a significant amount of outstanding debt. By early 2019, the economy was in a recession though in uncharted waters as partial capital controls in foreign exchange markets were imposed to prevent speculation on the Turkish lira.

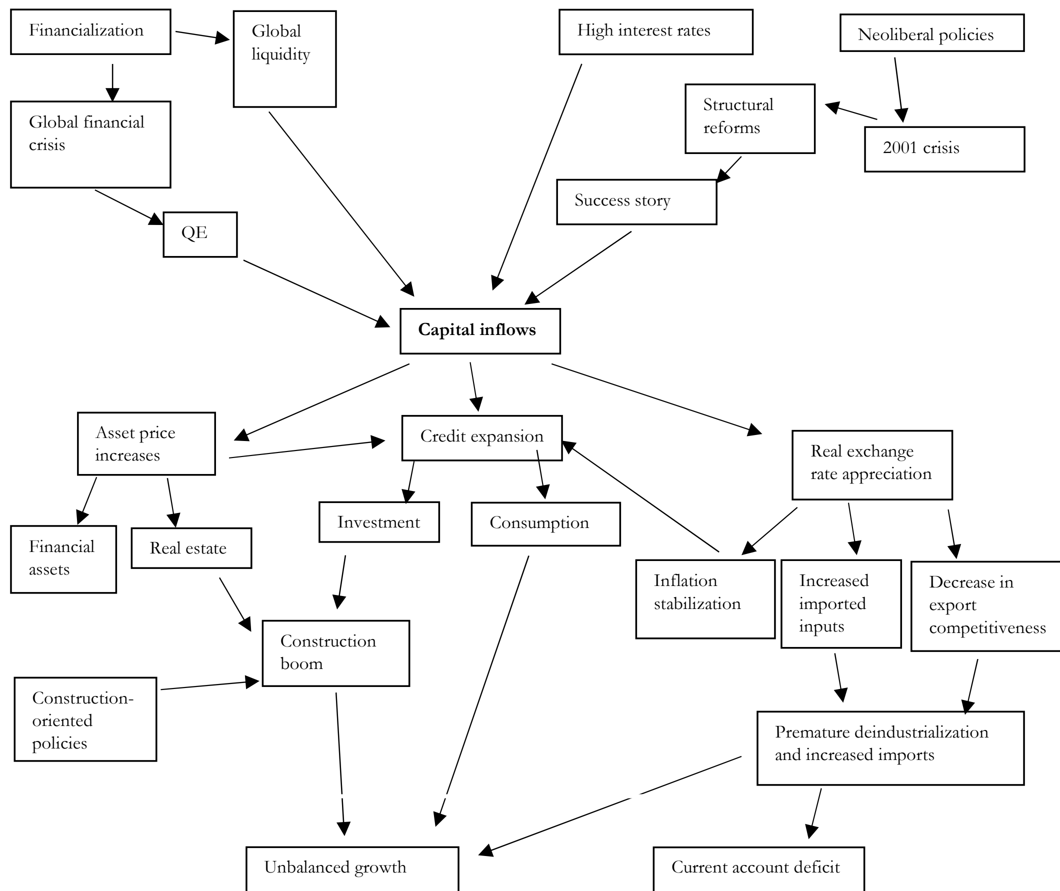

Figure 14: Overview of the foreign-capital-inflow-dependent, debt-led, construction-centered economic growth model

Note: Adopted from Orhangazi 2019: Figure 12.

Before things came to this point, starting in the second half of the 2000s and especially after the 2008-09 global financial crisis, a "*this time is different*" argument became dominant in Turkey. It was argued that as Turkey completed a series of structural reforms in the aftermath of the 2001 crisis, strengthened its banking system and managed to get the public debt under control, it was now immune from financial crises. In fact, the resilience of the Turkish financial system during the global financial crisis, coupled with the significant increase in capital inflows afterwards, declining domestic interest rates and seemingly robust economic growth were all seen proofs of this assessment. In fact, hopes were raised so much that the government declared that

the Turkish economy would join the largest 10 economies of the world by 2023! This time was indeed different, but not in the sense that the economy was now more stable; but in the sense that *new forms of external fragilities* compared with the earlier crises of the Turkish economy in the 1990s and the early 2000s were on the rise. We identify four significant differences.

