Managing the Crisis |

Turkey Country Report

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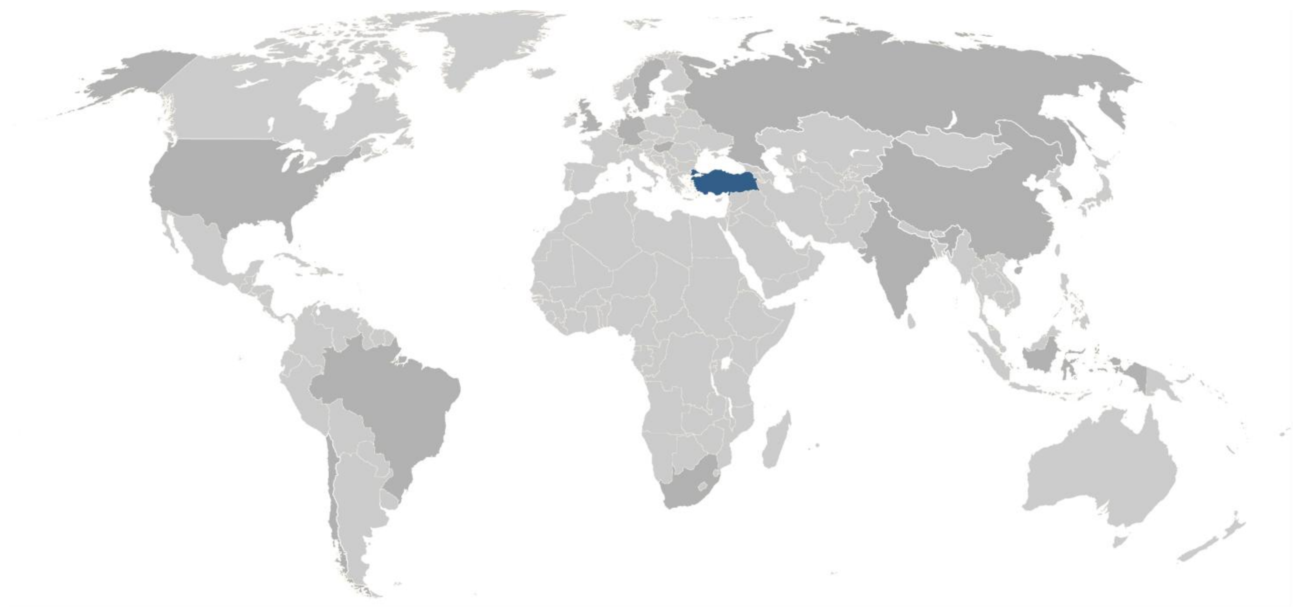

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1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

During 2007, public and private consumption combined accounted for 83.1 percent of Turkey's GDP. Private consumption comprised 73.4 percent of the country's total domestic product, while public consumption totaled an additional 9.8 percent. Private investment expenditures accounted for 18.1 percent of GDP, while public investment formed an additional 3.8 percent, for a combined total of 22 percent of GDP. Thus, total domestic demand totaled 105.1 percent of the nation's GDP. Domestic savings were the equivalent of 16.1 percent, and foreign savings of 5.9 percent of GDP.

Turkey's 2007 GDP growth was primarily driven by consumption and gross capital formation, which together contributed 5.6 percentage points to GDP. GDP grew by 4.6 percent due to the negative 1.2 percentage point contribution of the country's foreign balance.

The government has been successfully working to control deficits over the past decade. The central government budget deficit was the equivalent of 11.9 percent of GDP in 2001, but subsequently decreased to 11.5 percent in 2002, 8.8 percent in 2003, 5.2 percent in 2004, 1.1 percent in 2005 and just 0.6 percent in 2006. Because the average value of the central government's primary surplus as a percent of GDP amounted to 4.7 percent over the period 2001 – 2007, the central government's debt-to-GDP ratio had decreased from the unsustainable level of 69.2 percent in 2002 to a sustainable level of 39.6 in 2007.

However, the country's current account deficit had been on an upward trend since 2002, and the current account deficit reached 5.9 percent of GDP in 2007. Successive years of deficits had brought Turkey's external debt to $249.4 billion, representing 38.4 percent of GDP. Of this total, $160.1 billion had been incurred by the private sector. In 2007, Turkey was a net importer of foreign capital, for a total of $48.6 billion.

Turkey's financial system is primarily bank-based. In 2007, bank assets formed 76.2 percent of total financial assets. The central bank's share was 12.7 percent. Hence, bank and central bank assets together accounted for 88.9 percent of the country's total financial assets.

Policy priorities prior to crisis

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Throughout the 1990s, rising macroeconomic imbalances hampered Turkey's development and growth. Periods of high growth were followed by deep recessions. Large budget deficits and political instability were the major reasons for this unsustainable macroeconomic framework.

In 2001, Turkey faced a severe financial crisis. In response, the country introduced an ambitious reform program in May of that year. The key elements of this economic reform program included attaining fiscal discipline to foster medium-term debt sustainability, strengthening the banking system, improving the investment climate to attract larger amounts of foreign direct investment (FDI), speeding up the privatization of public enterprises, introducing social security and tax reforms, introducing inflation targeting, and maintaining a floating exchange rate regime.

The reform program was designed to sustain macroeconomic stability and improve the economy's resiliency, productiveness and efficiency. These reforms, without doubt, strengthened the country's macroeconomic fundamentals. In particular, the reforms achieved a level of soundness in the banking sector, which provided a buffer against external shocks. Strong fiscal discipline and tight monetary policies helped lower inflation and inflationary expectations and improve debt sustainability.

Structural reforms coupled with prudent fiscal and monetary policy paved the way for 27 quarters of uninterrupted growth, ending in the last quarter of 2008. GDP, which was $232.7 billion in 2002, almost tripled to reach $655.9 billion by the end of 2007. Moreover, GDP per capita increased from $3,403 in 2002 to $8,984 in 2007.

The weak point of this relatively successful reform program was the independent float exchange rate regime pursued after 2001. The normalization and improved credibility of the macroeconomic framework, along with high market interest rates in comparison to international interest rates, led to strong capital inflows. This dynamic caused the real exchange rate (RER) to appreciate. As a result, current account deficits and Turkey's foreign debt increased considerably between 2002 and 2007, making the country vulnerable to unfavorable external shocks.

However, this underlying vulnerability was masked by other more positive economic signs. Between 2002 and 2006, GDP growth averaged 7.2 percent and the economy created more than 2.8 million new jobs outside of the agriculture sector. In total, employment grew at a rate of 3.9 percent per year, though the unemployment rate remained at 10.3 percent through 2007. Monetary policy successfully reduced inflation from 53.4 percent in 2001 to 8.8 percent in 2007. Thus, policymakers were quite successful in embarking on a path of strong market-driven growth with low inflation. They placed strong emphasis on attaining fiscal sustainability, though not on attaining current account sustainability.

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

Turkish politics in the recent era has been characterized by significant transformation and a considerable degree of instability. In 2009, Turkey continued to project an image of a highly polarized society.

In the November 2002 election, the Justice and Development Party (AKP) captured 34.3 percent of the total vote. The Republican People's Party (CHP) came in second with 19.39 percent of the vote. The election produced Turkey's first single-party government since 1987, and because of the 10 percent electoral threshold, the country's first two-party parliament in 48 years. Abdullah Gül became prime minister and remained in the position until a constitutional amendment could be pushed through to allow Recep Tayyip Erdoğan to run in a March 2003 by-election. Erdoğan became the prime minister on March 14, 2003. Once in office, AKP displayed a deep commitment to fiscal discipline and economic reform, and its social policy was mainly targeted at helping the poor through informal channels. AKP's popularity was greatly boosted by a period of unusual economic growth, helped by a highly favorable global liquidity environment. Furthermore, the AKP's positive engagement with the Kurds and its promise to resolve the Kurdish conflict enabled it, in contrast to the opposition parties, to mobilize effectively in the predominantly Kurdish southeastern regions of the country.

In May 2007, the Turkish Grand National Assembly was scheduled to elect a new president to succeed President Ahmet Necdet Sezer, whose term ended on May 16, 2007. In the April before the vote, the military issued a warning via the Internet, in which it objected to the possible election of Gül as president. Similar concerns were voiced in a series of "republican" rallies, which took place in a number of Turkish cities that spring and featured a large number of people protesting against the AKP's alleged anti-secular activities. The CHP party leadership demonstrated its willingness to ally itself with the military by endorsing the "e-intervention."

Opposition parties led a Constitutional Court challenge to the procedures of the presidential election. This resulted in early general elections on July 22, 2007. The AKP won 46.6 percent of the vote, followed by the CHP (20.9%) and the Nationalist Action Party (MHP) (14.3%). Thus, the AKP managed to expand its share of the national vote from 34 percent in November 2002 to nearly 47 percent in July 2007. It was the first time since 1954 that an incumbent party in Turkey had increased its share of the vote; the AKP did so by an astonishing 14 percentage points. In general, the result was due to the AKP's success in achieving rapid economic growth since its first electoral victory in 2002.

Sezer reappointed Erdoğan as prime minister and then-Foreign Minister Gül declared his presidential candidacy. The parliament elected Gül in the third round of voting on August 28, 2007. President Gül approved Erdoğan's proposed cabinet on August 29, and the new government received a vote of confidence on September 5.

Having solved the presidential dilemma, the next step for the party leadership was to introduce a constitutional amendment to remove the ban on girls wearing headscarves in the universities. The AKP leadership saw this as a natural step on the path to securing what they considered to be fundamental religious freedoms. The ability to forge an alliance with the MHP facilitated the constitutional amendment's passage through parliament. One result, however, was a significant uproar from secularist segments of the Turkish state and society. Secularists charged that the AKP was becoming increasingly confrontational with the secular constitutional order. Indeed, it was the constitutional amendment involving the headscarf issue that prompted the Constitutional Court to bring a case against the ruling AKP in the early months of 2008, in hopes of banning the party. The Constitutional Court's case against AKP for the violation of secular principles was one of the most dramatic episodes in recent Turkish political history. The Court's final decision in the summer of 2008 allowed the AKP to continue, but contained a serious warning and a financial penalty for the party.

