The Present Global Crisis and Its Effect on the Turkish Economy

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Abstract

The global economic crisis first started in the USA in September 2008 as a widespread insolvency problem caused by mortgage debts of households that had become unpayable. The financial crisis, in turn, caused a serious recession. The economic crisis soon spread to other developed countries because their banks held assets of US banks that had become nearly worthless while exports of these countries to the USA decreased significantly. Then it spread to developing countries because direct private investments (DPIs) and financial funds flowing from developed to developing countries declined precipitously while exports of the latter to the former countries also fell down. The developed countries, however, took proper steps to ameliorate the crisis by lowering the interest rates, helping the insolvent banks financially as wel as launching public expenditure programmes. Turkey was one of the worst hit countries because she had been following wrong globalization strategies. Privatization process was corrupt while much of the DPIs went to those fields which did not yield much increase in employment or export potential. But most importantly, Turkey had raised interest rates to abnormally high levels and thereby had vastly expanded her internal and external debts. Hence, as a result of the global economic crises, Turkey suffered a significantly deep fall in her GNP growth rate and a very big increase in her unemployment rate. Though Turkey took several measures to ameliorate the balance of payments deficit and to expand total demand, hence production, the government refrained from making a stand-by agreement with the IMF in order to avoid strict discipline in her government expenditures due to first, local elections and presently, the coming parliamentary elections.

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1 The Present Global Economic Crisis

The present global financial crisis and global recession emanated in the USA first. The generally accepted date is September 2008 when two giant mortgage firms, Freddie Mac and Fannie Mae faced bankruptcy, followed by American Insurance Group (AIG) and all three received immediate, financial help from the American Treasury with partial nationalization as the quickest way of saving them. Since Lehman Brothers, on the other hand, had breached financial regulations, the government could not move to support it, hence Lehman Bros. went bankrupt. These events proved that the American financial sector faced a deep "insolvency" crisis on account of unpayable mortgage debts of households. These mortgage debts were called "toxic assets" because their presence invalidated the solvency of the financial firms dealing in mortgage credits (mortgage banks). But since the bonds as well as derivatives of mortgage banks were held in the hands of other financial institutions, that is, hedge funds, commercial banks as well as investment banks, the entire American financial sector was drawn into insolvency and crisis.

The mortgage crisis arose because of a number of reasons. One reason was that in order to keep the financial sector as "flexible" as possible, during the Reagan administration (1981-1989) it was largely deregulated. Secondly, real estate prices were rising continuously during the '90s. This prompted households to increase their mortgage debts, relying on the price rises. They also increased their personal consumption and decreased their personal savings. The mortgage banks, on the other hand, were happy to oblige this demand because it increased their profitability on paper in spite of the fact that a great portion of mortgage debts were to become bad debts. The fall in the prices of real estate in the later years since 1996 changed the entire climate. "Illiquidity" problems in the financial sector had arisen in September 2007 but turned

into a deep crisis of insolvency by September 2008.

To avoid or otherwise ameliorate the financial crisis, the American Treasury acted swiftly first with partial nationalization, then with an appropriation of a $700 bn. fund, called "Troubled Assets Relief Program" (TARP) to aid financial firms and banks facing illiquidity or insolvency problems on account of bad mortgage debts. FED, in addition, lowered the interest rate considerably in order ease the lending of banks. Furthermore, the FED fund that supports interbank credits was also raised.

In the later years, The US Treasury refrained from partial nationalization of banks and instead increased the equivalent of TARP to $2 trillion. Furthermore, banks were subjected to the so-called "stress tests" which investigated the financial strength of banks under simulated adverse economic conditions. Despite these radical measures nearly 200 banks went bankrupt.

The financial crisis also gave rise to a serious recession in the real sectors of the American economy. Therefore, measures were taken by the government, which were Keynesian in essence, to prevent or otherwise ameliorate the recession. The monetary measure was the fall in the interest rate which was to encourage or otherwise prevent a deeper fall in private investments as well as consumption credits, hence private consumption expenditures.

The Treasury, on the other hand, appropriated a considerably large amount of funds for expanding government investment and consumption expenditures to compensate the fall in private expenditures, partially if not fully. The items were selected in accordance with the needs of the economy at the time and included clean energy, social and productive infrastructure as well as health care.

Furthermore, also along Keynesian lines, personal taxes were lowered, particularly those falling on low and mid-income households in order to raise disposable household income, hence private consumption.

All the real sectors of the economy were hit hard by the recession, foremost the automotive sector, following the real estate and construction sector that had been at the center of the economic crisis. But since the automotive sector entails a large area of related sub-sectors, hence employment, the US government decided to lend aid to the two ailing American auto firms, the GM and Chrysler. The government demanded the GM to undertake the right steps of restructuring and also to lower its labor costs. Chrysler was demanded to go ahead with plans to be sold to a foreign company.

