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Financialisation and the Financial and Economic Crises: The Case of Turkey

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Financialisation and the Financial and Economic Crises: The Case of Turkey

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Abstract:

This study aims to evaluate the relationship between the real sector and the financial sector in the era of neoliberalism. To this end, we focus on the implications of financial developments for the main macroeconomic variables including, consumption, investment and income distribution. We also explore the impacts of the recent crisis on Turkish economy and the policies taken in response to the crisis.

The overall findings of this report provide considerable supports to four interrelated arguments. First, many well established properties of financialisation in advanced countries are not found in the Turkish case. Second, as opposed to domestically driven financialisation tendencies, financial flows, a part of global financialisation, have dominated important trends in the Turkish economy. Third, under the significant influence of financial flows, in general, the Turkish economy has shown a debt-led consumption boom type growth. Fourth, although the role of the export shock in explaining the impact of the recent crisis on the Turkish economy is very distinctive, the role of financial flows in the recent and especially previous crises are very important as well.

Key words: financialisation, economic and financial crisis, the Turkish economy, capital inflows, consumer debt, income inequality.

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I. Introduction:

Neoliberal economic policies have changed the role of the state in the economy since the late 1970s and early 1980s. Deregulation in labour markets and trade liberalization have been integral parts of this process. Furthermore, as a result of liberalization of cross-border capital movements and domestic financial markets, finance has gained considerable importance at both the national and international levels. The 1990s and the early 2000s witnessed a series of financial crises in developing countries.[1] Although western countries have suffered from a major financial collapse in 2007, developing countries have been the main victims of the crises after the 1980s. Financial liberalization seems to have played a big role in these crises. In many developing countries, current account deficits and debt accumulation gained importance, following the financial liberalization. The volatility of many macroeconomic variables significantly increased. Turkish economy demonstrates many traits of a typical developing country which has experienced such neoliberal transformation. High volatility in macroeconomic indicators and high frequency of crises have been among the characteristics of the economy since the 1980s.

This study aims to evaluate the relationship between the real sector and the financial sector in the era of neoliberalism. To this end, we focus on the implications of financial developments for the main macroeconomic variables including, consumption, investment and income distribution. We also explore the impacts of the recent crisis on Turkish economy and the policies taken in response to the crisis.

Next section provides a brief account of financial-flows driven cycles and the contributions of different components to GDP growth for the post-1980 Turkish economy. In this current and the following sections of the report, we will emphasize that the financialisation process has been mostly dominated by financial flows rather than changes in the motives and structure of domestic financial and non-financial institutions. This

[1] The Turkish crises and Mexican Tequila crises of 1994, the East Asian crisis of 1997, the Brazilian and Russian crises of 1998, the Turkish crisis of 2001 and Argentinian crisis of 2001-2002 can be counted among the major crises in developing countries.

section indicates that, based on the classification suggested by Hein (2012), post-1980 Turkish economic growth can be considered to follow a debt-led consumption boom, under the influence of financial flows.

The third section investigates income distribution in Turkey with a focus on the period after 2001. Our analysis in this section shows that, at a first glance, the distribution of income became less unequal between 2002 and 2011. However, since these results are derived from a size distribution of income analysis which largely neglects undistributed profits of the capitalist firms, this observation should be evaluated cautiously. The inclusion of undistributed profits radically changes the picture.[2] The functional income distribution analysis indicates a reduction of wage share throughout the period. Moreover, the social-class based income distribution analysis suggests a vast deterioration in the ranks of peasantry, which turns out to be the main source of the increase in the urban labour force Households in the lowest quintiles and the classes in the lowest echelons of the capitalist society experienced increasing deficits in their balance sheets throughout the period.[3] The households' deficit increased for almost all the quintiles. In this pretext, the real consumption of the higher quintiles and upper classes increased. Overall, the findings of this section support the idea that Turkish economy can be described by a debt-led growth regime, with a reduction in wage shares and a concomitant deterioration of balance sheets of households.

Shifting our attention to the trends in the balance sheets of nonfinancial corporate sector (section II.2), we make a couple of complementary observations. First, a hallmark of financialisation in advanced economies has been the increase in payments to the financial markets, especially in forms of dividends and stock buybacks. For the Turkish non-financial corporations (NFCs), dividend data is limited in our database. However, due to the institutional constraints stock buybacks were not possible until very recently. Shareholder pressure was also not visible as shareholder activism has been limited. This is a major institutional difference between western countries and Turkey. Second, bank financing in

[2]This is due to the fact that functional income distribution analysis uses national income data rather than household level data.

[3] The section on consumption implies that these deficits were met with borrowings from the banking system.

Turkey is still a very important channel. Third, there has been an increase in financial asset holdings; however financial incomes have been declining in the post-2001 era. This is partly due to declining interest rates, especially on government bonds.[4] Overall, the Section indicates that although financial motives might have gained importance, a classical financialisation of the NFCs has not been materialized in the Turkish economy.

Section II.3 examines the relationship between consumption and financialization in the Turkish economy. Accordingly, rising debt levels relative to household income put a considerable burden on households -especially for low income groups- through a rise in their debt stock and debt service burden. There is not enough evidence for a considerable rise in financial wealth among Turkish households. As the rise in financial assets does not show a similar increase, the burden of increased debt levels does not seem to be compensated by a rise in gains from asset acquisitions. Although household debt to GDP has increased considerably after 2002, the level is still low in Turkey relative to that in advanced countries. Overall, Turkish households have not still experienced a comparable financialization in their balance sheets as in advanced countries.

We document the developments in current account under the neoliberal regime in Section II.4. Turkish economy has been giving chronic current account deficits for a long time. The section highlights two main factors behind the widening of the current account deficit. The first one is the structure of Turkey's trade with the rest of the world and the composition of exports and imports. Turkey imports large amounts of energy, intermediary and capital goods; while it exports, to a large extent, low-value added products. Export competitiveness is mostly supported by relatively low wages. The second factor highlights the impact of capital inflows. Capital inflows have direct and indirect effects on the current account deficit. The direct effect is through the exchange rate. Periods of large capital inflows brings about an appreciation of the domestic currency and lead to increasing imports while holding back export growth. The indirect effect of capital inflows on the current account deficit works through the dynamics of the domestic economy. Large capital inflows lead to expansion of domestic credit, increased asset prices, and decreased interest

[4] In the pre-2001 era Turkish NFCs were earning high short term interest revenues through investments in government bonds.

rates. As a result, domestic economic activity increases. Given the high import content of domestic production, increased economic activity leads to an increase in imports of both consumption and investment goods (energy, intermediary goods, and capital goods). Overall, this section provides evidence for the fact that financial integration, which has dominated the financialisation process in Turkey, has played an important role in shaping the course of the current account balances. Documenting long-lasting exchange rate appreciation periods, current account deficits and increasing borrowings from rest of the world, this section further justifies the debt-led consumption growth regime for the Turkish case.

The last section in this study focuses on the implications of the recent crisis on the Turkish economy. The Turkish economy has been adversely affected by the crisis through mainly three channels, namely, expectations channel, trade channel and financial channel. The distinctive characteristic of the crisis was a severe export shock which can account for an important part of the decline in production in Turkey. Besides, a significant sudden stop in financial flows worsened the credit conditions of the economy. As a result, Turkish economy witnessed one of its worst economic down-turns after the Second World War. In fact, Turkish growth performance during the course of the global crisis was one of worsts among developing countries. Government and the Central Bank attempted to take significant policy measures in response to the crisis. However, these measures were either relatively late or/and not very effective. Although this section put more emphasis on the role of the export shock in explaining the impact of the recent crisis on the Turkish economy, it also highlights the important role of financial flows in the recent and especially in the previous crises.

The overall findings of this study indicate that financial markets in Turkey have been shallow relative to that of advanced countries. Many well established characteristics of the financialisation process in advanced countries, one cannot find in the Turkish case. As opposed to the domestically driven financialisation tendencies, financial flows, a part of global financialisation, have dominated important trends in the Turkish economy. In

general, under the significant influence of financial flows, Turkish economy has long demonstrated the attributes of a debt-led consumption boom type growth.

I. 1. Liberalization, Financial Flows Driven Cycles and Debt-Led Consumption Boom[5]

Turkish current account liberalization, which aimed at moving away from import-substitution industrialization to export-oriented growth, started in 1980. By the mid-1980s import quotas were mostly removed, customs tariffs were reduced, and generous incentives were offered to exporters. Trade liberalization was followed by the liberalization of the capital account and the convertibility of the Turkish Lira (TL) in 1989. Foreign exchange controls on capital outflows were removed, and both the current and capital accounts were completely liberalized. Capital account liberalization was concomitant to domestic financial market liberalization. Interest rate controls were abandoned in the 1980s and İstanbul Stock Exchange Market was established in 1986. The weight of the public sector in financial markets gradually decreased. Foreign entities were allowed to operate in Turkish financial markets. The importance of foreign investment in the Turkish financial markets has increased considerably, especially after 2002.

Capital account liberalization, accompanied by decreasing constraints on domestic financial markets has transformed the Turkish economy considerably. However, Turkish financial markets remained shallow relative to those in developed countries. In other words, in Turkey, a classical domestic financialisation trend in the form of exponential growth in financial balance sheets, household debt and non-financial firms' financial activities were not as apparent as in the case of developed countries. As of 2010, banking sector total assets / GDP ratio was around 90%. Until 2001, government securities dominated the banking sector assets. Similarly, many financial innovations such as derivatives, mortgages, and asset backed securities were introduced only after 2002. Until very recently, stock buybacks were not allowed. Therefore, there has not been a significant

[5] Turkey Country Report as a part of Working Package 2 provides an extensive disucssion of the economic and social developments after 1980s. This section only briefly discusses relevant trends in the Turkish economy after 1980s.

shareholder activism forcing NFCs to change their behaviours. Besides, bank financing is still very important for the NFCs and households. As Section II.3 illustrates, households still hold their financial assets mostly in the form of deposits. Furthermore, although there has been an increase in the ratio of household debt to GDP, it was only about 22.0 percent in 2012.[6] In the age of financialisation, the importance of deposits has declined and the ratio of household debt to GDP increased considerably in many countries; this has not been the case in Turkey.

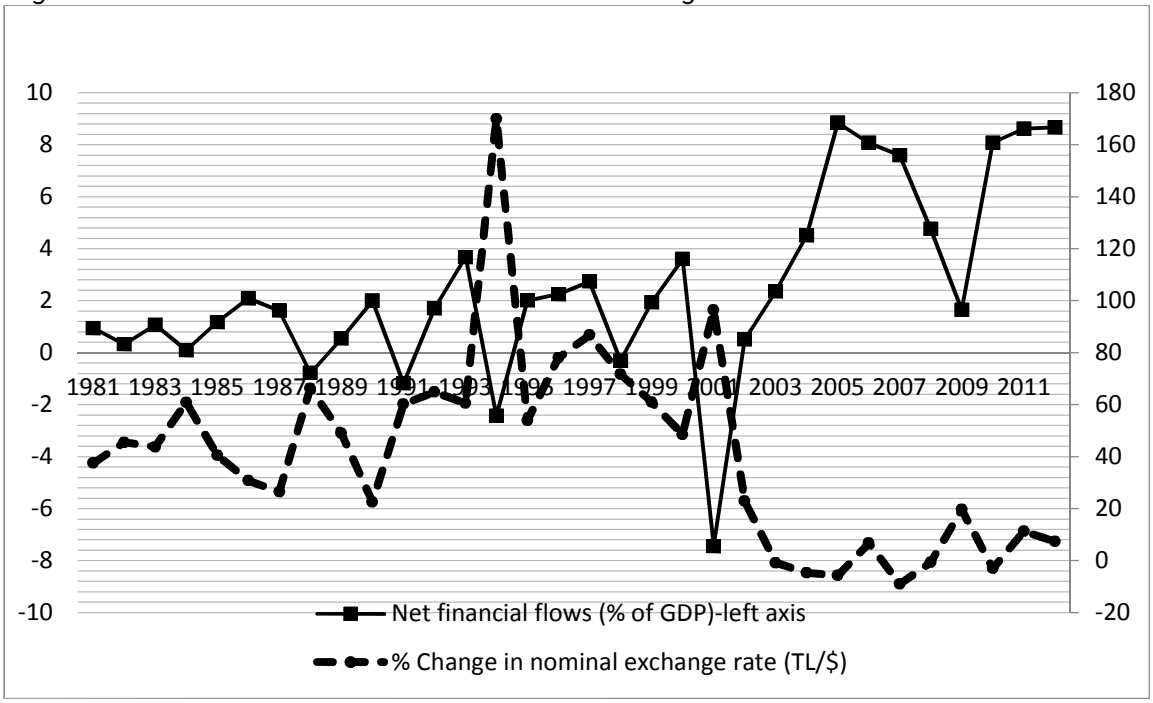
Under these conditions, domestic financial markets have been very sensitive to movements of foreign financial flows. In this sense, as discussed below, financial integration has shaped the course of the Turkish economy in many aspects.[7] Therefore, many of the discussions in this study put substantial emphasis on the role of financial flows in understanding many macroeconomic developments in the period of neoliberalism.