Nationwide local elections for provincial general assembly, municipal assembly and mayoral positions were held March 29, 2009. The AKP received 38.39 percent of the vote in provincial general assemblies and a similar percentage in municipal assemblies. The CHP and MHP followed the AKP, respectively drawing 23 percent and 15 percent of the vote. Prime Minister Erdoğan reshuffled his cabinet on May 1, 2009.

Recently, a shocking development displayed the evident depth of institutional opposition to the AKP's rise. An investigation uncovered an extensive secret effort by some officers and civilian leaders to destroy the AKP. This so-called Ergenekon inquiry has landed many officers, academics and others in jail, and the investigation has tarnished the military's reputation.

As emphasized above, Turkey remained a highly polarized society in 2009. Essentially, there are two camps. The first and larger group, which includes center-right politicians, liberals, and the religious population, supports the AKP and sees the party as fighting to free Turkish politics from subjugation by the military and the judiciary. They view the claim that the AKP wants to establish a religious state as fanciful and retrograde. The opposing camp is primarily composed of staunch secularists, the military, civilian bureaucratic elites and various types of nationalists. Remembering the AKP's roots in Islamist movements, they claim that the party is determined to weaken the Turkish military despite the country's unstable neighborhood. To them, the AKP is making the country more religious, partly in order to consolidate its position in the Muslim world, and at the expense of its traditional alliance with the West.[1]

The emergence of the AKP as a potent political force came at a time of considerable economic turmoil. In 2001, the Turkish economy faced a severe financial crisis and deep recession. Among the causes of the crisis, the three most significant ones were the deterioration of fiscal balances, problems in the banking sector and mismanagement of real exchange rates in an environment of capital account convertibility.

Analysis of public sector borrowing requirements as a percent of GNP prior to the 2001 crisis reveals that the public sector ran substantial deficits, which could be financed by borrowing from the private sector at very high real interest rates. On the other hand, state banks created substantial distortions, and Turkey lacked competent supervisory authorities, a regulatory framework, and adequate legal and institutional infrastructure in the banking sector. Furthermore, as government domestic securities as a share of domestic banks' total assets increased considerably due to very high real interest rates on government bonds, the banks became vulnerable to changes in interest rates. Finally, under shifting foreign exchange regimes, including the flexible arrangements of 1983 – 1998 and the crawling peg system adopted in 1999 – 2000, relatively high interest rates in comparison to international

[1] See M. Abromowitz and H. J. Barkey, "Turkey's Transformers," *Foreign Affairs* 8, 6 (November/December 2009): 118 – 128.

rates led to capital inflows and caused the real exchange rate to appreciate. As a result, the current account deficits and foreign debt increased considerably, making the country vulnerable to external shocks.

The 2001 crisis led to substantial depreciation in the real exchange rate. A new program named "Transition to a Stronger Turkish Economy" was put in place, with massive IMF support, tight fiscal targets, the introduction of a floating exchange rate regime and structural reforms. The government agreed to generate a primary surplus of 6.5 percent of GDP, which was accomplished through further increases in revenues, notably through ad hoc indirect tax adjustments. The achievement of this target was implemented rigorously, and central government primary surplus was maintained at 4.6 percent throughout the period from 2002 to 2007. Thus, Turkey made an impressive recovery from the 2001 crisis by adopting fiscal discipline as the cornerstone of a stabilization program. The program reflected a combination of determined fiscal restraint, sound disinflation policies, significant privatization efforts and structural reforms. As a consequence, the central government's public debt fell from 69.2 percent of GDP in 2002 to 39.6 percent in 2007. Furthermore, the average maturity of the central government's domestic debt stock increased from 20.6 months in 2004 to 25.7 months in 2007. Simultaneously, the share of external debt in total central government debt decreased from 38.2 percent in 2002 to 23.4 percent in 2007.

One of the major characteristics of the Turkish economy until the 2001 crisis was the presence of very high and persistent inflation, originating mainly from public sector imbalances. Large fiscal deficits funded from central bank resources, loose income policies that raised wages and salaries above productivity levels, and the pricing policies of public utilities that were treated as a means of raising revenues were key factors creating both demand and cost pressures. An unstable macroeconomic and political environment made it difficult to break the inflation inertia. During the period leading up to the crisis, the central bank implemented an accommodative monetary policy and had to sacrifice its price stability objective.

After the 2001 crisis, the new stabilization program prioritized the fight against inflation as one of its main economic policy goals. In line with this objective, the central bank was granted independence in 2001, and pledged to abstain from intervening in foreign exchange markets. It focused on reducing inflation to the targeted levels. Base money growth consistent with inflation targets and estimated GDP growth path were to serve as a nominal anchor. This framework was formalized as implicit inflation targeting at the beginning of 2002, and was implemented until the end of 2005. The regime contained many of the features peculiar to full-fledged inflation targeting, such as a numerical inflation target and the utilization of short-term interest rates as the main policy instrument. On the other hand, it lacked published inflation forecasts, which is one of the key instruments of inflation targeting. The term "implicit" also reflected a preparation phase during which technical capability, institutional capacity and the transparency of monetary policy would be enhanced. Macroeconomic preconditions such as a strong fiscal position and a stable financial environment were also to be fulfilled during this phase.

By the end of 2005, this approach had helped bring inflation rates down to single-digit levels, following several decades of double-digit inflation. Disinflation was also accompanied by strong economic growth. Financial sector stability was maintained, reflecting both declining risk premiums and interest rates. High levels of primary fiscal surplus were achieved and concerns about fiscal dominance faded. Although most of the preconditions were fulfilled, the central bank did not immediately shift to explicit inflation targeting. It announced its transition to explicit inflation targeting in 2006 after establishing a comprehensive operational framework.

Thus, both consumer and producer prices decelerated sharply after 2001. In 2004, consumer inflation declined to single-digit levels for the first time in thirty years, and inflation targets were undershot until 2006. The inflation rate was reduced from 53.4 percent in 2001 to 8.8 percent in 2007.

Exposure to specific market and trade risks

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Turkey liberalized foreign exchange operations and international capital movements in 1989. Since then, the Turkish lira has been fully convertible. Turkey followed a flexible exchange rate regime until 1998, adopted a crawling peg system in 1999 – 2000, and returned to an independently floating regime after 2001.[2]

The dilemma faced by Turkey under each of these systems was the domestic emergence of relatively high policy and market interest rates in comparison to international interest rates. This situation attracted strong capital inflows, causing the real exchange rate (RER) to appreciate. The appreciation of the RER together with the high interest rates increased the attractiveness of the Turkish lira (TRY) as a carry trade. This raised portfolio inflows and increased the rollover ratio of private sector foreign debts. These developments led to further appreciation of the RER, which resulted in competitiveness losses and increases in current account deficits. The current account deficit between September 2007 and August 2008 reached the unsustainable level of $49 billion, or 6.6 percent of 2008 GDP; by August 2008, Turkey's foreign debt had reached $286.9 billion, or 38.7 percent of GDP.

In general, a country does not have to worry too much about foreign debt levels if it tends to run current account surpluses, maintains relatively low foreign debt levels, and borrows mostly at longer term maturities. If, in contrast, a country runs large current account deficits year after year and concentrates its borrowing in shorter term maturities, it becomes quite fragile and subject to a crisis of confidence. Failure to recognize the precariousness and fickleness of confidence, especially in cases in which large short-term debts need to be rolled over continuously, may lead to real crisis if confidence suddenly collapses.[3]

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[2] For the definition of the relevant exchange rate regimes and classification of the Turkish exchange rate regimes, see the IMF publication, *Annual Report on Exchange Arrangements and Exchange Restrictions*, Washington, D.C.(various issues).

[3] See C. M. Reinhart and K. S. Rogoff, *This Time is Different* (Princeton: Princeton University Press, 2009), 51 – 100.

Turkey's domestic financial sector is rather small and shallow when compared with the financial sectors of developed countries. It includes banks, insurance companies and non-bank financial institutions such as factoring companies, leasing companies, consumer financing companies, pension companies, intermediary institutions, investment funds, investment partnerships and real estate investment partnerships. As of end-2007, total financial sector assets amounted to $590.4 billion, or 91.2 percent of GDP; 75.7 percent of financial sector assets belonged to the banking sector.

Although the banking system has a major share in the financial sector, in recent years the non-bank financial institutions have grown in number and size. No single authority is responsible for supervising and inspecting the financial system. The Banking Regulation and Supervision Authority oversees banks and leasing and factoring institutions. In addition, banks' capital market operations are subject to regulation and supervision by the Capital Market Authority.

The country's trade regimes have been substantially influenced by its deepening relationship with Europe. The 1995 EU-Turkey Customs Union Decision (CUD) required Turkey to implement the European Community's (EC) Common Customs Tariffs on imports of industrial goods from third countries as of January 1, 1996. Turkey also had to adopt all the EU's preferential trade agreements by 2001, and implement measures similar to the EC's commercial policy. As a result, Turkey signed free trade agreements (FTAs) with the European Free Trade Association countries, Israel, Macedonia, Croatia, Bosnia-Herzegovina, the Palestinian Authority, Tunisia, Morocco, Syria, Egypt, Albania and Georgia.

The CUD and more recently the Accession Partnership have been major instruments of integration into the EU and global markets, offering powerful tools to reform the Turkish economy. The 1995 decision has credibly locked Turkey into a liberal foreign trade regime for industrial goods, and holds out the promise of Turkey's participation in the EU internal market for industrial products. The accession process extends liberal commitments to reform to other spheres, determining the openness of domestic markets to competition from imports as well as the scope of distortions generated by domestic institutions and policies (e.g., monopolistic arrangements or subsidies). In contrast to the CUD, which imposes legally binding commitments on Turkey, the Accession Partnership merely provides a venue for cooperation, and assists Turkey in the adoption of the *acquis communautaire*. The extent of its use hinges upon the political will of both sides.