First, in the previous crisis episodes the source of fragilities mostly originated from the government budget deficits and public borrowing requirements, while this time it is the excessive and rapid expansion of domestic credit that, on the one side, made the construction-centered economic growth possible, but on the other side, made the economy more vulnerable to changes in credit conditions. It is important to remember that the financial crises of the 1990s made most developing countries cautious of public sector deficits. In Turkey, economic policies after the 2001 crisis were built on fiscal discipline while the Central Bank focused on inflation targeting. However, as Palma (2012) shows, fiscal discipline and price stability are not sufficient to maintain financial and macroeconomic stability during capital inflows, as the cases of Brazil and East Asian countries in the 1990s show. Eichengreen and Gupta (2014) find that the taper tantrum of 2013 affected developing economies with low levels of budget deficit and public debt as well. Furthermore, Caldentay and Vernengo (2012) show that excessive fiscal conservatism at the end may actually worsen the problems when the economy depends excessively on private spending, which is likely to collapse in the event of a decline in capital inflows, as seen in Central American economies in the 2000s. Furthermore, as Ivanova (2017) notes credit booms follow a similar dynamic where at the early stages of the business cycle increase in the credit volume stimulate consumption and investment and hence contribute to economic expansion. As long as the price level remains relatively stable, central banks refrain from intervening to the credit expansion. However, the credit boom eventually leads to asset price inflation and depending on which asset class is at the center of the investor and speculator interest, credit expansion finally gives way to financial distress. In this respect, it is important to note that capital inflows and domestic lending are linked to each other in a pro-cyclical manner. As capital inflows increase, the risk premia of the country usually falls and at the same time cross-border banking increases the domestic banks' lending capacity. If the credit growth exceeds domestic deposit growth, banks can resort to wholesale funding from foreign banks (Brunnermeier*, et al.*, 2012: 11). Hence, a divergence emerges between credit expansion and domestic deposit growth (Lane and McQuade, 2014).

The uncontrolled credit expansion made the containment of a negative credit shock difficult as the fragilities were not centered on a single entity - government debt - but spread and dispersed in the overall economy. Starting in 2018, it became clear that excessive and unpayable debt spread around most of the nonfinancial corporate sector and a series of bankruptcy pleads followed. Towards the end of 2019, it is still not clear how much of the domestic debt is unpayable as the government takes a piecemeal approach to the issue and forces the (public) banks to restructure debt for certain sectors or groups of firms.

The *second* major difference is the length of the preceding expansion. Earlier crisis episodes came after short, at most a couple years of, expansions in foreign capital inflows, which were followed by sudden stops or reversals. The current expansion, though, lasted from the early 2000s into the 2010s with only a brief interruption during the Great Recession. While the QE policies of the post-2008 era provided the push-factor for the continuance of capital inflows, Turkey's preference for a strong TL in order to help with the disinflation process and the absence of capital controls ensured that no policy action was taken to control the expansion. In fact, in 2009 the government relaxed the foreign borrowing rules for corporations. Whereas in the earlier regulations, firms with no foreign currency income source were allowed to borrow in foreign currency, now *all firms* were granted this option. This made it cheaper to borrow for the firms and contributed to increased capital inflows. In addition, the Central Bank introduced a "reserve option mechanism" allowing the domestic banks to keep their required reserves in foreign currency at the Central Bank, hence giving them an incentive to borrow in foreign currency instead of domestic currency to meet their reserve requirements. As such, the Central Bank began using non-conventional mechanisms; and yet preferred not to intervene and pretended that a debt-led growth model was stable even though there were no build-in stability mechanisms hindering capital outflows.

Third, the long period of capital inflows kept the Turkish lira overvalued for a long time, leading to an increase in import-dependence and loss of industrial base in export-oriented sectors. In previous crisis episodes, the sudden decline in the value of the currency usually helped economic recovery as it spurred an increase of the export volume. However, this time both the erosion of the traditionally export oriented industries, as well as the increased dependence of production to imported inputs renders an export-led recovery weaker.