Capital inflows have been a major driving force of credit expansion in the Turkish economy; and there is a clear co-movement between capital inflows and domestic credit expansion. In this vein, financial flows have dominated the course of current account through their impacts on credit and exchange rate. Figure I.1 displays the apparent relationship between financial flows and the nominal exchange rate over a long time horizon. Excluding a few rare cases that are mostly related to adverse developments in inflation rate, the episodes of appreciation of the effective exchange rate are mostly translated into episodes of appreciation of the real effective exchange rate as well.

[6] Although growing problem of household indebtedness is evident from the rising ratio of household obligations to household disposable income, which increased from 7.5% in 2003 to 51.7% in 2011, the indebtedness is still low relative to that of advanced countries.

[7] In other words, although the symptoms of domestically driven classical financialization would not be very apparent in the Turkish economy, the Turkish economy has been greatly shaped by global financialization trends.

Figure I.1: Financial Flows and Nominal Exchange Rate



Source: Turkish Central Bank, World Bank Development Indicators

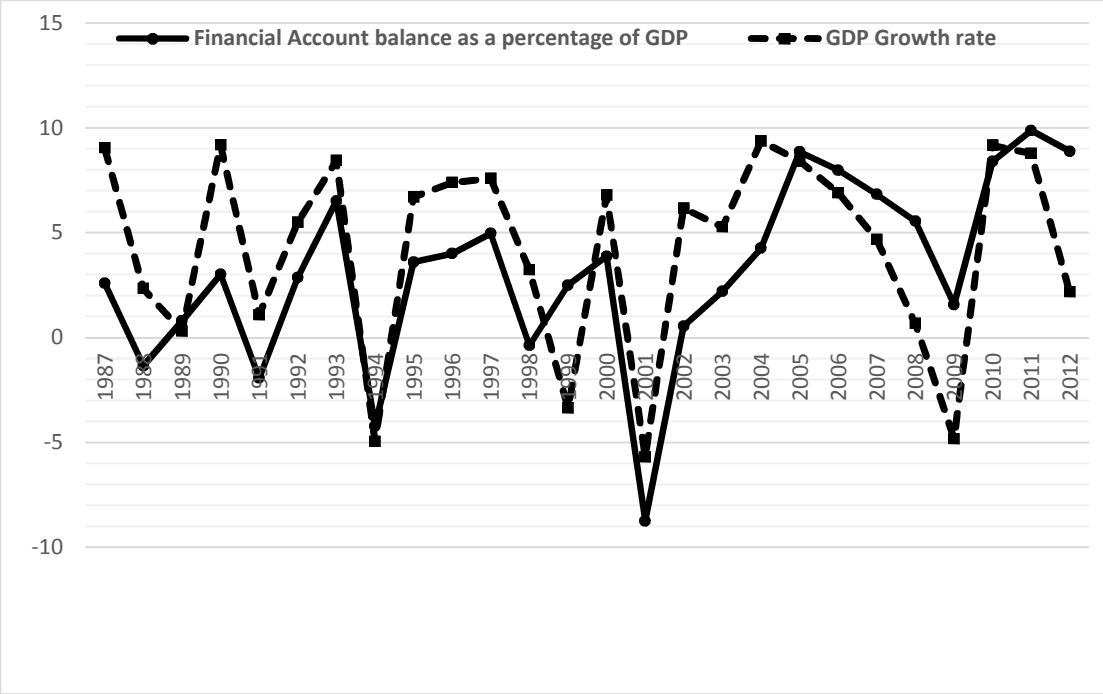
Overall, as Figure I.2 demonstrates, capital flows have dominated the growth process of the Turkish economy in the post-liberalization period.[8] Since the completion of the external financial liberalization in 1989, Turkish economy has been subject to a series of financial shocks and crises, mostly associated with boom-bust cycles of the capital flows. Booms have been generally driven by an increase in capital flows; and when the flows declined, the process was reversed causing a parallel decline in domestic demand. In this sense, throughout the period, co-movement of financial flows and growth of the economy has increased. The simple correlation between net financial flows and economic growth has been found 0.45, 0.66, and 0.75 for the periods of 1980-9, 1990-9, and 2000-12.

The role of capital inflows in the Turkish economy was similar to that in other developing economies. Analytically, "during the 1980s, the linkages between" economic growth and foreign capital "appear to be in the direction of domestic demand=>growth=>import=>current account deficits=>capital inflows (...)1990s of the

[8] See sections IV and VI below.

Turkish economy appear to have transformed the direction of the linkage into *capital inflows=>domestic demand=>growth=>import=>current deficits*" (Boratav and Yeldan, 2001).

Figure I.2: Financial Flows and Economic Growth (%)



Source: Calculated from Turkish Central Bank.

According to data presented in Figure I.2, post-1990 years exhibit four downturns (1994, 1999, 2001 and 2009), all of which coincides with declines or reversals of capital flows. Similarly, in all these four crises, a sudden stop of capital inflows and/or export revenues triggered the collapse.[9]

[9] A very detailed discussion about these crises can be found in Turkey Country Report of FESSUD WP-2.

I. 2. Growth and the Main Expenditure Components

In the early 1980s, liberalization of foreign trade and capital account was seen as a remedy for economic growth in Turkey. McKinnon-Shaw Hypothesis was the theoretical background of this policy change. McKinnon (1973) and Shaw (1973) suggested liberalization of the financial markets, and argued that particularly in developing countries, where the most valid saving method is bank deposits; high returns on deposits would increase the incentive to save, which is supposed to bring about higher investment and growth. Therefore, according to this view, financial liberalization would restore growth and stability by raising savings and enhancing economic efficiency. Furthermore, many developing countries were lured by the export-led growth strategy with trade liberalization, high subsidies to exports and increasing pressures on wages. Turkey was not an exception. However, the promises of neither financial liberalization nor trade liberalization were fulfilled in the Turkish case. An investigation of the main components of GDP can assist us comprehend the general picture better.[10]

Figure I.3 and Figure I.4 demonstrate Turkish economic growth and its demand decomposition in terms of main components of GDP. Since the liberalization of 1980s, Turkish economy has aspired to achieve an export-driven growth. However, even though the volume of trade has increased significantly, the contribution of net exports to growth has stayed negative. As discussed in detail in section II.4 below, Turkish exports are highly dependent on imported energy, intermediate and capital goods. Therefore, an increase in exports has always been accompanied by an increase in imports, preventing net exports to be positive.

Continuous current account deficits have meant accumulation of liabilities which should be sooner or later paid back. Unless the current account balance is not improved, debt servicing capacity of developing countries would be vulnerable to sudden stops or reversals in financial flows. With declining demand from developed countries in a deep

[10] One should be careful in investigating the contributions of different demand comonents to GDP growth. Since each of these components can be considered to endogenous variables, the determination of direct and indirect contributions of each demand component to GDP is much more complicated.

recession as in the case of the recent global crisis, the limitations of export-led growth strategy become even more obvious.

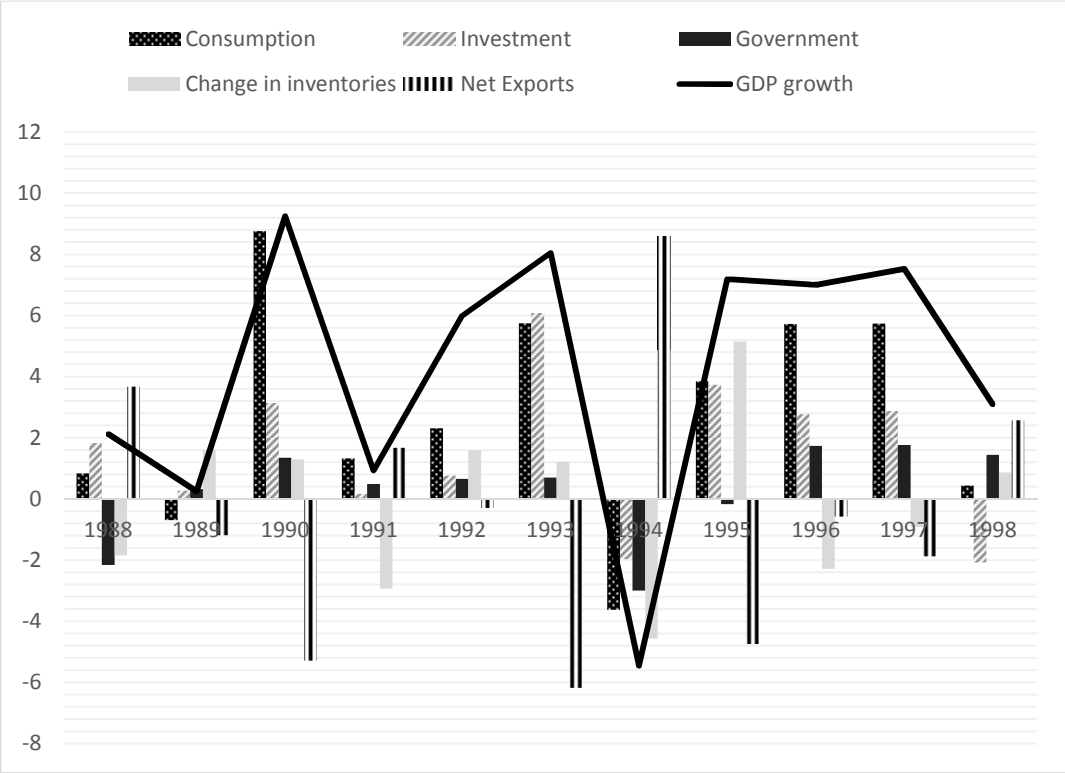
Despite a high import share, private consumption has been a driving demand generating force of the Turkish economy. As Figures I.3.a and I.3.b illustrate, with the exception of crises periods, consumption demand has been of high importance.

Contribution of investment demand to the growth of Turkish GDP has been erratic and cannot be a match to that of private consumption. In the last three crises of 1994, 2001 and 2008, a sharp negative movement in investment expenditures is very apparent. As briefly touched upon in Section III, the sharp decline in investment in 2008-9 most likely was stemmed from the impact of the recent crisis on expectations credits and exports markets.

The contribution of government spending to economic growth has been limited. The high government debt stock and debt servicing has put enormous burden on government budget and forced the government to cut its expenditures significantly from time to time. Turkish government followed tight budget policies especially in the midst of the crisis of 1994 and 2001. Following 2001 turmoil, due to the structural reform program implemented under the auspices of the IMF which required the government to slash its expenditures, contribution of government expenditures to GDP growth remained very low if not negative.[11] As elaborated in the following sections, the government has followed a relatively expansionary policy during the last crisis. However, this did not prevent the economy from experiencing one of the worst crises in its history. The positive contribution of consumption and investment to GDP growth experienced a brief interruption in late 2008 and 2009; yet, Turkish economy quickly recovered in 2010. Even though monetary and fiscal policy measures were implemented, these measures had limited impacts. Unlike the crises of 1994 and 2001, the quick return of foreign capital in 2010 was responsible for this recovery.

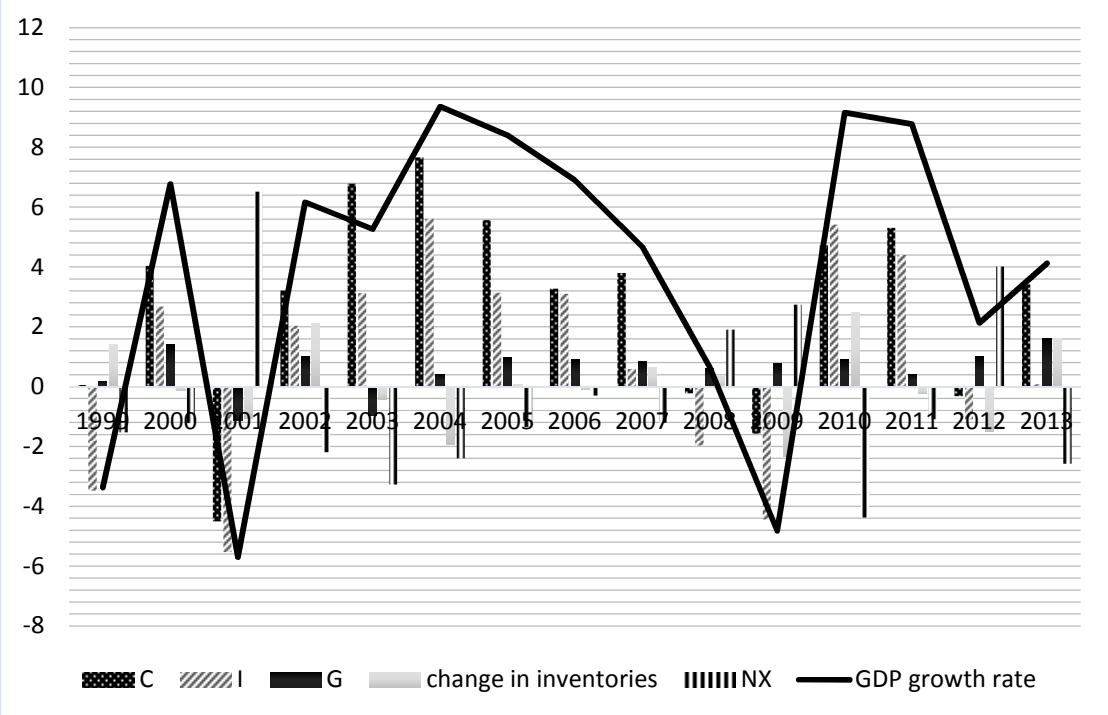
[11] The details of this program is discussed in Turkey Country Report of FESSUD WP-2.