As a result of these agreements, Turkish producers of industrial goods have become exposed to competition from imports and operate in one of the largest, if not the largest, free trade area for industrial products in the world. Turkish producers of industrial goods are now protected by tariffs from external competition to exactly the same extent as EU producers are. Moreover, they have to face competition from duty-free imports of industrial goods from world-class pan-European firms. In return, industrial producers have duty-free market access, unrestrained by the rules of origins and tariffs, to the European Economic Area (EU-27 and EFTA). The area was recently extended to Mediterranean countries that signed the Barcelona Declaration, including Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the Palestinian Authority of the West Bank and Gaza Strip.

The CUD has contributed to a significant increase in the contestability of domestic Turkish markets by giving trade policy predictability, transparency and stability, as well as by liberalizing market access. As of 2009, Turkish most-favored-nation (MFN) protection rates were very low with the exception of agricultural commodities; hence, one could state that tariffs for Turkey were largely a non-issue in the non-agricultural sector. Currently, industrial products move freely between the European Union and Turkey, with occasional exceptions associated with contingent protectionism measures and technical legislation. Regarding contingent protectionism, we note that both the European Union and Turkey have been active users of this type of measure, but the EU has done so to a larger extent. The formation of the customs union has not provided protection from EC anti-dumping measures, and the EU has continued to protect its sensitive sectors through forms of contingent protectionism. On the other hand, technical barriers to trade have significantly declined with Turkey's gradual adoption of the EU's technical standards regime.

In addition to its trade relations with the EC, Turkey also participates in the Economic Cooperation Organization (ECO), the Black Sea Economic Cooperation (BSEC) and the Euro-Mediterranean Partnership. The ECO is an intergovernmental regional organization established in 1985 by Iran, Pakistan and Turkey aimed at the sustainable socioeconomic development of its member states. In 1992, the organization was expanded to include Afghanistan, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan. On July 17, 2003, the ECO Trade Agreement (ECOTA) was signed between Afghanistan, Iran, Pakistan, Tajikistan and Turkey. The agreement pledges the reduction of tariffs to a maximum of 15 percent within a maximum period of eight years. ECOTA has binding provisions addressing state monopolies, state aid, protection of intellectual property rights, and dumping and anti-dumping measures. For its part, the BSEC aims to improve and diversify economic and trade relations between its 11 members. The member countries are Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldavia, Romania, the Russian Federation, Turkey and Ukraine. The BSEC Declaration was signed on June 25, 1992, and on February 7, 1997 a declaration of intent for the establishment of a BSEC free trade area was adopted. Recently, the BSEC launched projects to eliminate non-tariff barriers to regional trade and to harmonize trade documents in the region. Finally, the Euro-Mediterranean Partnership is a political, economic and social program aimed at creating an area of shared prosperity, including a Euro-Mediterranean FTA by 2010.

Turkish entrepreneurs' ambition to widen and strengthen their trade links with the rest of the world, and their success in differentiating their products and services, yielded a near-threefold increase in the volume of exports between 2002 and 2007. The shift from labor-intensive product exports toward relatively technology-intensive exports also contributed to this remarkable achievement. The total value of the country's exports was $36.1 billion in 2002 and reached $107.3 billion in 2007.

Finally, the determination of the Turkish government to create a stable economy has attracted both domestic and foreign investors. Turkey has emerged as a favorable investment destination because it has eliminated bureaucratic barriers to a large extent, improved its tax system, facilitated profit transfers and successfully pursued privatization programs. Foreign direct investment inflows, which averaged $1.1 billion between 1993 and 2002, increased gradually to reach $22 billion in 2007.

This economic success was accompanied by growth in domestic markets, particularly toward the end of the period. Between June 2006 and December 2007 alone, the Istanbul Stock Exchange Index increased by 56.65 percent. Although newspaper reports cited considerable increases in housing prices during the same period, the increase cannot be quantified because there are no published housing price indexes available in Turkey.

Growth in the country's banking industry was linked to a series of significant steps taken after the 2001 crisis, aimed at restructuring and rehabilitating the sector. Policymakers strengthened the financial structure of private banks, restructured state banks and improved the country's regulatory and supervisory framework. The banking sector has since achieved a much healthier and more robust position by strengthening its capital structure and implementing effective risk management. The decline in public sector borrowing requirements also contributed to the improvement in banking sector balance sheets, as banks gradually reduced the share of government securities as a proportion of total assets and started increasing the volume of credit given to the real sector and to households.

Following the post-2001 restructuring process, the banking sector showed rapid growth during the 2002 – 2007 period. The total assets of the banking sector (including deposit banks, development and investment banks, and participation banks operating according to a profit- and loss-sharing principle) rose from $140.6 billion in 2001 to $446.8 billion in 2007. Simultaneously, the ratio of the Turkish banking sector's balance sheet size to GDP increased to 67.9 percent by the end of 2007. The financial structure of the sector also became stronger during this period. As of the end of 2007, the return on assets and the return on equity were 2.7 percent and 21.3 percent respectively. While the capital adequacy ratio was 18.9 percent as of December 2007, the Tier 1 capital ratio, which is the ratio of core capital to the total exposure stemming from credit, market and operational risks, stood at 18.2 percent. In addition, risk management systems improved and public supervision became more effective in this period.

As of the end of 2007, deposit banking was dominant in the country's banking sector. Commercial banks and the development and investment banks combined hold 96 percent of the sector's assets, compared to three percent by the participation banks. Bank ownership is divided into state-owned banks (representing 25.6% of the sector), private banks (28.9%), fund-controlled banks (24.8%) and foreign-owned banks (20.7%). Sector-wide, loan portfolios represented the largest asset item at the end of 2007, taking a 49 percent share, while deposits represented the largest source of funds, with a 62 percent share.

Gross credit volume, defined as total loans plus gross non-performing loans, reached $239.9 billion by the end of 2007. Non-performing loans represented 3.5 percent of total gross loans, while the share of domestic currency loans as a proportion of total loans stood at 70.5 percent.

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Structural or policy advantages and disadvantages

Turkey has experienced two major financial crises during the last two decades, one in 1994 and the second in 2001. Both were debt crises. The 2001 crisis was very severe and resulted in a sharp economic contraction. As a result, the following section will focus on the 2001 crisis. Since issues related to the pre-2001 deterioration of fiscal balances and mismanagement of the real exchange rates were discussed above, as were measures taken to combat these problems, the following section focuses on problems in the banking sector.

Prior to the 2001 crisis, there were major distortions in Turkey's banking sector. First, distortions were created by the operations of state banks, which were used by various governments for a number of non-commercial objectives such as agricultural support, income redistribution, and the development of industrial, urban and physical infrastructure. Second, the share of government domestic securities as a proportion of banks' total assets was very high, making the banks vulnerable to changes in interest rates. Third, the private banks had substantial foreign currency liabilities. They had borrowed in foreign currencies and invested largely in high-yield Turkish lira-denominated government securities, exposing them to exchange rate risk. Finally, Turkey lacked competent supervisory authorities, an adequate regulatory framework, and legal and institutional infrastructure in the banking sector.

The restructuring process in the banking system started before the 2001 crisis, with the disinflation program of 1999. Initial efforts were directed toward making extensive amendments in the Banking Law. The government established the Banking Regulation and Supervision Authority (BRSA) as a regulatory and financial authority with administrational and financial autonomy in the banking sector. Duties and authorities regarding the supervision and regulation of banks, which were previously shared by the Treasury and the central bank, were transferred to BRSA. The authority began its operations in August 2000.

The first pillar of the banking restructuring process was to seek solutions for banks facing financial problems. At the end of 1999, five commercial banks with financial problems were taken under Savings Deposit Insurance Fund (SDIF) control, and the banking licenses of two development and investment banks were cancelled. Between 1996 and 2003, the Undersecretariat of the Treasury issued a special series of bonds, and resources were transferred from SDIF to reinforce the financial structures and support the restructuring of 20 banks under SDIF control. In the same period, the banking licenses of eight banks were revoked and the banks were liquidated.

As a second pillar of restructuring process, considerable public resources were devoted to strengthening the capital structures of the state-owned banks, whose financial structures had deteriorated to a considerable extent. These efforts were applied to the operational restructuring of the state-owned banks, and reinforced by a series of mergers. The end goal of this process was privatization.

In addition to the negative effects of the crisis, the problems of private banks were further deepened due to provisioning for non-performing loans, as well as an abrupt decline in the volume of loans available on the market as a result of the state-owned banks' restructuring and efforts to meet capital adequacy requirements. Therefore, at the third stage of bank restructuring, a program was adopted aimed at reinforcing private banks' equity capital. This program required a three-party audit before extending capital support, but subsequently reinforced the equity capital of private banks whose asset quality had deteriorated and equity capital had rapidly diminished. One bank was transferred to the SDIF due to shortage of capital. In addition, regulations were adopted establishing mechanisms to address bad balance-sheet assets.

One of the main objectives of the government's effort to restructure the banking system was to enact legal and institutional regulations improving supervision and audit systems. These reforms were aimed at changing risk-taking behavior and risk-management processes, and at enhancing corporate infrastructure. As a result of the measures implemented by the BRSA, banking legislation was aligned with international regulations, best practices and EU directives. International regulations were considered in adopting regulations designed to increase the transparency of banks' balance sheets, ensure compliance with international accounting standards and strengthen banks' financial structures.

The 2001 economic crisis also gave rise to an environment of uncertainty for non-bank sectors. In the real sector, many firms reduced their activities and investments; many others came close to or tumbled into insolvency. The ratio of non-performing loans to total loans (before provisioning) in the banking sector increased to 29.5 percent at the end of 2001. A three-year program for restructuring companies' financial-sector debt, known as the "Istanbul Approach," was introduced in June 2002. The stated purpose of the program was to make it possible for manufacturing companies, which were in financial distress and could continue their activities only if they were restructured, to work in a productive way; to increase employment and capacity utilization in the economy at large; and to provide order, health and transparency to the balance sheets of companies both in the real and financial sectors.

One long-term outcome of the post-2001 crisis period was that Turkey had a set of independent regulatory institutions in place as it faced the global crisis in 2008. These institutions included the central bank, the Banking Regulation and Supervision Authority (BRSA), Savings Deposit Insurance Fund (SDIF), the Privatization Administration, and the Capital Market Authority.