The financial crisis as well as the recession spread to other developed countries including the European countries as well as Japan, again because of a number of reasons. Many banks of other developed countries held the bonds, shares and derivatives of American financial institutions which had become nearly worthless, thus leading to financial crises in these countries also. In the second round, both the financial crisis and the decreased exports to the USA gave rise to recession.

The developed countries and the EU fought the financial crisis and recession with measures similar to those undertaken by the USA government and FED. Namely, both national central banks as well as the European Central Bank, the latter with a slight lag, decreased the interest rate. The respective treasuries, on the other hand, partly nationalized banks, mostly lent aid to the illiquid or insolvent banks while also organizing a program of their own to increase government investment and consumption expenditures. They also aided their automotive sector by encouraging and subsidizing sales of new cars to replace old cars.

The economic crisis also hit the developing countries of all levels, including the newly "emerging markets", generally causing balance of payments and recession problems. Firstly, the flow of foreign private capital (DPIs: direct private investments) as well as financial funds (bank credits) from developed countries fell down precipitously. Secondly, most of these countries direct their exports to developed countries. But because the developed countries were in recession, their imports, that is, their demand for exports from less developed countries showed a considerable decline.

A limited number of countries, however, suffered only slightly from the economic crisis. The list included foremost China which had benefited largely from globalization and flow of direct investments, hence had increased her growth rate and employment level as well as foreign exchange reserves. China was *de facto* away from socialist central planning and was implementing a mixed economy which accepts private investments and encouragement of direct private investment flows, as well as an open economy model. The second country which did not face a serious crisis was Brazil. The center-left government in Brazil had implemented pragmatic economic policies and had a sound balance of payments as well as budget performance. The third country was India, which did not rely much on exports but on software demand coming particularly from the USA. India had a relatively large mass of engineers working at low salaries compared to the US.

Because all countries cooperated and took the right kind of economic measures, the economic crisis and recession, though very deep, was prevented from developing into a deep depression. For cooperation, G20 rather than G8 was chosen because it included a much larger number of economically important countries, including Brazil, China, India as well as Turkey. Furthermore, the funds at the disposal of IMF were also raised considerably. It will definitely take a long time for the world to move back to normal and in the meanwhile many countries could face serious economic problems. The list includes Greece as well as other small European countries with fragile economies. But, the USA and GB would also be facing long term problems of budget deficits as well as external debt payments. Therefore, though recovery is on the way, it will not be a smooth swift ride back to normalcy. But, over time, market economy and globalization looks likely to prevail rather than reverting to closed economy models and French type of "*dirigisme*".

2 The Effects of the Global Crisis on the Turkish Economy

Turkey was one of the middle-income developing countries, or one of the "emerging markets" worst hit by the global economic crisis, despite denials to the contrary by the government circles. The reason was simple: While the governments of countries like China, Brazil and India had implemented correct globalization strategies that relied on their economic conditions, the Turkish government had followed wrong globalization strategies that left the Turkish economy in a very vulnerable position when the global economic crisis broke out. The only favorable factor was the relative strength of the Turkish banking sector. Following the 1998/1999 and 2001 economic crises and in accordance with the stipulations of the IMF *stand-by* agreement, the Turkish government at the time had taken radical steps to strengthen the private banks by means of raising their capital ratio and the ratio of their liquid assets as well as by strictly controlling the credits lent by the banks to the firms owned by the owner of these banks. In addition, Turkish banks cannot hold derivatives of US or European banks, hence did not face the problem faced by the European banks. But otherwise, Turkish economy was vulnerable. Since 2002, in accordance with market economy and stipulations of the IMF *stand-by,* the government had pursued programs of privatization as well as encouragement of direct private investments. These policies were certainly in the right direction, but they were wrongly implemented. For instance, privatization was carried on without taking effective steps to reemploy in other sectors the excess personnel the public enterprises employed which the new private owner had to shed. In addition, rumors always arose concerning corruption and partisanship displayed during the privatizations, thus causing considerable loss of government revenue. Secondly, direct private investments were allowed to enter many fields which did not yield an increase in exports, neither in employment. Most private capital that had flown to Turkey was interested in transferring profits back. But the gravest mistake was raising the interest rate to abnormally high levels (above %20 in nominal and about 10% in real terms) in order to attract the flow of short and long term external credit. As a result, the total external and internal debt of Turkey increased by about 100% in between the years 2002 and 2008. These credits went to the government, municipalities, public banks, private banks as well as private

firms. Thus, the yearly back payments of credit plus interest to be paid rose very significantly. Moreover, most of the credit thus received was channeled to infra-structural investments by the government and the municipalities hence did not much raise future exports. Such a large flow of foreign exchange in the form of increased financial flows as well as direct private investments artificially lowered the value of the dollar and other foreign exchange currencies. The effect of overvalued TL and under-valued foreign exchange, in turn, was to lower the domestic support prices of Turkish agricultural products. Since the price of basic materials and inputs used, in particular, the price of fuel was raised on account of ever increasing indirect taxes, agricultural production became unprofitable. Hence, during the period 2002-2008 agricultural employment decreased by about 1.5 million while the total absolute level of agricultural production also decreased. This was only slightly compensated by employment rises in other sectors. Thus, during the said period, Turkey experienced a GNP growth accompanied by a slightly rising unemployment rate.