Figure I.3.a Growth Contributions to GDP



Source: The Central Bank of the Republic of Turkey.

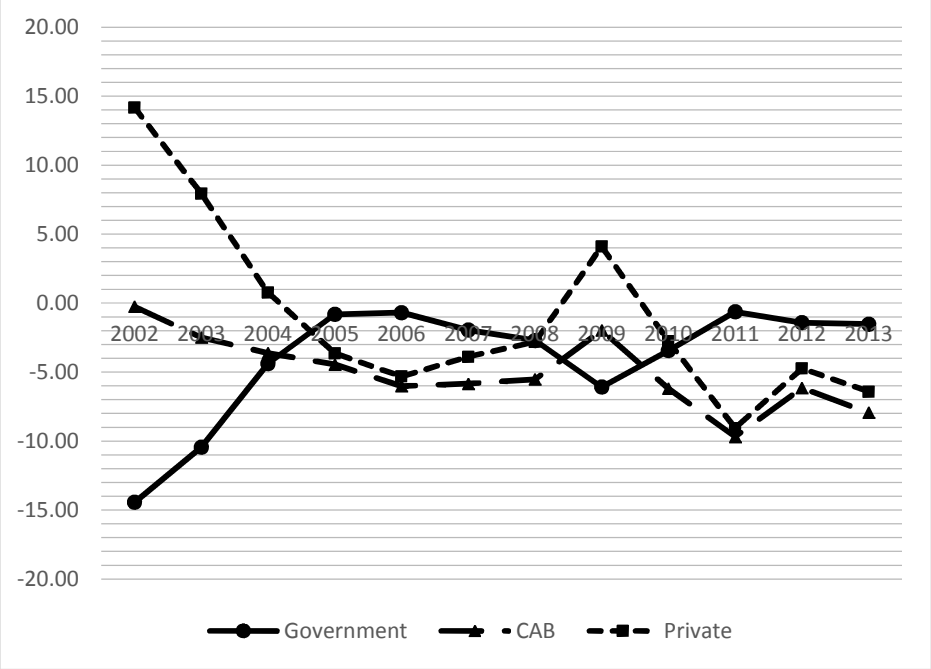
Figure I.3.b. Growth Contributions to GDP (1999-2013)



Source: The Central Bank of the Republic of Turkey.

Domestic expenditures have been traditionally higher than total income in Turkey. This has caused accumulation of external and internal liabilities in the balance sheets of private sector. The financial balances of private sector have been negative for a long time (Figure I.4). In other words, the growth of demand of households and firms depended on their borrowing activities. As it will be further evaluated in the following sections, the adjusted wage share relatively declined in the 2000s (Figure II.1.6 in section II). As a result, consumer debt increased in this era (section II.3).[12] Similar to households, firms also benefited from decreasing interest rates and bank loans become the major source of funding for NFCs after the crisis of 2001. The profitability of NFCs declined with the 2001 crisis. Even after the recovery, it could never reach to the pre-crisis levels. Thus, fixed investment expenditures and tangible fixed assets to total assets ratio of NFCs could never rise back to the pre-2001 levels.

Figure I.4 Financial Balances (as a percentage of GDP)



Source: World Economics Database, October 2014, IMF.

Overall, this section points out that the Turkish growth has been very erratic under

[12] Between 2002 and 2012 the ratio of household debt to GDP increased from 3 percent to 21 percent. Even though the outstanding level of household debt is very low compared to developed economies, this rapid growth of debt can be source of problems in the future if interest rates start to rise.

the influence of financial flows. According to the results of the simple decomposition exercise, private consumption has been the main contributor of Turkish economic growth. Although investment has partially contributed to the growth of the economy, investment expenditures have been much more volatile than consumption, aggravating the size of the growth cycles. Turkish economy has been suffering from current account deficits for a long time. In relation to this, Turkish economy has been relying on foreign borrowings. Furthermore, declining labor share and increasing debt of households are reported in succeeding sections. All these developments in Turkish economy seem to justify labeling the structure of the Turkish economy as a debt-led growth regime.

II. Long-run Effects of Financialisation on the Economy through different Channels

II. 1. Income Distribution in Turkey: 2002-2011[13]

Turkey experienced the worst macroeconomic crisis of the post-World War II period in 2000 and 2001. During the crisis the output contracted at a rate of -5.7 percent. Nevertheless, this contraction was expected prior to the crisis since the Turkish economy had given the signs of fragilities and vulnerabilities throughout the 1990s. This decade was sometimes called as the "lost decade".[14] It was marked by one major crisis erupted in 1994, political instability (consecutive short-lived coalition governments), increase of the level of public debt to an unprecedented level, increasing real interest rates and social distress. The average growth rate of the 1980s was 5.2 percent while it was 3.0 percent for the 1990s. The real GDP per capita displayed an erratic path for the whole 1990s. In addition to these, there were many other related social and economic problems which were influential for the most of the decade. No doubt, all these factors brought the Turkish economy to the brink of a collapse. Not unexpectedly, this environment created the precursors of the crisis of 2000/2001.

One question at this point awaits an answer: For whom – or for what – the decade was lost? Turkey pursued a neoliberal programme since the beginning of the 1980s. The decade of the 1980s might be called a preparatory phase; all the prerequisite steps were taken. The propagators of the new economic paradigm anticipated a riper environment for the advancement of neoliberal economic program in the 1990s. Nevertheless, due to political instability and economic fluctuations mentioned above, the 1990s was a very disappointing era for the Turkish economy. In this environment, the last coalition government, which was formed in January 1999, signed a new stand-by agreement with the IMF at the end of 1999. However, this agreement proved to be ineffective in eradicating the crisis generating tendencies. Just after the crisis of 2001, the Justice and Development

[13] The time span of the study is determined by the data availability. The first Household Budget Survey was conducted in 1988, then the second came in 1994. However, there are significant differences between these two surveys and the surveys conducted annually after 2002. For this reason, our analysis does not use these two surveys.

[14] According to Öniş and Şenses, the decade of the 1990s "has been a costly decade for the Turkish economy" (2009:3).

Party won the elections with a land sliding majority in the parliament in 2002. Then, the mature phase of the Turkish neoliberalism began. All the reforms which were intended to be initiated in the 1990s but delayed have been implemented under the successive Justice and Development Party (JDP) governments. It seems that the chaotic environment of the previous decade has been left behind. Moreover, all the social dynamics peculiar to the 1990s which put barriers against the neoliberal programs have been dismantled. Since 2002, with the forceful implementation of neoliberal programs step by step, the social formation of Turkey has been passing through the most extensive and intensive transformation of its history. One of the most striking features of this transformation has been its time span; as the figures at the end of this subsection will prove, this transformation has been materialized in nearly a decade. Doubtless, this process has significant repercussions upon the income distribution in Turkey. Income distribution in a capitalist social formation is shaped by structural forces. Hence, any structural change will eventually affect the distribution of income to a great extent. Any capitalist crisis, if it does not bring about any structural shift or any change in the policy regime implemented, will certainly have effects upon the income distribution, but these effects will be temporary.

This section aims to briefly analyze the trends in the income distribution in Turkey between 2002 and 2011. One of the basic issues in this section is the effects of the latest global financial crisis in 2008/2009 upon the income distribution.[15] The time span of this section covers the most mature period of neoliberalism in Turkey. In this sense, one may properly evaluate the repercussions of the unhindered neoliberalism on the income distribution in this period.

Before all, it should be emphasized that the methodology of the analysis of income distribution has been a long-lasting hot topic. With all their variants, generally there are three methodological tracks for the analysis of the distribution of income: size distribution of income, functional income distribution and social class based analysis. Each has its own merits and deficiencies. Each has a distinct underlying theoretical construction of society. In this sense, preferences concerning the methodology in the analysis of income

[15] For the Turkish macroeconomic and social history since 1980 the following studies provide invaluable insights: Boratav *et. al.*, 2000; Cizre-Sakallıoğlu and Yeldan, 2000; İsmihan and Metin Özcan, 2009; Öniş, 2006.

distribution do not only reflect scientific orientations, but also they exhibit the ideological and political positions. Besides all shortcomings and merits, each methodology provides important information about the change in income distribution. In this section we will utilize these three methodologies and report the related findings.

Our analysis shows that between 2002 and 2011, the distribution of income became less unequal at first sight. The share of the highest quintile declined throughout the period while that of the lowest one displayed a slight increase. The movement of the Gini coefficient throughout the period confirmed this conclusion; it declined till 2008, then increased in 2008 and 2009 (as a result of global financial crisis). However, since these results are derived from a size distribution of income analysis neglecting undistributed profits of capitalist firms, these results should be evaluated cautiously. The functional income distribution analysis, on the other hand, gives evidence of increasing share of public and private transfers for the whole period. This might be accepted as a symptom of the emergence of a new welfare regime. The share of wages seemed to rise as well; in 2011 its share in total factor incomes was 71 %. However, as will be shown below, this was due the huge increase in the number of workers rather than being an outcome of increase in wages. Furthermore, the functional income distribution analysis indicates a reduction of wage share throughout the period. In this sense, the inclusion of undistributed profits radically changes the picture.[16]

The social-class based income distribution analysis points to a vast deterioration in the ranks of peasantry which was the main source of the increase in urban labour force. Moreover, our analysis also shows that voluntary transfers (total public and private transfers net of retiree benefits) gained importance while the households in the lowest quintiles and the classes in the lowest echelons of capitalist society experienced increasing deficits in their balance sheets. The share of deficit households increased for almost all the quintiles while the real consumption of the higher quintiles and upper classes increased. A significant expansion of consumer credits in financial markets is directly related to this

[16] This is due to the fact that functional income distribution analysis utilizes national income data rather than household level data.

development.. Many of these stylized facts may imply that Turkey has been experiencing a debt-led consumption boom.

The next subsection discusses the stylized facts about the size distribution of income in Turkey between 2002 and 2011. The second and third subsections utilize the functional and social class-based income distribution analyses.

II.1.1. Size Distribution of Income in Turkey: 2002-2011

This and following subsections will present detailed analysis of the change in income distribution in Turkey between 2002 and 2011. The empirical material is obtained from the Household Budget Surveys (HBSs) which have been annually conducted by the Turkish Statistics Institute since 2002. The detailed information about HBSs is provided in Appendix II.1.I.

Table II.1.1. The Distribution of Household Disposable Income by Quintiles (percent)

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

Source: Authors' calculations from HBSs

Table II.1.1 shows the distribution of total household disposable income by quintiles. The last column gives the ratio of the share of the highest and the lowest quintiles. The table indicates that the share of the highest quintile decreased from 2002 to 2007, then rose in 2008 and 2009. The losses of the highest quintile seem to be the gain for all the remaining quintiles. Without any exception, the shares of four quintiles increased between 2002 and 2007. The highest gain was of the second and third quintiles. Nevertheless, in

2008 (the year of global crisis) and 2009 (the year in which contagion effects of the global crisis were felt to the utmost degree in Turkey), this trend was reversed. The share of the highest quintile rose again while the shares of others decreased.