The experience also provided Turkey with valuable – if painfully won – experience. The 2001 crisis was not only a domestic debt crisis and external debt crisis, but also a banking crisis, the severity of which surprised nearly all observers. The loss of income and wealth and the associated social and political stresses created in the country were unprecedented. GDP contracted by 5.7 percent, and the loss in employment is put at more than one million jobs. As a result, the country learned about the importance of sound money,

prudential supervision and fiscal sustainability. Popular or political resistance to reforms has been minimal.

Moreover, the Turkish government prepared its post-2001 stabilization program "Transition to a Stronger Economy" in close cooperation with the IMF and the World Bank. The program substantially transformed the Turkish economy, giving the country most of the institutions required for running a successful market-based economy. To this end, the government had to take measures that required the close cooperation of the parliament.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

The global financial crisis has had four major effects on the Turkish economy:

- The slowdown in the economies of Turkey's export markets has meant sharp drops in Turkish exports. This trend is expected to continue.
- Developments in world capital markets have reduced capital inflows into Turkey. The decrease in inflows has deprived the economy of its primary growth engine.
- Consumers and firms lost confidence in economic activity, and fears of recession triggered worries about the course of future events.
- The easing in oil prices has alleviated the pressure on the current account deficit.

In 2008, while merchandise exports increased by 23.1 percent to $132 billion, merchandise imports increased by 18.7 percent to $201.8 billion. During the same year, exports to the European Union (comprising 48% of total exports) increased by five percent to $63.4 billion, and imports from the EU (37% of total imports) increased by nine percent to $74.8 billion. Trade volumes began to plummet in the final months of 2008, however.

The volume of exports increased 33.7 percent year-over-year in the period between September 2007 and August 2008, but decreased by 21.3 percent during the subsequent year-long period ending in August 2009. On the other hand, while exports to the European Union decreased by 36.9 percent in the first eight months of 2009 (on a year-over-year basis), imports from the European Union decreased by 35.9 percent. Stagnation in the automotive industry and declines in machinery and equipment exports have been decisive in shrinking export performance.

Capital inflows into Turkey declined from $48.6 billion in 2007 to $33.7 billion in 2008, while the last three months of 2008 saw capital inflows turn into net outflows. In the period between August 2007 and July 2008, $55.6 billion of capital flowed into Turkey, while a net $2.3 billion flowed out of Turkey during the following 12 months ending in July 2009.

The onset of crisis also took its toll on consumer expectations. The consumer confidence index prepared by the Turkish Statistical Institute declined from 92.1 at the beginning of 2008 to 71.6 in January 2009. However, it had recovered to 81.3 by August 2009.

Another critical development of 2008 and 2009, but this time on the positive side, was the easing in oil prices. Crude oil prices had soared to $145 per barrel before spiraling lower to the current $70 – $80 level. This decline has alleviated some pressure on the current account.

Also on the positive side, the Turkish banking sector is much healthier than before. Turkish banks had not engaged in substantial trading in derivative instruments of the kind that created problems in industrial countries; the banks were largely satisfied with the relatively high yields they received on Turkish government bonds. Recently, however, the real sector has been complaining that banks are reluctant to renew credit lines or extend new credit. Since bank deposits are the primary investment instrument for most Turkish citizens, individual investors had very limited equity market exposure either directly or through mutual funds. Nor do they have any exposure to corporate bonds or derivative instruments. Additionally, since housing prices have not fallen substantially, Turkish consumers have not faced any significant wealth destruction. As a result, the decline in consumer expenditures due to wealth effects has been negligible. This is another positive development.

Private investment expenditures decreased substantially due to the tightening of credit markets at home and abroad, and to the loss of confidence in economic activity. Private consumer expenditures, by contrast, declined because of the decrease in GDP and the fact that fears of a deep recession triggered worries about the course of future events.

As a result of the developments summarized above, the global crisis undermined industrial production and employment. On a year-over-year basis, GDP declined by 6.4 percent during the last quarter of 2008, by 14.3 percent during the first quarter of 2009, and by seven percent during the second quarter of 2009. Simultaneously, the employment level was affected. The number of unemployed individuals increased from 2.2 million in May 2008 to 3.8 million in February 2009, while the unemployment rate increased from 9.2 percent in May 2008 to 16.2 percent in February 2009. As of July 2009, the number of unemployed was 3.3 million, and the unemployment rate stood at 12.8 percent. Nearly 2.7 million unemployed individuals were in the urban sector, where the unemployment rate was 16 percent.

While GDP increased by 4.3 percent (year-over-year) between the third quarter of 2007 and the second quarter of 2008, it declined by 6.5 percent during the subsequent 12-month period ending in the second quarter of 2009, also on a year-over-year basis. Thus, the crisis is a very severe one and resulted in a very deep recession. The loss of income is even larger than that experienced during the 2001 crisis. The 6.5 percent decrease in GDP stemmed mainly from declines in private investment and private consumption expenditures, stocks, and exports of goods and services. Here we note that:

- Private investment expenditures increased by three percent year-over-year during the third quarter of 2007 and the second quarter of 2008, but declined by 25.2 percent year-over-year during the subsequent 12 months ending in the second quarter of 2009.
- Private consumption expenditures increased by 5.4 percent year-over-year during the third quarter of 2007 and the second quarter of 2008, but declined by 4.1 percent year-over-year during the subsequent 12 months ending in the second quarter of 2009.
- Exports of goods and services increased by 5.9 percent year-over-year during he third quarter of 2007 and the second quarter of 2008, but declined by 6.5 percent during the subsequent 12 months ending in the second quarter of 2009.
- Stocks increased considerably during the third quarter of 2007 and the second quarter of 2008, but declined substantially during the subsequent 12 months ending in the second quarter of 2009.

In a publication for the European Commission, Mihai Macovei notes that the positive export trends recorded in recent years, in particular Turkey's specialization in higher value-added sectors such as automotive, white goods and equipment, as well as the country's deeper engagement in international trade, turned to Turkey's disadvantage once international trade flows collapsed.[4] All of these sectors, and in particular the car industry, proved highly sensitive to declines in external demand. Even before the start of the crisis, the textile, clothing and leather sectors were facing increased competition from emerging Asian countries.

Government projections for 2009 forecast further declines in merchandise exports, merchandise imports, and GDP, and additional increases in the unemployment rate. While the decline in merchandise exports is expected to amount to 25.4 percent, merchandise imports are expected to decline by 33.7 percent. GDP is expected to fall by six percent year-over-year, while the unemployment rate is expected to increase to 14.8 percent during 2009. In its World Economic Outlook, October 2009 report, the IMF forecasts a larger decline in 2009 Turkish GDP of 6.5 percent.

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers` associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

When the global financial crisis intensified during the last quarter of 2008, Turkish policymakers thought its impacts on the Turkish economy would be fairly limited. Their optimism stemmed from a number of factors, including the country's healthy banking sector, the prudent fiscal and monetary policies followed during the last few years, the floating exchange rate regime, and strong levels of international reserves.

According to the policymakers, the restructuring of the banking sector after the 2001 crisis, along with the improved supervision and regulatory systems of the following years, had made the Turkish banking system much stronger. The absence of toxic assets would prevent the sector from experiencing write-downs. Thus, with the post-2001 experience fresh in their minds, poli-

[4] See Mihai Macovei, "Growth and Economic Crisis in Turkey: Leaving behind a Turbulent Past?" *European Economy*. European Commission Economic Papers 386 (2009) http://ec.europa.eu/economy_finance/publications/ (accessed January 30, 2010).

cymakers thought the banking system was healthy, with a strong capital base and an improved risk management system in place, and they emphasized that the sector's soundness would provide a buffer against external shocks.

However, the 2008 global crisis turned out to be qualitatively quite different from what Turkey had experienced in the past. Previous crises had been sparked by the mistakes of Turkish policymakers, and the associated deep economic contractions had been limited to Turkey, rather than engulfing the whole world. Helped by the depreciation of the lira, exports picked up rather quickly in 2001 – 2002, which contributed to the recovery. There was also ample liquidity available once Turkey started to follow prudent macroeconomic policies. This time, however, the crisis was global. Demand for Turkish exports contracted and Turkey was faced with a "sudden stop" in its capital inflows. Therefore, recent history could not offer any guidance to the government in designing policy measures. Nevertheless, policymakers initially thought that the effect on Turkish economy could be contained.

To strengthen the real economy, the government took many measures. In order to mitigate the adverse effects of the crisis, the central bank lowered short-term interest rates considerably.[5] It resumed its intermediary role in the Foreign Exchange Deposit Market, extended the maturity of foreign currency deposits borrowed by the banks and reduced the lending rate. Furthermore, the foreign exchange required reserves ratio was lowered and daily foreign exchange selling auctions carried out.

A broader series of initiatives was also undertaken, such as a credit guarantee scheme for enterprises, and interventions in specific sectors that have come under increased pressure. Policymakers took immediate action to stem the rise in non-performing loans, especially loans extended to small and medium-sized enterprises (SMEs). Value-added taxes and special consumption taxes on selected products were temporarily cut in order to boost domestic consumption and revive economic activity.

Regarding the labor market, the government reduced the financial and non-financial burdens on employers and widened the scope of unemployment insurance payments.

In addition, the government announced a new and quite comprehensive investment incentive scheme including reductions in corporate income taxes, lower employment taxes and allocations of Treasury-owned land for investments made before the end of 2010.

[5] Since November 2008, Turkey has lowered the central bank policy interest rate by 1000 basis points.

Finally, with regard to improving innovative capacity, the government introduced a new and comprehensive Research and Development (R&D) Law in 2008. With this law, the government aimed to accelerate both foreign and local R&D investment and develop an environment more conducive to innovation.