When the global economic crisis broke out, Turkey's exports as well as the flow of external credits and direct private investments fell significantly. Therefore, Turkey had to lower its imports considerably as well. This, in turn, caused investments and production, i.e. GNP to decline because both rely on imported materials and goods.

The Turkish government took several measures to ameliorate the balance of payments difficulties and encourage the growth of production. One such measure was to seek new countries to direct Turkey's exports, other than the EU. These included Russia as well as many Islamic Middle Eastern and African countries. Another measure was to waive the indirect taxes on real estate, the automotive and the whites for a definitive period. Still another measure taken this time by the Turkish Central Bank was to gradually lower down the interest rate.

But the Turkish government deliberately refrained from entering a *stand-by* agreement with the IMF, declaring they did not need such a support. The fact, however, was that Turkey was going to face general local elections on March 2009 and the government did not want any restrictions on the government and municipality expenditures it would be making before the elections. Negotiations with the IMF were stalled once more in 2010, this time because general parliamentary elections are to be held on July 2011. The IMF had demanded from Turkey discipline in total public expenditures, not only in the government budget but also in the municipalities, public enterprises and other public spending institutions.

Therefore, the effects of the global economic crisis on the Turkish economy were, in fact, very severe. For instance, by November 2009 the ratio of total employment in Turkey had risen to 22%. Of this, 13.6% were those properly under the category of unemployed because they had applied for work but could not find jobs. 8.4%, on the other hand, had given up looking for work, hence were nominally under the category of "voluntary" unemployment. By 2007 the rate of growth of GNP had already gone down to 4,6%. In 2008 Turkey experienced a very big negative growth rate: – 6.5%. In the 3rd quarter of 2009, the rate was further down to –8.4%, but along with relative improvements in the world scene, the Turkish economy started to pick up again by 2010. Had Turkey, however, gone into an agreement with the IMF she would not have faced such grave falls in the GNP growth rate and increases in unemployment rate, and would have recovered sooner.

3 Conclusions

At the time of writing this article, global events still continue to progress. Nonetheless, even at this stage, we may make several observations and draw several conclusions from what has occurred thus far, concerning the global economic crisis, as follows:

- First, broadly speaking, the world has indeed become globalized economically and despite the severe economic crisis faced, it looks certain that globalization will continue; there would be no return to closed economy models.

- Secondly, the developed counties ameliorated the recession they faced, taking strictly Keynesian macroeconomic monetary and fiscal policies. There should not be, however, a shift to dirigisme, interventionism and protectionism, excepting France.
- Thirdly, it looks as if the adverse long-run effects of the economic crisis and measures taken to eliminate or ameliorate it will continue for a long time. USA would be struggling with a big external debt burden and a large balance of payments deficit; similarly the UK. The EU countries, on the whole, look as if it would take them longer to get out of stagnation, excepting Germany. The less financially disciplined countries in the EU, such as Greece and Southern Europe, make the recovery of EU (and the Euro) still more difficult.
- As many economists observed, some "decoupling" has actually occurred; China, India and Brazil, in particular, rose very fast to healthier economic standing compared to and despite the USA and EU. But, their performance does not seem enough to trigger the rest of the world significantly. The world economy still relies heavily on the robustness of the USA economy plus that of the EU.

Concerning the Turkish economy, on the other hand, the following observations and conclusions can be drawn:

Turkey was severely hit from the global economic crisis because she had implemented wrong economic strategies or otherwise implemented the right globalization strategies wrongly. But immediately following the crises, the Turkish Central Bank corrected its interest rate policy. This reversal plus a strong Turkish banking sector soon took hold. Thus, a deep dive down is about to be compensated completely by now with a fast rise despite the fact that the Turkish government had declined from making stand-by agreement with the IMF.

Has Turkey made a stand-by agreement promptly, the recovery could have surely been even faster, but at least the recovery is nearly complete by now. This is also a result of the "dynamism" of the Turkish economy and the people.

But more correct economic and international policies by the Turkish government can raise the growth rate to even higher levels. These policies include more proper DPI polies, more emphasis on production and exports, elimination of corruption and partisanship, stronger political and economic ties with the USA and the EU.

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