Figure II.1.1. Average real per capita income as a share of average real per capita income of the highest quintile (2003=100)

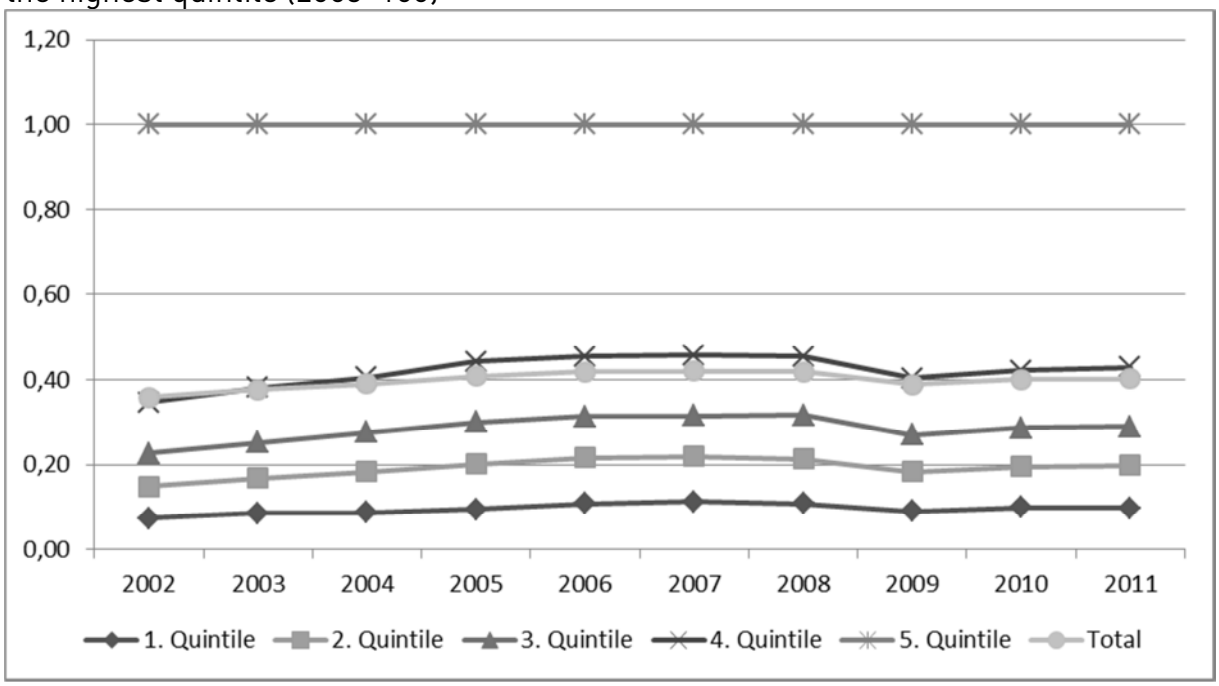


Figure II.1.1 shows the ratio of per capita real income in each quintile to that of the highest quintile. As the figure shows, with regard to the highest quintile, average per capita incomes rose between 2002 and 2007. Then they fell during the crisis, and then rose slightly afterwards. However the rate of increase for the lowest quintile was not so much high. The highest gain was of the fourth quintile between 2002 and 2007 (11 percent). The next step in the analysis should be evaluation of a very commonly used indicator, i.e. Gini index.[17]

Figure II.1.2 shows the change in Gini coefficients. There are two Gini coefficients. One is from our own calculations; the second one is the official Gini estimate by the Turkish

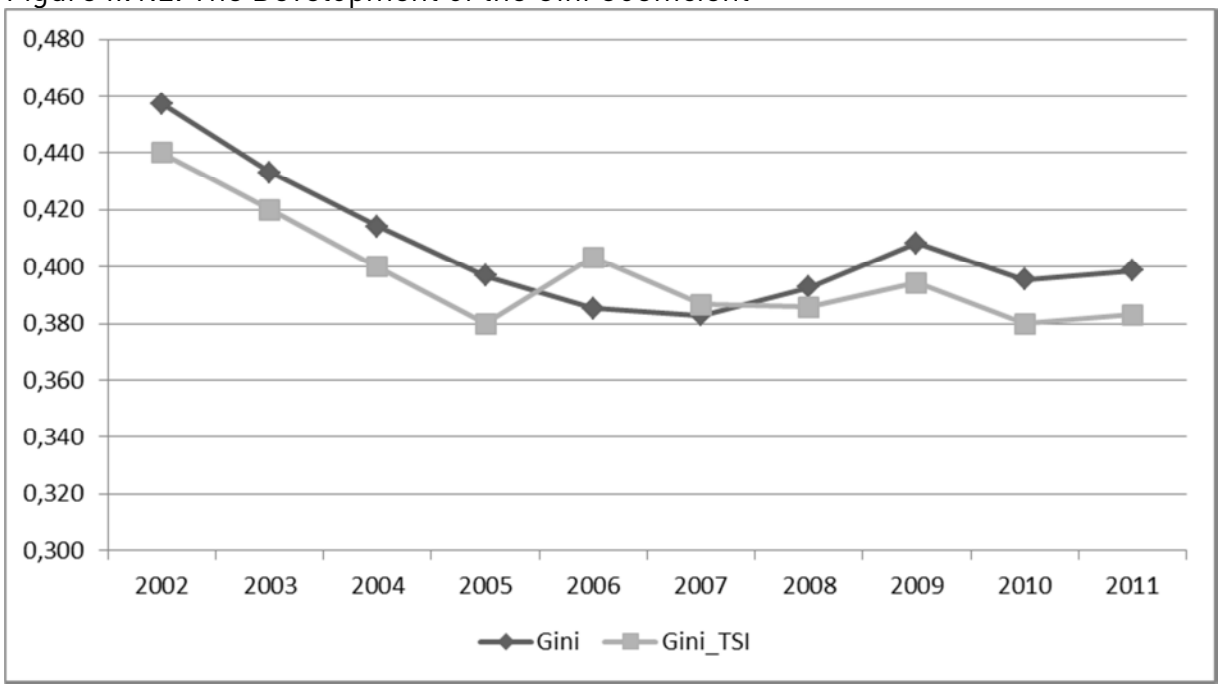
[17] OECD studies generally estimate the Gini coefficient for both disposable and market incomes. Market income is the income before taxes and transfers. Disposable income is the income level attained after net taxes are deducted. For Turkey, because of the insufficiency of tax and transfer data, disposable income is preferred for the analysis.

Statistics Institute (TSI). We prefer to discuss two of them since there is an important difference between them. The official one is estimated by using the household disposable income which also covers an "imputed rent" for the ownership of the house in which the owner resides. While calculating our own Gini coefficients, we ignored "imputed rent" [18] This preference is due to two factors. First, we think that the resulting estimates are not reliable. Second, if preferred, this scheme should be applied to the unpaid services of durable consumer goods and every item in the home production set. Inevitably, such an inclusion results in the artificial increase in household incomes.

Figure II.1.2 confirms the observation exhibited by Table II.1.1; the Gini coefficients declined up to 2007 then showed a steep incline. Then, they both fell after 2009. Except for the year 2006, the Gini coefficient estimated by the authors was higher than the officially announced one for all the years. The highest values for the coefficients were observed at the beginning of the period, these were the years of slow recovery from the the crisis of 2001. According to our calculations, the Gini coefficient dropped from 0.45 in 2002 to 0.39 in 2011. However, despite the improvement in the period, Turkey has the third worst income distribution among OECD members (following Chile and Mexico) (OECD, 2013).

[18] According to the explanatory notes given by the TSI (http://www.turkstat.gov.7tr/PreTablo.do?alt_id=1011), the imputed rent is estimated with two methods. In the first one, the imputed rent is assumed to be equal to the average of the rents of the houses in the vicinity. In the second, an econometric method is used. However, even though contemporary national income accounting practices in majority of the countries add this component to the household component, we omit it from our calculations.

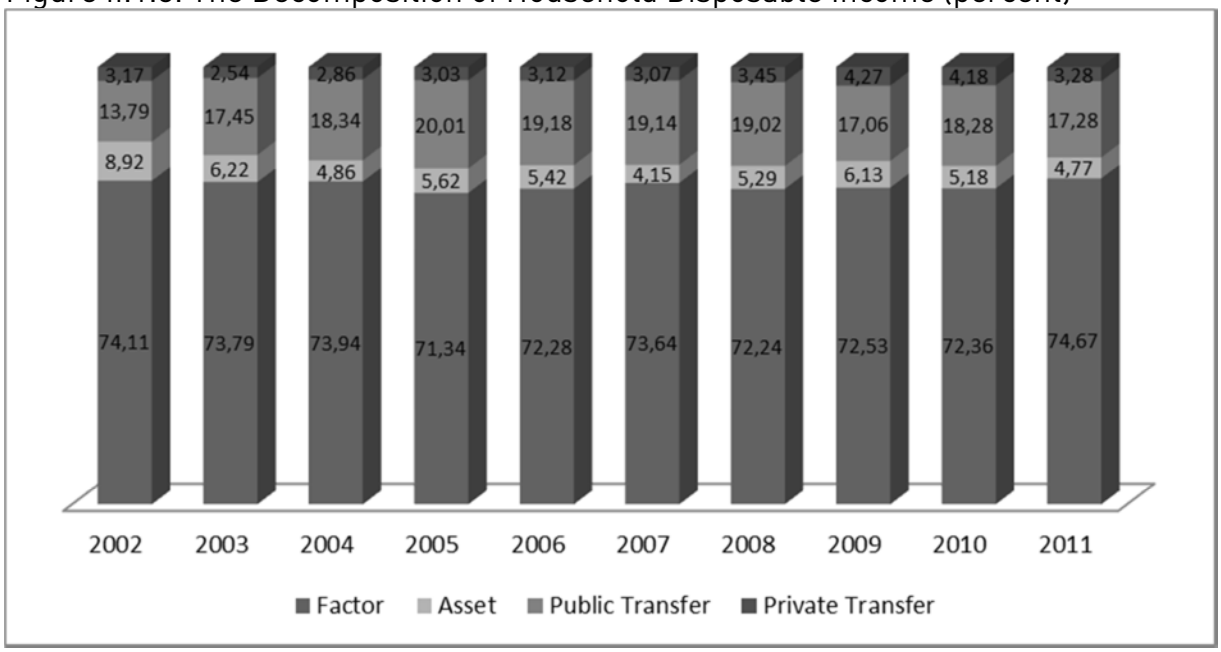
Figure II.1.2. The Development of the Gini Coefficient



II.1.2. Functional Income Distribution in Turkey: 2002-2011

In this subsection we will give a brief summary about the change in functional income distribution in Turkey. Figure II.1.3 shows the decomposition of total household income between factor and asset incomes, public and private transfers.

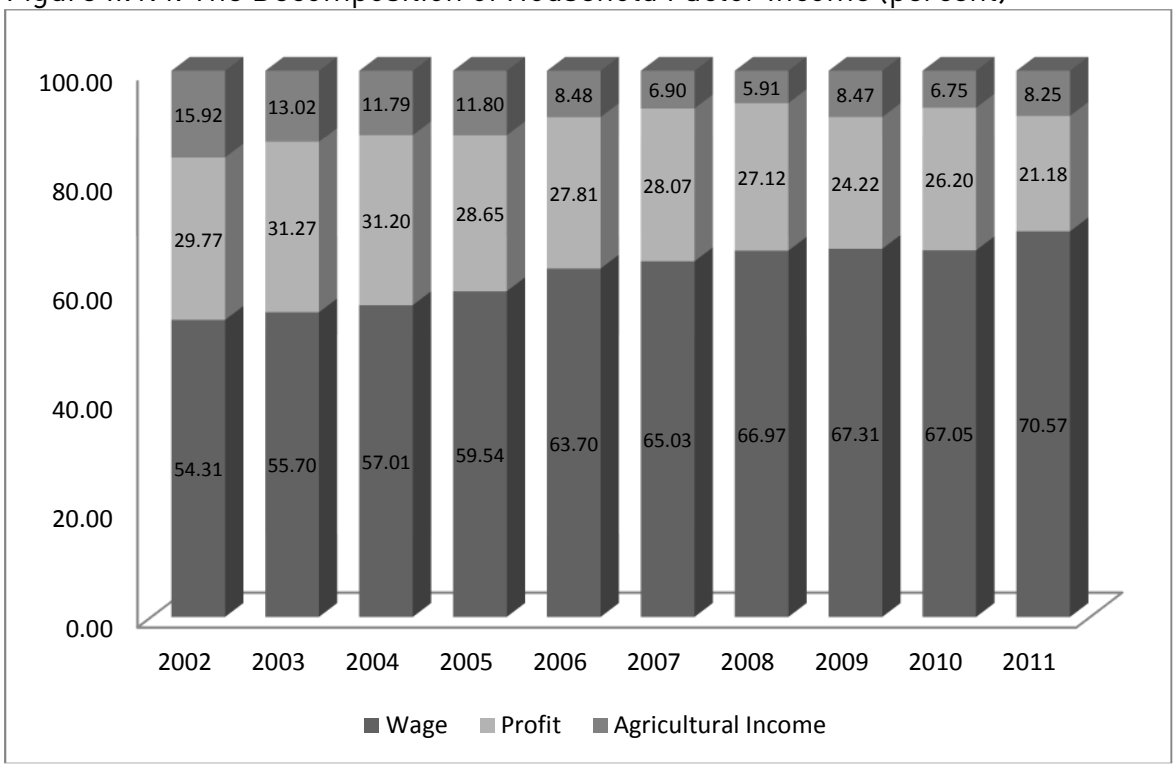
Figure II.1.3. The Decomposition of Household Disposable Income (percent)



As the figure indicates, the share of factor incomes seems to be stabilized around 73 percent. When the contagion effects of global crisis reached Turkey, the share of factor incomes dropped more than 1 percent then rose in 2011. On the other hand, the share of asset incomes was more than 8 percent in 2002, and then began to decrease. It fluctuated around 5 percent after 2002. Interestingly, it increased in 2008 and 2009. This might be due to the decrease in the share of other components. Most of the asset income comes from fixed payments like annuity payments and predetermined rent. For this reason, they remain intact in nominal terms. The second highest share is of public transfers. As will be discussed below, the last decade in Turkey has been witnessing the emergence of a new welfare regime. This new welfare regime institutionalizes a selective public transfer provisioning system and rests mainly upon this distribution. As Figure II.1.3 shows, for the period of 2003-2011, the average share of public transfers was nearly 18.5 percent. Even though any comparison with other OECD members inevitably reveals that this figure is quite low, the share of public transfers has been on the rise.