In general, the measures introduced by the government were considered to be a meager policy response to the crisis. Many economists believe that the government's measures were weak and came rather late. It seems that until the summer of 2009, the government was too optimistic. However, the sharp contraction in global economic activity, weak domestic demand conditions and sudden stops in external capital flows ultimately negatively impacted the Turkish economy, and the disinflation process accelerated in 2009. As a result, policymakers had to act. The dramatically negative performance of the Turkish economy in the first half of 2009 seems to have lessened the government's optimism.[6] Starting from early summer 2009, the government signaled that it was working on a comprehensive program, and would also introduce concrete measures to deal with the effects of the global crisis on the economy. As a result of these efforts, it announced a medium-term program in September 2009.

In pushing for these stability measures, the driving forces included the media, the Turkish Industrialists' and Businessmen's Association (TUSIAD) and the Union of Chambers and Commodity Exchanges of Turkey (TOBB). Lobbying efforts by these sectoral and regional groups were ultimately quite effective.

The measures finally introduced required action by the ministries, the central bank, and the Banking Regulation and Supervision Agency. In some cases, the new policies required changes in laws, and hence the cooperation of the parliament.

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

In designing their response to the crisis, policymakers consulted the media and sectoral lobbies. The administration also approached international organizations, but with limited utility.

[6] During the first quarter of 2009, GDP contracted by 14.3 percent yoy.

Turkey's most recent stand-by agreement with the IMF ended in May 2008. As the global financial crisis intensified, policymakers approached the IMF and talks started for a new loan agreement. During negotiations in January 2009, Turkey agreed to reduce its fiscal deficit. However, these talks were suspended until after local elections on March 29, and picked up again at the G-20 meeting in Pittsburgh on September 24 – 25, 2009. As of November 2, 2009, the two sides had not reached a deal.

This delay has been caused in part by local political concerns. As explained in more detail under "Economic and political effectiveness of the crisis response," Turkish politics in the recent era has been characterized by a considerable degree of instability, leading to concerns about the timing of the next general elections. Election periods in Turkey are generally marked by significant increases in populist decisions intended to boost economic activity. If the election period kicks off in summer 2010, then the government, unless its hands are forced, does not want to conclude a stand-by deal with the IMF. Prior to the elections, it would like the freedom to follow the expansionary fiscal policies that it considers conducive to winning. It knows from previous experiences that a stand-by agreement with the IMF would constrain its policy space.

More broadly, Turkey has contributed to global anti-crisis efforts as an active member of the G-20. The country participated in the G-20 summit in London on April 2, 2009 as well as the G-20 summit in Pittsburgh on September 24 – 25, 2009.

3. Policy Content

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

While focusing on mitigating the threats posed by the crisis, Turkey has tried to avoid losing sight of the long term. With this in mind, it has taken necessary measures that will strengthen the country's macroeconomic fundamentals. The Medium Term Program announced in September 2009 covers the 2010 – 2012 period. It outlines the country's fiscal targets for the next three years, proposes an exit strategy from the crisis and provides forecasts for major macroeconomic variables. The main purposes of the program are to establish a framework that will enable Turkey to achieve a sustainable growth rate in the aftermath of the crisis, and to raise society's welfare.

Considering the weakness in domestic and external demand, and the tight external financing conditions, the government is expecting the economy to contract by six percent in 2009. Since it will take time for trade flows and the global economy to rebound, recovery in economic activity is expected to be gradual. The forecasts predict successive annual growth rates of 3.5 percent, four percent and five percent for the period 2010 – 2012. In addition, Turkey expects that 1.25 million jobs will be created over the same period, which will translate into a 1.5 percentage point decline in the unemployment rate by 2012 from the expected 2009 level of 14.8 percent.

On the fiscal front, the government expects gradual improvement. In 2009, the budget deficit is expected to total 6.6 percent of GDP, and the government predicts a gradual decline to 3.2 percent by 2012. The public debt to GDP ratio will peak at 49 percent in 2010, stabilize by 2011 and start to decline in 2012. Turkey aims to:

- support private sector-led growth by increasing predictability in the economy;
- increase the economy's competitiveness and flexibility through necessary structural reforms; and
- maintain a sustainable growth rate by taking advantage of socially and economically strong assets within the country.

As one of the main pillars of its medium-term structural reform agenda, Turkey intends to use a fiscal rule to govern public finance.[7] By adopting the rule, it intends to attain a long-term sustainable fiscal position both in terms of debt stock and budget deficit, and thereby sustain fiscal discipline permanently.

The stimulus package is supposed to amount to 0.8 percent of GDP during 2008, 2.1 percent of GDP during 2009, and 1.6 percent of GDP during 2010.[8] Overall, the package is spread over the period 2009 – 2012.

On October 17, 2009 the minister of finance submitted the 2010 draft budget to parliament. Highlights from the budget, which is completely in line with

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[7] The fiscal rule is expressed as $\Delta a = y(a_{-1} - a^*) + k(b - b^*)$ where Δa refers to public deficit adjustment/GDP; a_{-1} to previous year realized public deficit/GDP; a^* to targeted medium-long term public deficit/GDP; b to the real GDP growth rate; b^* to the long term average real GDP growth rate; y to the convergence velocity coefficient of the public deficit to its medium-long term target; and k to the reflection coefficient of conjuncture effects (y and k coefficients are negative. The negative Δa indicates a decrease in the public deficit. Values of parameters, the definition and content of public deficit, details about application, monitoring and reporting, exceptions and other issues will be finalized during the process of infrastructure formation for fiscal rule).

[8] Turkish Republic Prime Ministry State Planning Organization, "Medium Term Economic Program (2010 – 1012)," September 2009 http://www.dpt.gov.tr/DPT.portal (accessed January 20, 2010).

the Medium Term Economic Program announced in September 2009, are as follows:

- Total central government expenditures are expected to increase by 18.1 percent in 2009 and by 7.6 percent during 2010. On the other hand, total central government revenues are expected to decline by 2.4 percent in 2009 and increase by 16.1 percent in 2010. As a percent of GDP, total expenditures are expected to increase from 23.8 percent in 2008 to 28.2 percent of GDP in 2009 and then decline to 27.9 percent of GDP in 2010. Total revenues are expected to decrease from 22 percent of GDP in 2008 to 21.5 percent in 2009, and then increase to 23 percent in 2010. The resulting budget deficit, amounting to 1.8 percent of GDP in 2008, is expected to increase to 6.6 percent in 2009.
- The government acknowledges the necessity to reduce the budget deficit. However, it does not take an aggressive stance in terms of fiscal adjustment. It hopes to narrow the budget deficit by about 1.7 percentage points to 4.9 percent of GDP in 2010, down from 6.6 percent of the GDP in 2009.
- The government does not foresee any easing in noninterest expenditures, but a 0.4 percentage point portion of the expected decline in the deficit is driven by lower interest payments. It seems the government has made critical decisions to slashing current expenditures, which are projected to decline by eight percent in nominal terms. However, current transfers comprised mainly of pension salaries and other social transfers are to rise by around 10.6 percent, representing a 5.3 percent real increase.
- The fiscal adjustment comes entirely from the revenue side of the budget. The government projects an increase in tax revenues to 18.8 percent of GDP in 2010, up from 17.3 percent in 2009. In mid-2009, the government decided to hike the special consumption tax (SCT) on petroleum and tobacco products, to raise the prices of valuable papers used in official transactions, and to increase VAT rates in first-class restaurants from eight percent to 18 percent. The full-year impact of these measures is estimated at 0.8 percent of GDP. Another 0.3 percent of GDP increase in tax revenues could come from the expected buoyancy impact associated with rising imports and VAT collections. The government is also likely to hike the SCT on tobacco products and petroleum products once again.

Table 1: Central government budget, 2008 – 2010 (million TL)

	Expenditures			**Annual % change**		**Percent of GDP**		
	2008	2009	2010	2009	2010	2008	2009	2010
Total expenditures	225 967	266,752	286,928	18.05	7.56	23.78	28.18	27.89
Non-interest expenditures	175,306	211,252	230,178	20.50	8.96	18.45	22.32	22.37
Personnel	48,825	56,313	60,349	15.34	7.17	5.14	5.95	5.87
Social security	6,402	7,187	11,110	12.26	54.58	0.67	0.76	1.08
Current expenditures	23,941	27, 386	25,186	14.39	-8.03	2.52	2.89	2.45
Current transfers	70,116	92,358	102,153	31.72	10.61	7.38	9.76	9.93
Capital expenditures	18,441	18,662	18,928	1.20	1.43	1.94	1.97	1.84
Capital transfers	3,173	3,426	2,866	7.97	-16.35	0.33	0.36	0.28
Lending	4,411	6,480	6,903	46.91	6.53	0.46	0.68	0.67
Reserve appropriation	-	-	2,103	-	-	-	-	0.20
Interest payments	50,661	55,500	56,750	9.55	2.25	5.33	5.86	5.52
Revenues	208,898	203,928	236,794	-2.38	16.12	21.99	21.54	23.02
Tax revenues	168,087	163,561	193,324	-2.69	18.20	17.69	17.28	18.79
Income tax	38,028	37,657	41,516	-0.98	10.25	4.00	3.98	4.04
Corporate tax	16,905	16,581	17,965	-1.92	8.35	1.78	1.75	1.75
Special consumption tax	41,832	41,513	54,631	-0.76	31.60	4.40	4.39	5.31
Domestic VAT	16,799	19,016	22,636	13.20	19.04	1.77	2.01	2.20

	Expenditures			Annual % change		Percent of GDP		
	2008	2009	2010	2009	2010	2008	2009	2010
VAT on imports	29,968	24,348	30,108	-18.75	23.66	3.15	2.57	2.93
Motor vehicle tax	3,944	3,995	4,328	1.29	8.34	0.42	0.42	0.42
Banking and insurance trans.	3,695	3,758	3,875	1.71	3.11	0.39	0.40	0.38
Stamp duty	3,945	4,045	4,399	2.53	8.75	0.42	0.43	0.43
Other fees	12,971	12,648	13,866	-2.49	9.63	1.37	1.34	1.35
Non-tax revenue	40,811	40,367	43,470	-1.09	7.69	4.30	4.26	4.23
Budget balance	-17,069	-62,824	-50,134	268.06	-20.20	-1.80	-6.64	-4.87
Primary balance	33,592	-7,324	6,616	-121.80	-190.33	3.54	-0.77	0.64
GDP	950,099	946,678	1,028,802					

Deputy Prime Minister Babacan previously claimed that the government would not hike the corporate, income or value-added tax rates.