Finally, the *fourth* difference can be found in the institutional and policy environment of the second half of the 2010s. The rapid chain of events that took place in this period, including a failed coup attempt, a fundamental political regime change, the erosion of institutional decision-making and the restart of the armed conflict within the country, together with Syria-related developments all contributed to an increase in both political and economic uncertainties. The government's reluctance to provide a coherent policy framework to deal with the crisis results in a fragmentary approach that on the one side includes a debt-financed fiscal expansion, use of state banks to continue credit expansion, and selective bailouts and deals to save firms politically close to itself but on the other hand attempts to put the burden on the working class through increased taxes and wage suppression. The lack of an orthodox policy framework to tackle the crisis is leading many to call for structural reforms. In its latest Article IV Mission Concluding Statement the IMF has also joined the group and called for a focus on structural reforms with special emphasis on increasing labor market flexibility. We now briefly discuss whether the so-called structural reforms can actually bring relief to the economy.

4. STRUCTURAL REFORMS AND THE WAY FORWARD

The "structural reform" agenda of the IMF and the World Bank, in its broadest sense, aims to create a global market society through minimizing government regulations and interventions in the economy. In the 1990s this agenda was imposed on a number of developing countries through policies coded as the Washington Consensus. Currently there seem to be four major items on the agenda. The first item is usually known as "austerity", which, in order to keep the public debt below certain thresholds, include cutting public spending and increasing tax collection to balance government budgets. Behind this policy approach lies the belief that increasing public debt leaves less funding for private investment, and hence, creating an obstacle in front of private sector investment and economic growth. Therefore, it is argued, the government budget deficit needs to be kept to a minimum, be it through spending cuts or through increases in tax collection. The taxation side usually includes an increase in indirect taxes (such as sales or value added tax) rather than an expansion of the tax base over capital incomes possibly by way of an increase in the taxation of corporate profits or on the incomes of the wealthy. The implicit assumption here is that lower taxes on corporations are supposed to induce more private investment. In fact, one of the pillars of the post-2001 crisis policy framework in Turkey has been primary budget surpluses. Yet the above-summarized fragilities and vulnerabilities of the economy had accumulated in a period when the primary government budget balance was in surplus, and the total government debt to GDP ratio was kept well below the suggested thresholds. The current instability does not stem from public debt, nor there is any reason to expect that austerity policies would address the prevailing structural problems and fragilities of the Turkish economy. On the other hand, the Turkish government does not seem willing to follow austerity policies as a whole and has been preferring, especially after the 2018 exchange rate crisis, to increase public borrowing and spending as much as possible to keep the economy afloat. The important question in this regard is where that public spending goes; whether to creating jobs and alleviating poverty through social programs and investment in education, health and so on, or only to selective firm bailouts, unproductive construction programs and funding military adventures.

The second item on the structural reform agenda involves privatization of all sorts of public enterprises and the opening up of all areas of the economy to private capital. As the narrative goes, public sector, without the profit motive, is inefficient and therefore is prone to waste; whereas the private sector would intrinsically increase efficiency of resource allocation as well as quality of services provided. Turkey has already not only privatized the vast majority of the public enterprises, but it has also removed most barriers in front of private markets including the role of agricultural subsidies and opened up almost all markets to foreign competition as part of the post-2001 crisis policy framework. As such, again, there is no reason why privatizing whatever little left would contribute to getting rid of the financial fragilities accumulated. Yet, the government started a Sovereign Wealth Fund and lump-summed all public assets and enterprises under this fund. While the

objectives of this policy action are not clear, it is expected that the fund will be used as a parallel budget disguising the true balances.

The third item on the structural reform agenda in the last decade pertains pension reform. It is suggested that the costs of public pension funds and social security systems are increasing and putting greater strains on the government budgets and therefore social security premiums need to be increased, retirement age raised, the public's role in social security should be decreased and private pension fund system should be supported to enable individuals to save for their own retirement. In the context of Turkey, attempts to spread private pension funds intensified in the last year, with the claim that this policy would increase savings and hence lead to increased investment in the economy. However, this claim ignores the fact that a major problem for the social security system in Turkey is the lack of efficient collection of employer payments to the system and essentially aims to put all the risks on individuals. [4]

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

None of the items on this structural reform agenda problematize the excessive dependence of the economy on foreign capital inflows, the resulting exchange rate misalignments and its import-dependence consequences. Similarly, neither the debt-led nor the construction-centered characteristics of the economy is questioned. They do not address the immediate issues of debt deflation or skyrocketing unemployment rates. A real reform program needs to rethink the fully liberal external accounts and debt-driven nature of the economy and think about ways to de-financialize the economy to make it work for the majority rather than the domestic and international rentiers. However, given the current political environment, there seems limited space for serious policy discussion.

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

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