Figure II.1.3 does not give any clue about the primary distribution of factor income between wage and profit. Figure II.1.4 provides the change in the decomposition of factor incomes between 2002 and 2011.

Figure II.1.4. The Decomposition of Household Factor Income (percent)

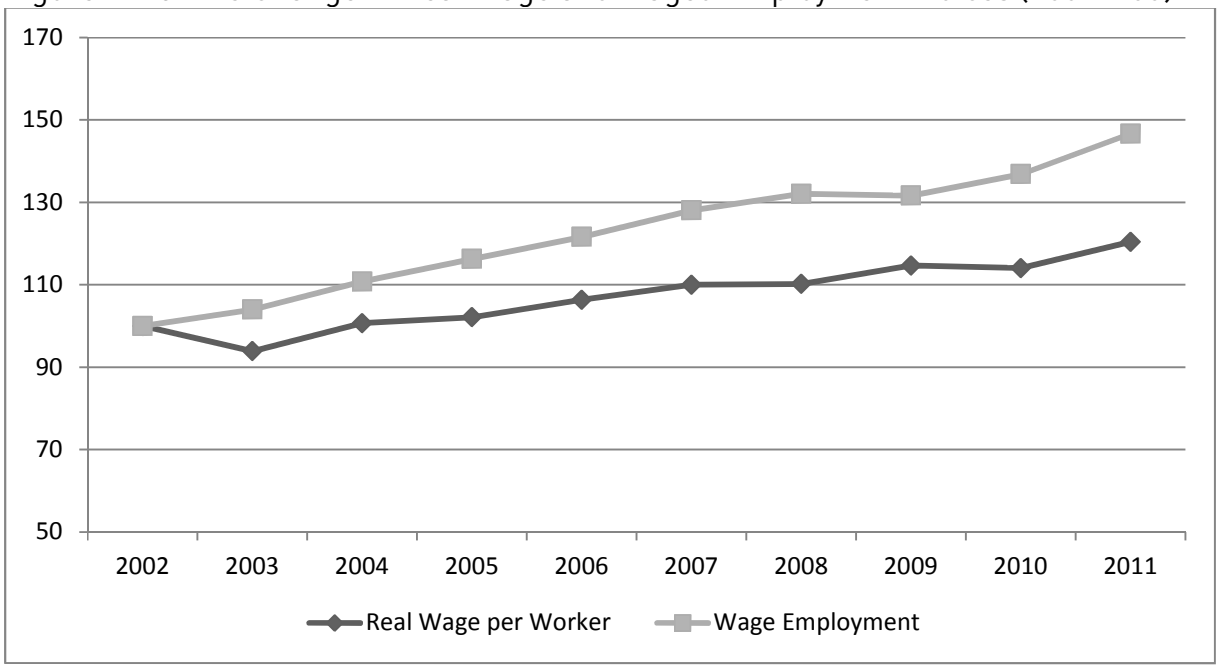


This figure provides striking observations. The share of wage income rose from 54.31 percent in 2002 to 70.57 percent in 2011. Even in the crisis years of 2008, and 2009, this share displayed a rising tendency. On the other hand, the share of agricultural income dropped to half of its 2002 level at the end of the period. The share of profit (entrepreneurial income) decreased by nearly 8 percent between 2002 and 2011. This radical change deserves a detailed analysis. Functional income distribution analysis (as well as size distribution analysis) fails to provide an explanation at this level. In the last part of the section, we will outline the change in class structure of Turkish capitalism in the period under scrutiny. In that part, the figures point to a rapid dissolution of peasantry and enlargement of urban and rural labor force stock. In this context, the change in the shares of incomes of production factors should be ascribed to a noticeable quantity effect, rather than a price effect. This is verified in Figure II.1.5. On the one hand, the annual real wage rate per worker increased nearly 20 percent, in this entire period.[19] On the other hand, the waged employment index rose by 47 percent in the same period. Therefore, we should conclude that the sharp increase in the wage share in total household factor income was

[19] When the real wage per worker is estimated in hourly basis, the hourly wage rate seems to be nearly fixed for all the period. In this period, the working hours increased steeply (Bahçe and Köse, 2010).

more a result of increase in the stock of laborers than the increase in real wage rate. The same explanation should be propounded for the case of the steep decline in the share of agricultural income. It declined at a rate of 50 percent between 2002 and 2011. This share exhibited a secular decline between 2002 and 2008, and then increased by 2.55 percent in 2009. This sudden reversal in 2009 was due to the reverse migration from the urban centers to rural areas as a reaction to the crisis conditions. Apart from this, this decline was the result of two inter-related factors. First, especially in the first half of the 2000s, government implemented an income support scheme under the auspices of the World Bank directed towards peasantry. According to this scheme, peasants received an income support payment of which amount depended on the acreage of the land owned. Interestingly, the payment was not made on the condition of cultivation; it does not matter they cultivated the land they own or not, all the land-owning peasants received this payment. This certainly reduced peasants' incentive to cultivate their land. Most of the peasants left their land uncultivated and migrated to cities. The second factor was the drop in other support payments to peasants (like support schemes for fertilizers, seed and fuel) and abandonment of support purchases of a number of crops by government. These two factors resulted in the sudden erosion of the ranks of peasantry.

Figure II.1.5. The Change in Real Wage and Waged Employment Indices (2002=100)



Furthermore, there is a methodological and empirical problem here. The entrepreneurial income (profit) also covers the income from self-employment. The income from self-employment should be decomposed into a wage and a profit component. This will certainly increase the share of wage against the share of profit.

These observations should be assessed very cautiously because of a structural limitation of the dataset we used. Indeed, this limitation is a general problem for all the household-level income datasets. The income definition of these datasets does not cover the retained profits of firms. This exclusion is a direct outcome of the fallacious dichotomy between households and firms put forward by neoclassical microeconomics. This theoretical tradition, dichotomizing households and firms and neglecting the property relations, has inclined to turn firms into inhumane decision making units. In this framework, there occurs two conflicting distribution series, one from micro-level (household level) and the other from macro-level, GDP estimated using income approach. The latter is more likely to provide a complete view of the functional income distribution since this measure also incorporates the retained profits.

However, the TSI stopped providing GDP calculated from income approach series in 2006. In order to fill the gap we can use the data provided by Annual Macro- Economic Database (AMECO) of the European Commission. Figure II.1.6 indicates the change in the adjusted wage share (the ratio of total compensation of employees - adjusted with the wage component of self-employment income - to GDP). As the figure indicates, the wage share increased up to 1991, and then wage share displayed a decreasing trend (except for short-period increase in 1999). During the period in which the contagion effects of the global financial crisis reached Turkey, it showed an incline at a very low rate, and then declined again. One may question the reasons for the discrepancy between this figure, and figures II.1.3 and II.1.4. As mentioned earlier, the latter covers only the household income and do not include undistributed profits of the capitalist firms whereas, the denominator in the estimated wage share in Figure II.1.6 incorporates the undistributed profits. When this last item is included, the course of the wage share radically changes. This fact casts so much doubt upon the analytical validity of the size distribution analysis.

Figure II.1.6. The Development of Wage Share 1988-2012

Source: http://ec.europa.eu/economy_finance/ameco

For a more concrete and coherent analysis of the change in income distribution, the size distribution for each income type should be employed.

Table II.1.3: The Size Distribution for Each Income Type (Row percent)

	Quintiles				
	1	2	3	4	5
2002	10.3	14.4	16.8	23.5	34.9
2003	17.8	16.9	17.9	20.0	27.5
2004	18.5	17.1	15.7	22.7	26.1
2005	14.8	20.7	18.8	17.7	28.0
2006	19.7	17.6	17.5	17.3	27.9
2007	20.5	21.8	18.1	18.8	20.9
2008	19.5	18.1	16.6	19.3	26.4
2009	15.9	17.9	19.3	15.9	30.9
2010	17.3	18.9	17.5	20.1	26.2
2011	15.5	14.4	14.7	24.1	31.3

a) Agricultural Income

	Quintiles				
	1	2	3	4	5
2002	7.9	13.0	16.3	21.9	40.9
2003	7.4	12.9	16.6	22.6	40.5
2004	8.0	13.6	18.1	22.9	37.4
2005	8.7	13.8	17.7	23.6	36.2
2006	8.6	14.8	18.1	22.7	35.8
2007	8.7	14.1	18.1	22.7	36.3
2008	8.3	14.3	18.3	24.1	34.9
2009	7.3	13.2	17.2	22.8	39.4
2010	8.1	13.9	17.2	21.9	38.9
2011	7.8	12.7	16.7	22.3	40.5

b) Wage Income

	Quintiles				
	1	2	3	4	5
2002	7.1	11.7	14.6	20.9	45.7
2003	8.0	11.9	14.9	20.1	45.1
2004	7.9	12.2	16.0	20.8	43.2
2005	8.1	13.1	16.2	21.7	40.8
2006	8.3	13.4	16.5	21.1	40.6
2007	8.6	13.3	16.3	21.2	40.5
2008	7.9	12.7	16.5	21.9	40.9
2009	7.4	12.7	16.3	20.8	42.8
2010	8.2	13.4	16.2	20.9	41.4
2011	7.9	12.5	15.9	21.4	42.3

c) Total Factor Income

	Quintiles				
	1	2	3	4	5
2002	1.1	3.8	5.4	11.6	78.2
2003	1.3	3.8	7.0	13.8	74.0
2004	1.8	4.6	11.0	19.8	62.8
2005	1.2	4.8	11.8	20.4	61.7
2006	2.6	5.6	8.3	20.1	63.4
2007	1.6	4.8	10.3	22.2	61.0
2008	1.5	5.0	9.2	16.9	67.4
2009	1.2	3.9	8.7	15.2	70.9
2010	0.9	4.5	6.8	17.6	70.3
2011	1.8	4.4	10.0	16.5	67.2

d) Asset Income

	Quintiles				
	1	2	3	4	5
2002	13.5	15.1	20.5	18.2	32.8
2003	14.5	13.8	16.4	19.5	35.8
2004	14.5	13.9	13.1	15.2	43.3
2005	12.6	14.3	13.9	18.1	41.1
2006	14.9	16.1	14.0	19.9	35.1
2007	17.0	15.1	17.5	15.9	34.5
2008	16.6	13.7	13.6	20.1	36.0
2009	12.5	15.6	16.0	20.5	35.5
2010	15.4	16.4	16.3	19.6	32.3
2011	14.0	12.9	15.8	18.2	39.1

e) Private Transfers

	Quintiles				
	1	2	3	4	5
2002	4.9	12.6	21.6	25.0	35.9
2003	4.4	13.2	20.2	25.4	36.7
2004	5.1	12.8	19.7	25.6	36.9
2005	5.1	13.5	20.6	25.3	35.5
2006	6.1	14.3	19.9	25.6	34.0
2007	6.0	14.0	20.2	25.1	34.8
2008	7.0	14.1	20.4	24.5	34.1
2009	6.6	14.5	20.4	26.9	31.5
2010	6.9	13.2	20.2	26.4	33.3
2011	7.2	15.9	21.2	26.3	29.5

f) Public Transfers

Table II.1.3 gives the size distribution of each income type among quintiles. At first sight, the size distribution of agricultural income displays a more equal distribution. The most unequally distributed income type is, as expected, asset income. For this income type, the highest quintile earned nearly 50 times more than the lowest quintile. There are striking observations for the year 2009. Except for public transfers, the ratio of the income of the highest to that of the lowest quintile increased for all the income types. However, the size distribution of public transfers throughout the period exhibit an unexpected unequal distribution. The decomposition of public transfers which will be given below reveals the reason behind this. Retiree benefit is by far the largest component of public transfers. Especially, retirement from public employment seems to be a privilege for the highest quintile.