Targeting and coverage of policy tools

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Total central government expenditures are expected to increase by 11.4 percent in real terms during 2009.[9] While real interest payments are expected to increase by 3.35 percent, real non-interest expenditures are expected to increase by 13.7 percent. The largest increases in non-interest expenditures during 2009 are taking place in current transfers and personnel expenditures. Thus, the government has increased subsidies to low income groups by providing funds for health care, social security institutions and municipalities. Since such transfers to the low income segment might help the government maintain or even expand its voter base on the eve of the upcoming elections, as explained in more detail under “Economic and political effectiveness of the crisis response,” the government is intending to carry similar measures into 2010 and increase subsidies to low income groups by providing additional funds to health care services and needy families.[10]

Real capital expenditures are expected to decline by 4.5 percent in 2009. The government has not planned to use an increase in public investment as a means of stimulating the economy. In 2010, the real capital expenditures are expected to decrease a further 3.4 percent.

Noting that entrepreneurs with no loan records and small enterprises frequently encounter difficulties in accessing finance, the government decided to introduce a loan guarantee mechanism.[11] In October 2009, the Treasury transferred one billion Turkish lira to the loan guarantee fund. According to the rules adopted by the government, commercial banks extending credits will be liable for 35 percent of the credit risk, while 65 percent of the risk will be covered by the loan guarantee fund. These rules went into effect on July 15, 2009 and will remain in force for a period of two years.

[9] In order to obtain the real expenditure figures, the nominal expenditure figures in Table 1 for the years 2009 and 2010 have been deflated by the GDP price deflators. The expected increase in the GDP deflator during 2009 is six percent, and the expected increase in the GDP deflator during 2010 five percent.

[10] Turkey introduced the Health Transformation Program in 2003. The program has been a success, improving the governance, efficiency of and access to the health system by providing universal health insurance under a single social security institution.

[11] In the loan guarantee mechanism, a third party is incorporated into the system between the bank that extends the loan and the borrower. The loan guarantee is provided by the third party. As a result, the risk encountered by the bank extending the loan is reduced. If the small-sized enterprise cannot overcome problems faced in repaying the loan amount, the guarantee mechanism will be triggered and the bank will collect the receivables from the guarantee fund.

In general, the financial sector in Turkey prior to the global financial crisis was quite healthy. There was thus no need for direct support through loans, guarantees or capital injections.

By contrast, the real sector was addressed through a series of industrial and structural policy measures. In particular, value-added taxes and special consumption taxes on selected products were temporarily cut so as to boost domestic consumption and help revive economic activity. Unlike many other countries, however, no specific stimulus measures increasing public expenditure on infrastructure projects have been announced.

As of the time of writing, it remained difficult to say whether the government's mix of stimulus measures was adequately targeted and delineated.

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

Development as an objective of stimulus policies

In September 2009, the government introduced the Medium Term Program. The proposed measures in the program do not in themselves constitute significant reform, and are unlikely to propel Turkey along a new, well-defined growth path that enhances the country's integration into the changing global economy. At best, the measures can be considered as a corrective strategy rather than a new growth strategy. Thus, there was no major change from the development strategy pursued prior to the crisis.

The program's goals are largely aimed at rekindling economic activity. A useful way of analyzing this was developed by Swan in a path-breaking 1963 paper summarizing the aims of macroeconomic policy under the categories of internal balance and external balance.[12] While internal balance requires full employment of a country's resources and domestic price stability, external balance for a country with foreign debt refers to a state of affairs where current account sustainability is achieved.

Prior to the emergence of the global financial crisis, Turkey, it could be argued, had satisfied the internal balance but not the external balance. With the emergence of the crisis, the output gap increased to 5 percent during the last

[12] See T.W. Swan, "Longer-Run Problems of the Balance of Payments," in *The Australian Economy: A Volume of Readings*, edited by H. W. Arndt and M. W. Corden. (Melbourne: Chesire Press, 1963).

quarter of 2008, 10.2 percent in the first quarter of 2009 and 6.7 percent in the second quarter of 2009. Domestic demand recovered in the second quarter of 2009 mainly because of the tax incentives on sales of durable goods. On the whole, the figures indicate substantial underemployment of resources. Turkey is thus far from attaining internal balance.

As emphasized under “Exposure to specific market and trade risks,” the current account deficit in the 12-month period ending August 2008 reached the unsustainable level of $49 billion, amounting to 6.6 percent of 2008 GDP. By the end of 2008, the country’s external debt had increased to $278.1 billion, or 37.5 percent of GDP. Of this total, $186 billion of foreign debt had been incurred by the private sector. The current account deficit during the financial crisis (August 2008 – July 2009) has decreased substantially due to the enormous contraction in the volume of imports. In fact, the current account deficit during the August 2008 – July 2009 period amounted to $16.4 billion, and is expected to decline to $13.5 billion during 2009, making it about 2.2 percent of GDP. The current account-to-GDP ratio of 2.2 percent indicates that current account sustainability is not an issue as of November 2009. As of the second quarter of 2009, however, the external debt of the country amounted to $278.1 billion (44.4% of GDP), of which $177 billion was owed by the private sector.[13] If GDP were to increase in the future and the economy were to move towards attaining internal balance, then imports would increase and again raise concerns about current account sustainability.

Turkey is trying to attain internal balance. To do so, the country faces issues related to fiscal sustainability. To emphasize this aspect consider the following back-of-the-envelope calculations. GDP in 2009 is expected to amount to TRY 947 billion. As mentioned above, the output gap amounted to 10.2 percent of GDP in the first quarter of 2009 and 6.7 percent in the second quarter of 2009. If the average value of the output gap for 2009 were eventually 7 percent, then the gap would amount to about TRY 66 billion. Being optimistic, assume that the value of the long run government consumption expenditure multiplier equals one, the value of the long run government investment expenditure multiplier equals two, and that government expenditure increases are equally divided between consumption and investment.[14] In that case, if Turkey increased its annual total government

[13] Note that with the intensification of the crisis, the lira depreciated. As a result, GDP measured in terms of U.S. dollars is expected to decrease from $734.9 billion in 2008 to $626.6 billion in 2009. The increase in debt-to-GDP ratio is therefore due to the decline in GDP measured in U.S. dollars.

[14] E. Ilzetzki, E. G. Mendoza and C. A. Vegh argue in their article “How Big are Fiscal Multipliers?,” Center for Economic Policy Research Policy Insight No. 39 (2009) that in developing countries, the response of output to increases in government spending is smaller on impact and considerably less persistent than in high income countries. The cumulative multiplier for high income countries rises from an initial value of 0.24 (the impact effect) to a long-run value of 1.04. On the other hand, the impact effect in developing countries is almost nothing and the cu-

expenditures by about TRY 44 billion per year over the next few years, then over time it could hope to achieve internal balance. But this would imply that the annual central government deficit would have to increase each year by 44 billion, leading to an increase in central government debt and an increase in the debt-to-GDP ratio. Keeping government expenditures at the increased level over the next few years would imply that domestic debt would explode over time. As a result, concerns about fiscal sustainability would be unavoidable.

According to government policymakers, there is no need to increase government expenditures because aggregate demand for goods and services will increase over time as conditions in the world economy improve. Thus, the bet of the government is that the world economy will recover toward the end of 2009 and during 2010. With the recovery in the world economy, Turkish exports will increase. Domestic demand, on the other hand, which had contracted in tandem with deteriorating business and lending conditions, would also increase in parallel with the improvements in the world economy. Thus, under the policies announced in the Medium Term Program, Turkey will be moving toward attaining internal balance without having to increase public expenditures.

When the economy recovers and achieves internal balance, the country, as emphasized above, could end up with substantial current account deficits similar to those during the period prior to the emergence of global financial crisis. The policy document does not mention anything about the attainment of external balance. The Medium Term Program emphasizes that Turkey will not change its independently floating exchange rate regime. Under such a regime, no automatic mechanism exists to move the economy towards attaining internal and external balances.

If Turkey does not pursue appropriate policies, the economy could move toward attaining internal balance over time, but not external balance. Hence, Turkey in the future may again face constraints imposed by current account sustainability considerations. Attainment of external balance would require depreciation of the real exchange rate (RER). In this case, however, the

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mulative long-run multiplier is just 0.79. In other words, in the long run an additional dollar of government consumption crowds out some other component of GDP (investment, consumption, or net exports) by 21 cents. The degree of exchange rate flexibility is a critical determinant of the size of fiscal multipliers. Economies operating under predetermined exchange rate regimes have long-run multipliers of around 1.5, but economies with flexible exchange rate regimes have multipliers of essentially zero. The degree of openness to trade (measured as exports plus imports as a proportion of GDP) is another critical determinant. Relatively closed economies have long-run multipliers of around 1.6, but relatively open economies have very small or zero multipliers. In highly-indebted countries, the output response to increases in government spending is short-lived and much less persistent than in countries with a low debt to GDP ratio. The multipliers for the United States in the post-1980 period are rather small (in the range of 0.3 - 0.4) both in the short and long run. On the other hand, multipliers for government investment are large (around two).

country could face non-negligible risks stemming from the balance sheets of the non-financial private sector, which as of the second quarter 2009 had foreign debt amounting to $177 billion. Policymakers' major concern under such circumstances would be to establish whether the country would be able to meet its external payments obligations.

National bias and protectionism

- Has the stimulus included "buy national" clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country's executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

As of the end of 2008, Turkey had 107 anti-dumping duties in force. Most of the anti-dumping duties had been imposed on imports from China (42 duties), Indonesia (10 duties), Taiwan (nine duties), Thailand (eight duties) and India (seven duties). These measures mostly affect textiles and clothing. The majority are specific duties, though some are ad valorem duties as high as 100 percent. During 2009, Turkey added 27 new anti-dumping duties. These duties were imposed on imports from China (eight duties), Indonesia (four duties), Malaysia (four duties), Thailand (three duties) and India (three duties). The new measures have affected motorcycle and bicycle tires and tubes (nine duties), polyvinyl chloride (four duties) and polyester synthetic staple (three duties).

Turkey is an important user of anti-dumping measures. As of October 5, 2009, it had 19 anti-dumping investigations in progress, most of which concerned imports from China. On the other hand, Turkey did not make extensive use of countervailing measures and safeguard actions. It has reported one countervailing measure against imports from India, and it has not taken any safeguard actions under GATT Article XIX.

With regard to trade with the European Union, there is free movement of industrial products between it and Turkey with the exception of contingent protectionism measures and technical legislation. Regarding contingent protectionism, we note that both the European Union and Turkey have been active users of contingent protection measures, though the European Union has been more so. The formation of the customs union has not provided protection from EC anti-dumping measures, and both the European Union and Turkey have continued to protect their sensitive sectors through contingent protection measures.

A recent WTO/OECD/United Nations Conference on Trade and Development (UNCTAD) report emphasizes that Turkey has increased import tariffs (from 80 percent to 130 percent) for 13 tariff lines (wheat, melsin, rye, oat, buckwheat).[15] These agricultural commodities are not covered by the EU-Turkey customs union decision. Agricultural import tariff rates in Turkey have been and still are very high and the agricultural sector is extensively protected from foreign competition.[16]

The stimulus package did not include any "buy national" clauses. It is difficult to assert that Turkey is using anti-dumping measures as a protectionist tool during the global financial crisis since it has been using these measures extensively for quite some time.

With respect to currency manipulation, the government has said it intends to maintain an independently floating exchange rate regime. Although the central bank has reduced the policy interest rate by 1000 basis points since November 2008, policy and market interest rates remain high by international standards. This has attracted capital inflows, causing the real exchange rate (RER) to appreciate, resulting in further competitiveness problems.

Export industries have been given some additional support. The central bank increased the exports rediscount credit limit from $500 million to $2.5 billion. Additionally, the rules and principles applicable to the exports rediscount loan limit were redrawn in order to make the use of these loans easier. The limits on Eximbank (Turkey's export credit bank) credits to firms have been increased, and the repayment period for short-term Eximbank credits has been lengthened by an additional three months.

The Treasury increased the Eximbank's loan and guarantee limit to $4 billion, and the institution's capital supply has been increased from TRY 1 billion to TRY 1.5 billion.

[15] See OECD/WTO/UNCTAD, "Report on G20 Trade and Investment Measures," prepared for the Pittsburgh summit in September 2009 http://www.oecd.org/document/2/0,3343,en_2649_34529562_43685104_1_1_1_1,00.html (accessed January 30, 2010).

[16] See World Trade Organization, *Trade Policy Review Turkey 2007*, Geneva: WTO Publications, 2008.

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Social protection

In response to the global crisis, the government introduced a new package of labor-related measures directed at companies, employees and retired people. Eligibility for "short term employment compensation" implemented through the Unemployment Fund was extended from three to six months, and the total amount of the related compensation was increased by 50 percent. In addition, unemployment compensation was increased by 11 percent. Furthermore, starting from April 2009, the government is subsidizing additional employment by firms. For these workers, the employers' contribution to minimum wages will be covered by the government for six months, and can be extended for another six by a decision of the Council of Ministers. However, the government has not issued consumer checks or introduced any reductions in income tax rates.

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political communication

As emphasized under "Agility and credibility," the government was too optimistic about the country's response to the global crisis until the summer of 2009. At the initial stages, the prime minister even claimed that crisis would have almost no effect on the Turkish economy. Since the global crisis is qualitatively quite different from what the country had experienced in the past, recent history could not offer guidance to the government in designing policy measures. As a result, the government was cautious and refrained from any drastic policy measures. The measures introduced were communicated at different times through press conferences and through the media. The sharp contraction in global economic activity, weak domestic demand conditions and sudden stops in external capital flows did indeed affect the Turkish economy adversely, and the disinflation process accelerated in 2009. In September 2009, the government called a press conference to announce its Medium Term Economic Program, explained in some detail above.

Responses to the government's measures mainly came from political parties, the press, employers' associations and sectoral lobbies. In general, these groups expressed complaints about the need to design comprehensive policy measures and to sign an agreement with the IMF. Some stressed that by shunning an agreement with the IMF, the government was making a bet on global recovery and tying its political future to the pace and vigor of global growth.

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

Modes and time frame of implementation

The crisis management measures announced by the government have on the whole either been implemented or are in the process of implementation. Table 1 above shows the extent and direction of implementation over the next two years.

Some sectoral lobby groups have called for a different policy tack, however. Since the developments in world capital markets have reduced capital inflows into Turkey, thus depriving the economy of its primary growth engine, these groups insist that the government should sign a new loan agreement with the IMF. They have emphasized that an IMF anchor would constrain the public sector's fiscal expansion, and also help the private sector to roll over its short-term foreign debt. Furthermore, such an agreement would relieve the pressure of possible exchange rate devaluations. Private sector companies with foreign debts are very much afraid of devaluation because of the potential balance sheet effects.

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

As mentioned above, Turkey is contributing to the global efforts as an active member of the G-20.

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/ stabilization

The Ministry of Finance has introduced several tax policies in response to the crisis aimed at boosting different sectors. Payments of taxes due and payable before September 1, 2008 were deferred to December 2008, and payments could be made in 18 installments.

In addition, a new tax amnesty law was passed. As of October 1, 2008, real and legal persons having funds and other precious assets abroad were allowed to bring these assets and funds to Turkey by paying a two percent tax. Furthermore, current income tax and corporate taxpayers were allowed to register their existing securities and real properties inside Turkey which were unregistered as of the same date, by paying a five percent tax.

On March 13, 2009, the government announced new measures to ease the adverse effects of the global financial crisis. Accordingly, it was decided that:

- Consumption taxes applied to durable goods and automobiles would be lowered for a period of three months;
- Value-added taxes (VAT) applied to real estate would be lowered from 18 percent to eight percent for a period of three months; and
- An additional subsidy of TRY 75 million would be extended to small to medium-sized enterprises (SMEs).

On March 25, 2009, the government reduced the VAT rate received from the sale of offices and other workplaces to eight percent. The fee applied to real estate purchases was reduced from 1.5 percent to 0.5 percent. The VAT rate on furniture, certain industrial and work machines used particularly by SMEs, information technology products, and office furniture fell from 18 percent to eight percent. These tax reductions were to be effective for a period of three months. Later, the government extended VAT reductions to certain other products as well.

In June 2009, the government extended the temporary cut in tax rates for another three months, to September 30, 2009. In this context, it was further decided that the resource utilization support fund tax rate applied on consumer credits be cut by five percentage points, from 15 percent to 10 percent. In addition, the time limit of the tax amnesty law was extended until the end of 2009. Furthermore, the authorities are creating an incentive scheme for investment and employment, which aims to strengthen Turkey's potential growth rate and thereby ensure a more sustainable recovery. In particular, the investment scheme is meant to provide more than just a short-term boost to domestic demand. It is intended to attract more foreign investment and reduce regional social and economic imbalances in order to enhance Turkey's competitiveness. The scheme encourages large-scale investments to be made until the end of 2010. Its incentives extend into the medium and long term (up to 20 years), and are differentiated according to region and sector of activity. It is further supported by well-designed corporate tax incentives and a partial exemption from the payment of the social contributions premium. In addition, the government decided to decrease the tax rates on certain commodities and introduced tax exemptions for certain types of transactions.

Monetary and currency policies in support of stimulus/ stabilization

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

The central bank has relaxed monetary policy significantly in the form of aggressive cuts in policy rates. Between November 2008 and the end of October 2009, the policy interest rate was reduced by 1000 basis points. Furthermore, the central bank took the following additional actions:

– It resumed its activities as an intermediary in the foreign exchange deposit market until the uncertainty in international markets is dispelled (October 9, 2008).
– It doubled its transaction limits to $10.8 billion (October 23, 2008) and extended the lending maturity from one week to one month in the foreign exchange deposit market (November 21, 2008).
– It adopted a strategy to use foreign exchange reserves primarily to support the banking system's foreign exchange liquidity needs. The reserve requirement ratio remained unchanged at six percent for lia-

bilities denominated in Turkish lira, but was lowered from 11 percent to nine percent for foreign exchange liabilities (November 28, 2008). With this measure, the central bank provided additional liquidity of $2.5 billion to the banking system.

In addition, the government repealed the condition that set forth assignment of the reserves for letters of credit to the central bank. Additional measures were implemented by various organizations during the first months of 2009 as global volatility continued to affect domestic markets. For example, Law No. 5834 on “Omission of the Past Records for Unpaid Checks and Protested Promissory Notes, and Credit and Credit Card Debts,” also known as the law for the amnesty of records, allowed the deletion of real and legal persons’ past records kept at the central bank relating to unpaid checks, protested promissory notes, and credit card debts and other credit debts, as long as such sums were totally paid before or within six months after the law’s effective date, or were restructured and totally paid. In addition, the central bank published its regulation on the “Liquidity Support Facility” governing the principles and procedures set forth for the utilization of credit facilities as stipulated in subparagraph (c) of paragraph (I) of Article 40 of the central bank law. Accordingly, loans will be available:

- as advance payments, with one month maturities for a maximum one year period;
- at the lending rate set for the intraday transactions carried out at the Interbank Money Market (note that interest rates applicable to credits of this nature are higher than those applicable to normal open market transactions);
- against collateral accepted at the Interbank Money Market, and will be limited to an amount twice the value of the applying bank’s equity capital.

The central bank extended the maturity in the foreign exchange deposit market in order to prevent a possible foreign exchange squeeze in the financial market. Accordingly, the lending rate was reduced to 5.5 percent from 7.0 percent for the U.S. dollar and to 6.5 percent from 9.0 percent for the euro. The maturity of interbank transactions was extended from one month to three months.