We should classify all the transfers into involuntary and voluntary transfers. Voluntary transfers include all the transfer types reported in Household Budget Surveys, except for pension benefits and tax repayments. Hence, public voluntary transfer set includes old-age pensions, widows' and orphans' pensions, in-kind contributions from state, social assistance payments from state, direct income support payments to peasants and state scholarships. Private voluntary transfer set covers pension benefits from a foreign country, scholarships from a foreign country, in kind and in cash transfers from private individuals and non-governmental organizations, alimony payments and scholarships from non-governmental organizations. The voluntary transfers have been used aggressively to combat poverty. In this context, the volume and direction of voluntary transfers are crucial. Table II.1.4 shows the size distribution of voluntary transfers.[20]

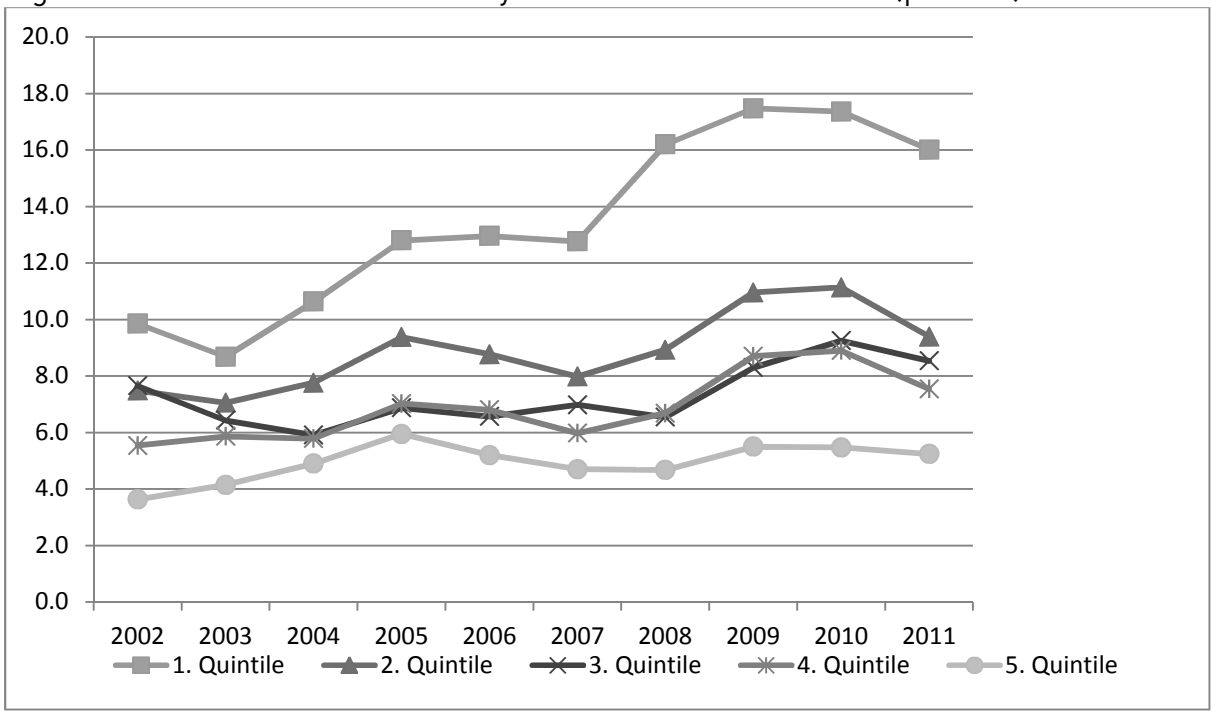
The share of the lowest quintile increased by nearly 7 percent between 2002 and 2008. In 2008, this quintile received the third largest share in voluntary transfers. The second quintile's share stabilized around 15 percent. The share of the highest quintile declined by nearly 4 percent in the same period. The poorest quintile's share decreased by 3 percent in 2009. This was due to the financial strain upon the budgetary incomes under

[20] The voluntary transfer figures used for this study derived from HBSs underreport the volume of voluntary transfers in Turkey since these figures do not cover the transfers distributed by municipalities.

crisis conditions. In this year, the volume and share of private transfers received by this quintile also decreased. In Turkey, most of the private transfers have been distributed by independent and autonomous foundations. The main benefactor for these foundations is the central government budget, as most of their income comes from the central budget. Therefore, any reduction in central budgetary income certainly brings about a decrease in private transfers.

The impact of the voluntary transfers should be evaluated in relative terms also. Figure II.1.7 shows the share of voluntary transfers in the total income of each quintile. The share of voluntary transfers for the lowest quintile increased from 10 percent to 16 percent between 2002 and 2011. For the other quintiles, it moved in a fixed band till 2007, then increased at a low rate.

Figure II.1.7. The Share of Voluntary Transfers in Total Income (percent)



The coverage rate of the new system should also be estimated. Table 5 outlines the share of households benefitting from voluntary transfers in the household population of each quintile. This share increased secularly for the lowest quintile. It began from a relatively low value in 2003 (32.1 percent), then rose to 60.2 percent in 2006. It continued to increase for the rest of the period. The share in other quintiles declined after 2006. The same pattern was also observed for the whole population. For the effects of the crisis,

comparing the table below with Table II.1.4 provides an interesting observation. As Table II.1.5 verifies, in 2009, per capita household voluntary transfer declined for the lowest quintile while it increased for the other quintiles. The reverse movement for the share of voluntary transfers, in the same year, implies increasing number of households in the lowest quintile received less voluntary transfer. On the other hand, the decreasing number of households in higher quintiles was paid higher voluntary transfers. This bidirectional trend seemed to continue in 2010 and 2011.

Table II.1.4: The Share of Households Receiving Voluntary Transfers in Household Population of Quintiles (percent)

Quintiles	2003	2006	2009	2011
1	32.1	60.2	64.0	66.2
2	29.5	53.1	51.7	45.4
3	26.1	47.7	45.7	41.6
4	24.7	45.2	43.4	39.8
5	23.0	39.5	33.9	31.4
Total	27.1	49.2	47.7	44.9

II.1.3. Class Based Income Distribution

In this subsection, benefitting from a long lasting study upon the class structure of the capitalism in Turkey, we will outline the stylized facts about the change in class structure and income distribution among social classes (Köse and Bahçe, 2009, Bahçe *et. al.*, 2011). The derivation of social class status is a cumbersome process. We have used HBSs to derive the class structure topography. Initially, we define class position of individuals and then using this information the class status of households is determined. The details of this procedure is explained in Appendix II.1.1. Table II.1.5 shows the change in class structure at household level between 2002 and 2011.

Table II.1.5. Class Based Decomposition of Household Population (percent)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Urban Propertied Classes	12.7	12.3	13.0	12.2	12.6	11.5	12.6	12.3	11.6	11.4
Petit Bourgeoisie	8.2	8.1	7.0	7.2	8.4	6.3	6.2	7.1	6.7	5.7
Rural Propertied Classes	6.2	6.2	5.3	4.3	3.4	3.2	2.0	2.1	3.4	3.0
Landed Subsistence Peasants	8.5	6.2	6.7	7.5	5.7	4.3	4.9	7.9	5.6	5.8
Urban Working Classes	49.6	49.7	50.6	51.7	52.3	57.7	56.8	55.4	56.0	57.7
Rural Working Classes	4.3	3.8	4.8	4.2	5.1	4.0	4.3	5.6	5.0	4.8
Out of Working population	1.9	1.6	1.8	1.4	1.4	2.0	1.9	1.1	2.4	2.3
Retiree	8.6	12.2	11.0	11.4	11.2	10.9	11.4	8.6	9.4	9.3
Total	100	100	100	100	100	100	100	100	100	100

The foremost striking fact is the enlargement of the urban working class. This class also incorporates the urban unemployed as the basic constituent of the reserve labor army. The share of this class increased from 49 percent to 57 percent between 2002 and 2011. In the crisis year of 2009, a short and slight reversal in this trend was observed, it recovered later on. In absolute terms, the number of urban working class households was nearly 8 million in 2002; it exceeds 11 million in 2011. The source of this massive increase is obvious; rural propertied classes, subsistence peasants and petite bourgeoisie to a lesser extent. The combined share of three classes was 22.9 percent in 2002, it decreased to 14.5 percent in 2011. Such a huge transformation in a very short time was unprecedented in the social and economic history of Turkey. This has certainly significant impact upon the income distribution between social classes.

The change in population shares of social classes have certainly resulted in significant alterations in the shares of each class in total income. Table II.1.6 gives the change in social class-based income distribution. As expected, the income share of urban laborers increased from 46.7 percent to 58.7 percent from 2002 to 2011. The change in population share of this class in the same period was nearly 8 percent. This implies that per capita household for this class increased, albeit at a very low rate.

Leaving aside the fluctuations within the period and comparing only the beginning and the end, only the shares of urban and rural laborers increased. The shares of the rest

declined. The highest rate of decrease was of urban and rural propertied classes. This might lead to an illusion that Turkey headed towards a wage-led growth regime. However, this can be refuted on several grounds. First, as mentioned before, the retained profits of capitalist firms are not covered by the dataset used here. The share of the retained profits in GDP is estimated as 30-40 percent. Undoubtedly, this exclusion radically changes the picture. We should not forget that the ownership structure of capitalist firms in Turkish economy is dominated by family-owned conglomerates. Most of the retained profits are earned by these firms. If included, these profits will substantially alter the distribution. Second, household level micro datasets generally do not cover the households in top oligarchic income brackets like top 0.01 or 0.1 percent. Therefore, particularly the total income of highest echelons of the society is underestimated. So, the income shares of urban and rural propertied classes given below are generally biased downwards.

Table II.1.6. Class-Based Income Distribution (percent)

	2002	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*
Urban Propertied Classes	24.5	25.3	25.4	21.9	22.2	20.3	23.1	22.9	21.0	20.3
Petite Bourgeoisie	6.6	7.8	6.8	7.1	8.3	6.8	6.2	6.3	5.9	5.0
Rural Propertied Classes	8.4	6.2	5.7	4.9	3.6	3.2	2.3	1.2	3.4	3.7
Landed Subsistence Peasants	4.0	2.9	3.0	4.2	3.1	2.5	2.4	5.8	3.1	3.0
Urban Laborers	46.7	46.5	48.3	50.9	51.6	57.2	55.1	54.5	55.9	58.7
Rural Laborers	1.9	1.5	2.0	1.6	2.2	1.6	1.8	2.2	2.2	2.0
Not Working	0.8	0.6	0.5	0.6	0.4	0.6	0.6	0.4	0.7	0.6
Retiree	7.2	9.2	8.4	8.9	8.5	7.9	8.5	6.7	7.9	6.7
Total	100	100	100	100	100	100	100	100	100	100

For the effects of new welfare system, the share of each social class should be estimated. Table II.1.7 below provides the share of voluntary transfers in total income of each class. The share of voluntary transfers was comparatively low for all the classes in 2002 and 2003 because these were the years of recovery from the crisis of 2001.. During these years, there were financial constraints upon government budget. Then, the share of voluntary transfers began to rise for most of the classes. In the ranking according to shares, not working households are on top; the period average share for this class was 80

percent. Voluntary transfers seem to draw a demarcation line between survival and incapacity to meet physical needs. The second place was hold by rural labourer households. On average, voluntary transfers captured 26 percent of total income of this class. It is important to note that, even though it was relatively low, the share in income of urban laborers was on rise.

Table II.1.7. Share of Voluntary Transfers in Total Income of Classes (percent)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Urban Propertied Classes	1.9	1.4	2.0	2.7	2.5	2.3	3.2	3.4	4.2	3.5
Petite Bourgeoisie	4.6	2.5	2.5	4.2	3.3	5.8	4.2	5.5	6.5	5.4
Rural Propertied Classes	3.3	5.0	4.1	7.4	10.9	7.4	6.8	14.5	11.0	7.7
Landed Subsistence Peasants	13.3	10.2	13.0	16.2	20.9	20.3	18.2	13.5	18.0	16.3
Urban Laborers	5.0	6.1	6.3	7.1	6.5	5.6	6.3	7.8	7.4	7.1
Rural Laborers	10.6	30.4	25.4	24.9	27.3	27.5	27.8	34.6	31.1	26.5
Not Working	38.0	76.4	77.6	89.3	84.0	94.2	84.9	79.6	96.0	80.3
Retiree	5.9	6.5	9.2	9.2	8.0	8.5	9.4	11.4	10.6	10.0

In the class-based framework, the distribution of income among classes has two dimensions; inter-class and intra-class distribution. Neoliberal economic programs have aggravated the polarization tendency around capital/labour nexus. However, this does not entail parallel homogenizations at each pole of the nexus. These programs also dictate a structural segmentation at both ends. In this context, the change in class-based income distribution should also be analyzed both at inter- and also intra-class level. For this aim, we employ a widely used Gini decomposition technique. [21] Table II.1.8 gives the results of this Gini decomposition technique. There are two panels in the table. The first one is for the decomposition of the Gini coefficient with voluntary transfers. The second is for the Gini without voluntary transfers. The difference between two might be accepted as a proxy for the repercussion of the voluntary transfers upon the income distribution.

[21] The decomposition used here was proposed by Pyatt In this set up, the Gini coefficient is decomposed into three components, between, within and overlap. The last one is the part of the Gini which could be adhered to neither between nor within components.The decomposition is obtained by using Stata 10. A user-written module for Gini decomposition is employed. For details see Aliaga and Sylvia, 1999.

Table II.1.8. The Components of the Gini Coefficient of Class-Based Income Distribution

	Gini of Total Oncome				Gini without Voluntary Transfers			
	Between	Overlap	Within	Total	Between	Overlap	Within	Total
2002	19.8	14.4	11.5	45.7	21.3	14.3	12.0	47.6
2003	19.0	13.3	10.9	43.2	21.2	12.5	11.4	45.1
2004	19.4	11.4	10.6	41.4	21.6	10.6	11.1	43.3
2005	16.5	12.2	10.9	39.6	18.8	11.5	11.5	41.8
2006	15.9	11.8	10.9	38.6	18.1	10.9	11.4	40.4
2007	15.2	10.6	12.4	38.2	17.3	9.3	13.0	39.6
2008	17.0	10.0	12.2	39.2	19.2	9.2	12.9	41.3
2009	16.7	11.7	12.4	40.8	19.0	10.7	13.2	42.9
2010	15.8	11.5	12.1	39.4	18.2	10.6	13.1	41.9
2011	17.1	9.7	12.9	39.7	19.0	8.7	13.7	41.4

Note: For the sake of simplicity, all the values are multiplied by 100.

The figures for the decomposition with voluntary transfers reveal that the major component of the inequality is between components. Its average share is nearly 42.5 percent whereas the average share of within component is about 29 percent. The rest is accrued to the overlap component. The Gini coefficient for total income decreased up to 2007, then exhibited an increasing trend. In the decrease phase, between component also decreased while the within component displayed a stability around 10.9. In the second phase both components increased with the Gini component. The rate of increase for the within component was higher than that of between component. This observation is interesting in the sense that especially in this second phase government expanded the voluntary transfers. This strategy was more likely to be a precautionary step against market-oriented increasing inequality. The second panel providing the stylized facts about the Gini without voluntary transfers in Table II.1.10 might provide supporting evidence for this claim. The Gini without voluntary transfers followed the same trend with the Gini of total income, albeit at a higher level. This is also true for the between and within components. The difference between the figures with and without voluntary transfers unfolds the degree of the effectiveness of voluntary transfers. Table II.1.9 gives the results of a simple calculation as a proxy of the effectiveness. Each figure demonstrates the ratio

of the difference between value with voluntary transfers and without voluntary transfers to the value without voluntary transfers.

Table II.1.9: The Rate of Decrease with the Inclusion of Voluntary Transfers (percent)

	Between	Within	Overall
2002	7.0	4.2	4.0
2003	10.4	4.4	4.2
2004	10.2	4.5	4.4
2005	12.2	5.2	5.3
2006	12.2	4.4	4.5
2007	12.1	4.6	3.5
2008	11.5	5.4	5.1
2009	12.1	6.1	4.9
2010	13.2	7.6	6.0
2011	10.0	5.8	4.1

As Table II.1.9 shows, the rate for the decrease in the between component is much higher than the rate of decrease of within component and overall Gini coefficient. This implies that voluntary transfers were much more effective in reduction of inter-class income distribution inequalities. This is the reason why the share of voluntary transfers is higher for not working households, rural laborers and subsistence peasants. The new welfare regime, even though it has been yet in a period of foundation, seems to generate significant outcomes.

II.1.4. Income Distribution and Developments in the Balance Sheets of Households

Contemporary analyses indicate that there has been a significant correlation between financialization of the incomes of highest income brackets and mandatory borrowing of the households in the lower brackets. In this respect, any analysis of the relation between the income distribution and financialization eventually turns into an accounting analysis of the distribution of the surpluses and deficits among the income brackets or classes.

In this section, we will carry on a deficit/surplus analysis for both income brackets and social classes. Table II.1.10 gives the deficit/income ratios and the share of deficit households for each income quintile. The figures are estimated using monthly consumption

and household income data.[22] The table shows that the lowest quintile was always in a deficit throughout the period. The highest quintile, on the other hand, gave surplus for the whole period. A striking observation is that during the crises, the surplus quintiles increased their surpluses (mostly due to the fact that the households in these group have the opportunity to reduce the consumption levels) while deficit quintiles faced higher deficits (as a result of inability to reduce their consumption levels, because their consumption basket mainly covers subsistence goods). However, these figures provides information about the aggregated level. The second part of the table displays the share of deficit households in each quintile. More than 50 percent of the households in the lowest quintile gave deficits in the period under investigation. Moreover, during the crises and post-crisis periods (2003 and 2009), this share increased. This tendency was also observed for other quintiles. These figures reveals an obvious demarcation line between lower and upper echelons of the society; deficit at the bottom and surplus at the top.

Table II.1.10: Deficit-Surplus Accounting for Income Brackets

	Deficit/Total Income (percent)						Deficit Households/Total Households (percent)					
	Quintiles						Quintiles					
	1	2	3	4	5	Total	1	2	3	4	5	Total
2003	-17.5	3.6	11.1	19.2	36.6	20.6	59.6	44.7	34.8	27.7	17.9	36.9
2004	-14.4	6.5	10.0	17.2	33.2	18.8	52.4	34.5	29.9	24.2	17.3	31.7
2005	-17.5	-1.5	7.0	11.5	21.3	10.4	55.9	42.4	33.2	28.4	25.9	37.2
2006	-10.8	-0.6	4.1	8.7	24.3	10.9	52.0	42.0	36.4	32.2	23.7	37.2
2007	-9.7	1.6	6.0	11.9	26.2	13.0	50.0	37.3	32.0	28.9	19.8	33.6
2008	-13.3	-3.8	4.9	11.6	27.4	12.6	54.6	49.3	39.6	29.4	23.9	39.4
2009	-18.6	-4.2	4.4	27.4	29.9	17.3	59.9	49.1	40.4	32.0	22.6	40.8
2010	-10.6	-2.2	3.4	10.9	29.1	13.3	56.1	47.5	39.1	32.5	22.7	39.6
2011	-13.6	-1.0	6.4	11.3	27.2	13.1	55.4	46.5	37.2	29.8	24.4	38.7

However, this analysis should be complemented with analysis at the level of social classes. Table II.1.11 displays a clear-cut fragmented picture. Landed subsistence peasants and rural laborers were in deficit positions during the whole period. Urban labourer households seem to stabilize their surplus around 10 percent. The share of the deficit households was the highest among landed subsistence peasants and rural laborers.

[22].Because of the data collection mechanism of the Household Budget Surveys, this table should be evaluated cautiously. Household Budget Survey datasets are not panel data sets. In each quarter of the year, the household set which are surveyed has been changed. The consumption figures are only for the month in which the questionaire has been delivered to the household. Since there is no household tracking system; any household's inter-month consumption and income allocation mechanism could not be observed. Moreover, the composition and the level of the consumption differ significantly among the months, but, because of the mechanism mentioned, this variance can not be observed either.

Towards the end of the period, nearly 40 percent of the urban laborers gave deficits. Most interestingly, the figure for the surplus social classes increased by at least 7 points between 2007 and 2008. These classes are mostly rural classes. More importantly, to a great extent, this table supports the observations from the previous one which indicates a structural break between surplus classes at top and deficit classes at the bottom. This break also seems to coincide with a division among urban/rural nexus.

Table II.1.11: Deficit – Surplus Analysis for Social Classes

Deficit/Total Income (percent)									
	2003	2004	2005	2006	2007	2008	2009	2010	2011
Urban Propertied Classes	40.6	36.0	23.2	27.9	30.1	25.1	27.6	30.0	25.2
Petite Bourgeoisie	25.8	21.4	15.1	17.9	12.9	11.1	10.2	9.8	12.5
Rural Propertied Classes	35.6	37.2	30.2	19.8	22.7	27.7	11.3	29.1	38.4
Landed Subsistence Peasants	-8.1	-19.0	-4.7	-5.5	-8.1	-9.8	51.0	-9.8	-6.4
Urban Laborers	12.9	12.9	7.1	6.1	10.0	9.3	10.6	9.3	9.6
Rural Laborers	-10.0	-0.4	0.1	-0.8	-5.6	2.8	-3.4	-3.0	-1.0
Not Working	-16.1	3.6	7.2	4.4	7.4	16.3	16.6	11.7	8.5
Retiree	9.8	7.5	-6.6	-4.2	-0.5	6.6	0.8	6.2	7.0
Total	20.6	18.8	10.4	10.9	13.0	12.6	17.3	13.3	13.1
Deficit Households/Total Households (percent)									
	2003	2004	2005	2006	2007	2008	2009	2010	2011
Urban Propertied Classes	19.6	16.7	26.1	25.6	21.5	31.0	31.7	29.3	29.9
Petite Bourgeoisie	30.7	23.3	29.2	27.9	32.7	42.2	37.6	40.9	37.7
Rural Propertied Classes	25.3	22.3	32.6	28.2	27.6	29.2	46.7	25.3	19.6
Landed Subsistence Peasants	54.6	58.7	53.4	53.4	53.0	49.9	48.4	53.4	48.7
Urban Laborers	38.5	31.6	37.0	38.0	32.7	39.2	39.9	39.8	38.8
Rural Laborers	54.7	44.0	48.8	45.3	51.3	47.3	51.2	47.4	48.1
Not Working	63.1	40.6	32.0	39.5	30.2	27.7	38.7	37.8	41.3
Retiree	40.3	36.3	42.4	44.4	39.7	44.2	47.2	43.2	43.2
Total	36.9	31.7	37.2	37.2	33.6	39.4	40.8	39.6	38.7

Lastly, Hein (2012) makes an important distinction between the different capitalist accumulation regimes under financialization; namely between debt-led consumption boom, export-led mercantilism types and domestic demand-led type. He defines the first type as: "debt-financed consumption demand which allows for flourishing aggregate demand and the realisation of rising profits against the background of redistribution at the expense of (low) labour incomes and stagnating real investment, as another feature of finance-dominated capitalism" (Hein, 2012:6). The following table complemented with the information provided by previous two tables seems to imply that Turkey can be characterized by debt-led consumption boom type.

Table II.1.12: Consumption, Wage and Income

	Per Cap. Monthly Real Consumption (2003==100)				
	All Households	Lowest Decile	Consumption/Wage	Consumption/Income	Consumption/Income (Lowest Decile)
2003	199.84	117.55	1.16	0.85	1.90
2004	222.78	105.44	1.23	0.86	1.63
2005	250.90	127.60	1.42	0.94	1.70
2006	246.14	122.03	1.45	0.93	1.51
2007	255.02	114.70	1.24	0.90	1.34
2008	263.15	101.36	1.27	0.87	1.15
2009	291.93	193.61	1.09	0.84	2.21
2010	327.03	126.23	1.44	1.00	1.34
2011	360.42	138.65	1.44	0.99	1.35

As Table showing, the average per capita consumption rose secularly between 2003 and 2011, while the ratio of consumption to wage rose in most of the years. This indicates that wage income fell short of financing consumption. Moreover, for the al households, the ratio of consumption to income increased throughout the period, except for the years 2008 and 2009.

II.1.4. Conclusion

Turkey has been passing through a period of mature neoliberalism in the sense that most of the predetermined reforms have been implemented in a very ripe environment. The political situation (one party government since 2002) has facilitated the continuation of the process. Beside this, the political and economic elite which have been promoting these reforms since the military coup in 1980 removed all the obstacles to the neoliberal reforms. In this environment, the alterations in institutional set up, governments' addiction to neoliberal programs and foreign support to these reforms eased the financial constraint. Foreign capital flows culminated in the period. Under these conditions, in the first sub-period between 2002 and 2007, relatively high growth rates were achieved. Turkish economy began to falter before the effects of the global crisis were felt. Beginning from 2007, GDP growth began declining and the economy almost stopped generating

employment. The year of 2009 was the year of a full scale crisis. 2010 witnessed a weak recovery.

The income distribution indicators have followed the same trend. Size distribution of income displayed a trend in the favor of lowest quintiles between 2002 and 2007. Then this trend was reversed in the rest of the period. The development of the Gini coefficient confirmed this trend. The increase in the lowest quintiles' share in voluntary transfers could not stop or slow down this trend. On the other hand, the functional income distribution analysis gives striking results. The share of wage income rose rapidly between 2002 and 2011. The share of public transfers increased also. Increase in the share of wage income was not due to the increase in real wage rate; rather it was a direct outcome of the increase in the number and share of labourer households. Class-based income distribution analysis proves this. The dissolution of peasantry and several other classes increased the number of households joining the ranks of working class. The increased proletarianization was a common symptom of neoliberal programmes and Turkey was not an exception. Under these conditions, the retreat of formal welfare system might have brought about disastrous outcomes not only for labor, but also for capital. The social and economic reproduction of the increasing labor force necessitates a welfare system. With the retreat of former one, a new welfare regime has been emerging in Turkey. This system uses voluntary transfers to aid social and economic reproduction of labor force, and also to support the sustainability of reserve labor army. Our class-based analysis provides significant insights about this process.