The Banking Regulation and Supervision Agency (BRSA) adopted measures aimed at preserving the financial strength of banks and containing the effects of abrupt changes in the financial asset prices of banks’ capital adequacies. For this purpose, BRSA implemented the following changes:

- required banks to get permission for distribution of their 2008 earnings;
- allowed banks to reclassify the securities in their balance sheet, shifting them from trading portfolios to investment portfolios; and
- allowed banks to restructure loans that apparently posed no problems in order to ensure smooth functioning of the loan relations between banks and non-financial institutions.

The government sought authorization from the parliament to increase deposit insurance coverage for a period of two years, from its previous level of TRY 50,000. This amendment allowed for a direct Treasury guarantee on the deposits insured, since the Savings Deposit Insurance Fund's (SDIF) own resources would not have been sufficient to cover the deposits for which the SDIF was authorized under the current law.

Credibility of funding mechanisms

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

Turkey's stimulus package is supposed to amount to 2.1 percent of GDP during 2009 and 1.6 percent of GDP during 2010. With the decrease in tax revenues due to economic slowdown and the increase in government expenditures needed to alleviate the adverse effects of the global financial crisis, the budget deficit is expected to increase in 2009. Keeping fiscal discipline in the back of its mind, the government is targeting a gradual improvement in the central government budget deficit. According to the Medium Term Program 2010 – 2012, the budget deficit will decline from 6.6 percent in 2009 to 4.9 percent in 2010, to four percent in 2011 and to 3.2 percent in 2012. Accordingly, the ratio of public debt to GDP is expected to increase from 39.5 percent in 2008 to 47.3 percent in 2009. After peaking at 49 percent in 2010, this ratio is expected to stabilize by 2011 and settle at 47.8 percent in 2012. Thus, the program – and the commitment to the eventual termination of expansionary fiscal policy – seems to be credible.

As detailed in "Scope of stabilization and stimulus policies," the stimulus program has been treated as part of the normal budget. It is a national program, with no cross-level burden sharing between the center and regions.

6. Feedback and Lesson-Drawing

Policy feedback and adaptation

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

As detailed above, the government has modified and expanded its crisis management program over time, particularly as the depth of the domestic effects became apparent.

Institutional restructuring

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Turkey undertook major institutional reorganization after the 2001 crisis. The policymakers in the current crisis felt no need for further institutional capacity building in terms of financial supervision. With the exception of the loan guarantee mechanism explained in "Targeting and coverage of policy tools," no new institutions were created.

7. Tentative Economic Impact

Economic and political effectiveness of the crisis response

- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

The latest economic performance indicators state that Turkey's GDP has declined by 14.3 percent year-over-year during the first quarter of 2009, and by seven percent year-over-year during the second quarter of 2009. The latest employment data referring to the period July – August 2009 indicate that while the population 15 years old and older has increased by 881,000 individuals year-over-year, the number of employed individuals in the non-agricultural sector declined by 314,000. The unemployment rate increased from 9.9 percent during July – August 2008 to 12.8 percent during July – August 2009. The unemployment rate in the urban sector increased during the same period from 12 percent to 16 percent. Regarding foreign trade, we note that merchandise exports during the period October 2008 – September 2009 compared to October 2007 – September 2008 declined by 26.6 percent, and merchandise imports by 34.7 percent over the same period. The monthly figures for September 2009 indicate that this trend has not changed, and that while merchandise exports have declined by 33.6 percent year-over-year, merchandise imports have declined by 30.4 percent. Finally, the capacity utilization rate has been increasing gradually from the lows experienced during January 2009. The rate has increased from 64.1 percent during the first quarter of 2009 to 69.9 percent in the second quarter of 2009, and to 70.7 percent in the third quarter of 2009.[17]

According to the forecasts of the Medium Term Economic Program (2010 – 1012) published in September 2009, GDP will increase by 3.5 percent in 2010 after declining by six percent in 2009; the unemployment rate will decline from 14.8 percent in 2009 to 14.6 in 2010; merchandise exports will increase by 9.1 percent in 2010 after decreasing by 25.4 percent in 2009; and merchandise imports will increase by 14.2 percent after declining by 33.7 percent in 2009. For 2010, the government predicts a 7.5 percent increase in investment expenditure with an eight percent increase in private investment expenditure. Consumption expenditure is expected to increase by 2.5 percent.

These government projections seem to be on the optimistic side, and are based on the assumption that the world economy will recover soon. But Turkey’s recovery may be hindered by adverse developments in the world economy and also by the projected large increase in the unemployment rate, which could potentially decrease the aggregate demand. Furthermore, prospects for external trade expansion may also be overly ambitious.

Short-term political goals and electoral dynamics will likely play a significant role in the way the government’s program is received and amended in the coming year. As explained under “Executive, fiscal and monetary capacities to respond to downturn,” Turkish politics in the recent era has been characterized by a considerable degree of instability. Turkey continues to project an image of a highly polarized society, and political uncertainties have weighed heavily on Turkish financial markets.

Election periods in Turkey are generally marked by reluctance on the part of governments to make major decisions in key policy areas, but are often accompanied by a significant increase in populist decisions intended to boost economic activity. Consequently, budget deficits swell and economic balances deteriorate substantially. Both the July 2007 and the March 2009

[17] Note that the capacity utilization rate was 82.1 percent during July – August 2008.

elections proved that the ruling political party, AKP, operates no differently. The primary surplus dropped from 4.6 percent of GDP in 2006 to -2 percent of GDP in 2009. Only one-third of this deterioration stemmed from cyclical factors; the rest was structural deterioration. Recent opinion polls suggest that the AKP's electoral support remains on the decline. Despite the lack of a strong alternative, it is obvious that the next election does not promise an easy victory for the AKP.

Although the crisis was not triggered by the AKP government, economic problems will continue to undermine its electoral support. Unless it can boast of some economic successes, the AKP will have difficulty gaining the support of voters who previously voted for other political parties. Thus, the AKP government should do its best to reduce the unemployment rate and accelerate economic activity.

Article 77 of the Turkish Constitution stipulates that "elections are held every four years." Thus, with parliamentary elections having been held in July 2007, the next regular election date is July 2011. But early elections could be held in November 2010 or March-April 2011.

After the AKP's major victory in the July 2007 elections with 47 percent of the vote, its support ebbed to 38 percent in the municipal elections. Recent opinion polls indicate that the AKP could garner 35 percent to 36 percent of the vote. These levels are critical, as a political party that receives this level of support may not be able to win the majority of the seats in parliament, depending on the number of parties that exceed the 10 percent threshold for parliamentary representation and the distribution of the votes within the country.

Under the assumption of slow recovery, the best thing for the AKP government would be to postpone the elections as much as possible within the limits of the constitution. However, if AKP leadership sees its voter base eroding, it could decide to hold the elections even earlier than the dates mentioned above.

According to government circles and the IMF, Turkey's economy will be recovering next year. However, the recovery that will be witnessed prior to the elections will be hardly discernible by the public at large. This is because there will be no drastic improvement in the unemployment rate or in real wages; the profitability of the corporate sector, and of SMEs in particular, will not be much better.

The AKP leadership is aware of the fact that the attitude of a person who has been unemployed for two years will be completely different from another who was recently laid off.

If the election period in Turkey kicks off in the summer of 2010, then the government, unless forced, will not want to conclude a stand-by deal with the IMF. Instead, it would prefer to be free to follow the expansionary fiscal policies that it considers to be appropriate tools for winning elections.

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

Structural distortions

As emphasized above, the Medium Term Program can be considered as a corrective strategy rather than as a new growth strategy. Thus, no major change from the development strategy pursued prior to the crisis is expected. There is no evidence that the structure of the economy will change.

This does hold out the possibility that old imbalances will re-emerge. As emphasized in “Exposure to specific market and trade risks,” a country does not have to worry too much about foreign debt levels if it tends to run current account surpluses, maintains relatively low foreign debt levels and borrows mostly at longer term maturities. Until the emergence of the global financial crisis, however, Turkey had been running large current account deficits year after year, and has concentrated its borrowing at relatively short and medium term maturities. Although the problem currently is not as acute as it was at the start of the global financial crisis, it could emerge again as the country achieves internal balance. Since external debt needs to be continuously rolled over, the country could again be subject to a crisis of confidence.

8. Concluding Remarks

During 2009, GDP is expected to decline by six percent according to the government, and by 6.5 percent according to the IMF. Thus, the real sector has taken more of a battering in this crisis than in 2001. According to IMF, Turkey is one of the few countries that was adversely affected by the crisis to such a large extent. Other countries include Ireland (7.5% decline) and Iceland (8.5% decline) among the advanced economies; Estonia (14% decline), Latvia (18% decline), Lithuania (18.5% percent decline), Hungary (6.7% decline) Bulgaria (6.5% decline) and Romania (8.5% decline) among emerging European economies; Russia (7.5% decline), Ukraine (14% decline), Armenia (15.6% decline) and Moldova (9% decline) among CIS states; and Mexico (7.3% decline) among western hemisphere economies.

Why was Turkey affected to such an extent by the current crisis? One reason was the decline in external demand. Here Kaminski and Ng (2007) note that when exports were expanding, network trade was the driving force for the Turkish economy's integration into global markets. In particular, the integration into EU-27 production and distribution value chains and networks structures drove Turkey's increasing participation in the division of labor based on outsourcing and production fragmentation. This trend turned to Turkey's disadvantage once international trade flows collapsed. A second reason for the enormous decline in GDP was the sudden stop of capital flows. With capital inflows turning to outflows, the economy was deprived of its primary growth engine. In addition to developments in external trade, domestic demand contracted in tandem with deteriorating business prospects and lending conditions.

By designing appropriate policies for attaining internal balance as well as external balance, Turkey could in principle reduce the fragility of its economy. The main issues facing the Turkish economy are related to the acquisition of high quality institutions that will allow policymakers to run a successful market economy and follow the "universal" principles of sound economic policy.[18]

[18] According to Dani Rodrik, the "universal" principles of sound economic policy consisting of allocative efficiency, macroeconomic and financial stability, social inclusion, and market economy are embedded in five sets of non-market institutions: property rights, regulatory institutions, institutions for macroeconomic stabilization, institutions for social insurance, and institutions of conflict management. On these issues see Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions and Economic Growth* (Princeton: Princeton University Press, 2007).

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

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