II. 2 Financialization and investment in capital stock

II. 2.1. Introduction

This section aims to explore the relationship between nonfinancial corporations (NFCs) and financial markets in Turkey using detailed balance sheet and income statement data for the period 1998-2012. There are two goals. First, to find out the aggregate tendencies in this period in terms of the NFCs financing and investment decisions and second, to assess the impact of NFCs' involvement in financial markets on their investment behavior. There is a growing literature, mostly focused on advanced economies, looking at the changing relationship between NFCs and financial markets in the last couple of decades. These changes are twofold: On the one hand, nonfinancial corporations began increasing their acquisition of financial assets and deriving an increasing share of their income from financial sources. On the other hand, the management of nonfinancial corporations came under increased pressure from financial markets to maximize short-run returns, which led to increased payments to financial markets in the forms of interest payments, dividend payments and stock buybacks (Crotty 2003, Stockhammer 2004, Orhangazi 2008).[23] These studies argued that the changes in the relationship between financial markets and NFCs had a negative impact on the levels of investment. Crotty (2003) argued that financial markets' pressure on nonfinancial corporations led to a shortening of planning horizons, the erosion of long-term corporate goals and an increase in the amount of cash flow paid to financial markets. Stockhammer (2004) argued that the rise of shareholder value and the emergence of a market for corporate control led to a decline in

[23] The concept of financialisation is frequently used to designate these changes. Financialisation is a term that has gained widespread usage in the critical economics literature in the last two decades, especially in the aftermath of the 2007-08 U.S. financial crisis. However, the term lacks a clear, agreed-upon definition and its precise use and form have been ambiguous. At a general level, it refers to the increase in the size, importance and power of financial markets, transactions, institutions, motives and financial elites in the functioning of the economy in the post-1980 era. Some describe the financialisation process as a shift from productive activities to financial activities, while others emphasize the dominance of finance in general over economic activities (Epstein 2005). At the firm level, financialisation is used to designate changes cited above in the relationship between the nonfinancial corporate sector and financial markets, especially in the US economy but also in other advanced capitalist economies to varying degrees. There are also some more specific uses of the term, such as "financialisation of commodities" or "financialisation of food" in which financialisation refers to increased financial activity in markets where commodity or food items futures are traded and future streams of revenue from these have been transformed into tradable financial assets.

the desired investment levels of the nonfinancial corporations as these developments shifted power to the shareholders and changed management priorities. The empirical analysis of Stockhammer (2004) suggested that for the USA, the UK and France financialisation affected capital accumulation negatively. Orhangazi (2008) argued that both these factors as well as nonfinancial corporations' involvement in financial investments contributed to lower levels of investment and empirically reached to similar results using firm-level US data. Hein (2010) and Hein and van Treeck (2010) constructed models of investment behavior and investigating linkages between financialisation and investment.

A number of recent studies examined similar issues for the case of Turkey. Demir (2007) in a cross-country study including Turkey suggested that financial liberalization led to a channeling of nonfinancial sector savings to speculative short-term investments instead of long-term investment projects and this has changed the pattern of nonfinancial corporate sectors' capital accumulation. In a study on the investment and saving behavior of nonfinancial corporations Özmen *et al.* (2012) argued that in Turkey the financial sector remains limited in mobilizing funds for firms that are dependent on external financing for investment. However, they have not analyzed to what extent corporations use their internal savings for fixed capital accumulation as opposed to financial investments. Gezici (2007) examined the effects of financial liberalization on the investment decisions of manufacturing firms in Turkey and "negative impact of uncertainty on investment is worsened under financial liberalization, while there is no evidence of declining importance of liquidity. Overall, results suggests that financial reform policies did not lead to expected benefits for the investment of real sector firms while producing increased uncertainty that impedes investment further." Akkemik and Özen (2014) observed that nonfinancial corporations in Turkey have shifted significant amounts of working capital from productive activities to the acquisition of high-yield interest bearing assets in an effort to gain short-term interest revenues and argued that they have done so as a response to highly uncertain macroeconomic conditions.

We use a comprehensive firm-level dataset compiled by the Central Bank of Turkey to analyze the saving and investment behavior of Turkish nonfinancial corporations. In

doing so, we aim to contribute both to the burgeoning literature on financialisation which so far has been largely limited in terms of empirical analyses to advanced economies and at the same time contribute to the literature on the investment behavior of Turkish nonfinancial corporations. we provide both aggregate data and firm-level analysis.

The rest of the section is structured as follows. In the next subsection, we summarize the theoretical channels through which the changes in the financial markets-NFC relationships could potentially affect the investment behavior of NFCs. In the third subsection, we use detailed aggregate balance sheet and income statement data and present tendencies in the nonfinancial corporate sector.

II.2.2. Finance Investment Nexus: Theoretical Channels

In standard economic theory financial sector is seen as providing necessary services to support the activities of nonfinancial corporations, most significantly their investment in productive assets. The growth and development of financial markets, mostly referred as financial deepening in the context of developing economies, is supposed to enhance the functions of the financial markets and allow them to better mobilize savings and allocate them more efficiently, as suggested by the McKinnon-Shaw hypothesis (McKinnon 1973; Shaw 1973). Underlying this hypothesis is the efficiency of the financial markets. Financial liberalization and deregulation is supposed to eliminate financial market inefficiencies and doing so improve the investment and growth performance of the economies.

Post-1980 era was characterized by financial liberalization and deregulation worldwide. In the advanced economies, and especially in the US economy the relationship between financial markets and nonfinancial corporations has changed significantly in this era. [24] Two developments were particularly emphasized. On the one hand, there has been an increase in financial market pressure on nonfinancial corporations through changes in corporate governance, starting with the hostile takeover movement of the 1980s and proceeding to the so-called shareholder revolution of the 1990s. The same period has therefore witnessed an increasing transfer of earnings from nonfinancial corporations to

[24] See Orhangazi (2008) for a review of these changes in the US economy.

financial markets in the forms of interest payments, dividend payments and stock buybacks. On the other hand, nonfinancial corporations themselves have been increasingly involved in financial activities and derived an increasing share of their income from these activities. These developments reflect a change in the objectives of top management, which includes an increasing propensity for short-termism in firm decision making (Crotty 2003, Stockhammer 2004, Krippner 2005, Orhangazi 2008).

These changes in the relationship between financial markets and nonfinancial corporations, now mostly referred to as financialisation of nonfinancial corporations, are often associated with lower investment in fixed capital accumulation. There are two channels through which financialisation potentially can have negative effects on the productive investments of nonfinancial corporations:

1. First, availability of financial investment opportunities and nonfinancial corporations' increased involvement in acquisition of financial assets has the potential to have a negative impact on real investment.

    1.1 If external funds are relatively limited, either because additional external funds come with a higher cost or because the firm considers internal funds to be safer than external funds, then acquisition of more financial assets would leave less resources for real investment.

    1.2 Nonfinancial corporations are under increased pressure by financial markets to maximize short-term returns. This pressure could lead them to choose financial investments over real investments which bring returns only in a longer-term period.

2. Financial markets' pressure on management to increase dividend payments and stock buybacks is the second channel through which financialisation potentially had a negative impact on investment.

    2.1 Increasing payments to financial markets leave firms with less funds available to finance real investment.

2.2 The short-termism imposed upon firm management by financial markets shortens the time-horizon of management and could hamper long-run investment projects.

2.3 when management uses external financing for real investment, because of the volatility of financial markets, the cost of funding in the coming years for long-term investment projects becomes more uncertain.

In the case of Turkey, the first channel might very well be in works. However, stock market capitalism is less-well established in Turkey, shareholder activism is very much limited, corporations are still controlled by large groups, stock buybacks were not allowed (until very recently), and most corporations are organized as holding companies which also include affiliated banks. In the following subsection, we will look at aggregate nonfinancial corporate sector data to assess the relationship between financial markets and nonfinancial corporations and their financing and investment behavior.

II.2.3. An Overview of the Investment and Financing Behavior of the Nonfinancial Corporate Sector

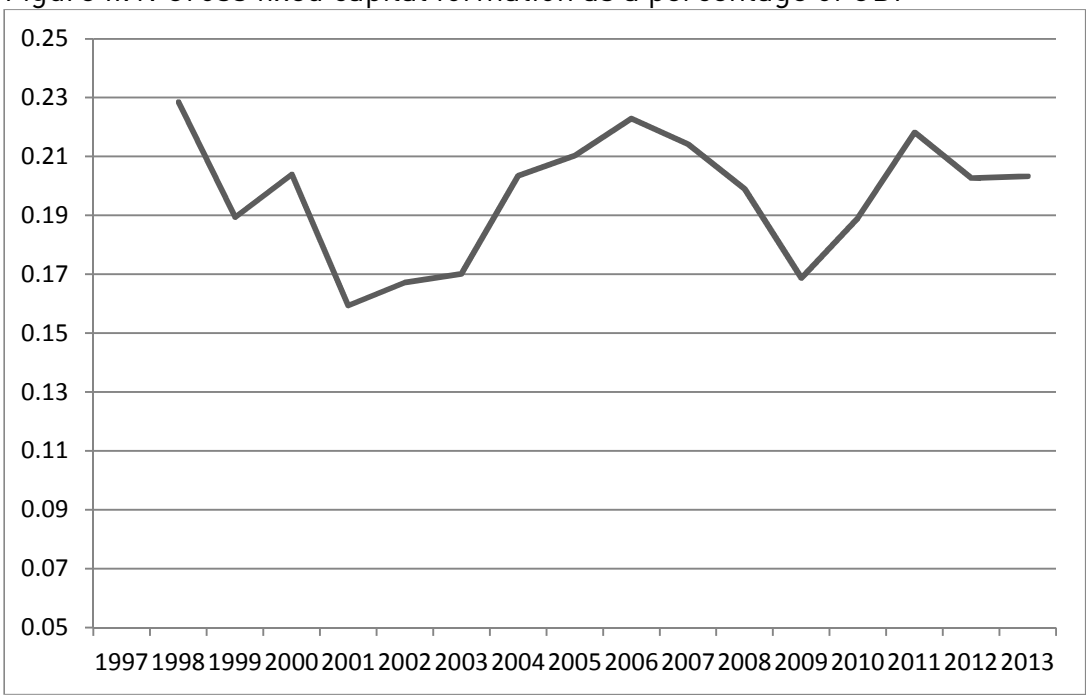
In this subsection we present aggregate data on the nonfinancial corporate sector. Most data are available for the period 1997-2012.

II.2.3.1 Investment

Figure II.1 shows gross fixed capital formation as a percentage of GDP using data from national accounts.[25] Gross fixed capital formation as a percentage of GDP oscillates around 20 percent except during recessions and following years. There are marked declines in this ratio around the 2001 and 2008 recessions. When we look at tangible assets to total assets ratio of the NFCs, in Figure II.2, we observe first that this ratio falls following the 2001 crisis and this trend is reversed by 2006, although it does not reach back to the levels before 2001.

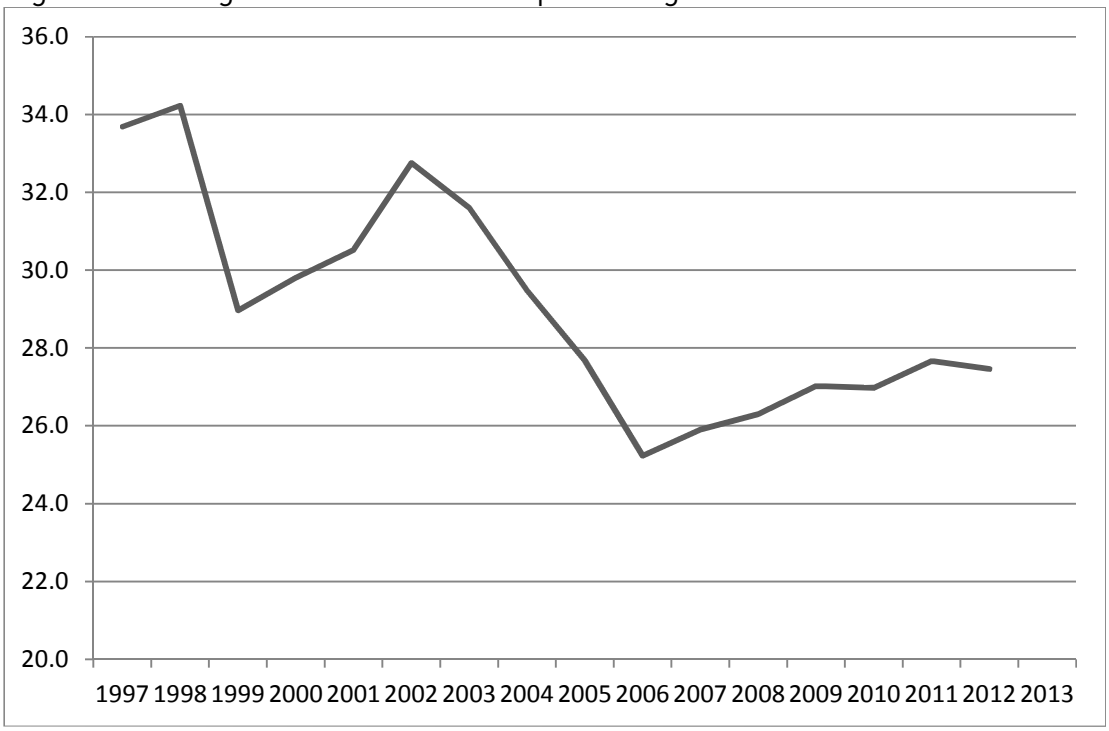
[25] There are significant differences in this ratio when real GDP figures are used. This needs to be explained.

Figure II.1: Gross fixed capital formation as a percentage of GDP



Source: CBRT Data Delivery System
Note: Both variables are used in current prices.

Figure II.2: Tangible fixed assets as a percentage of total assets

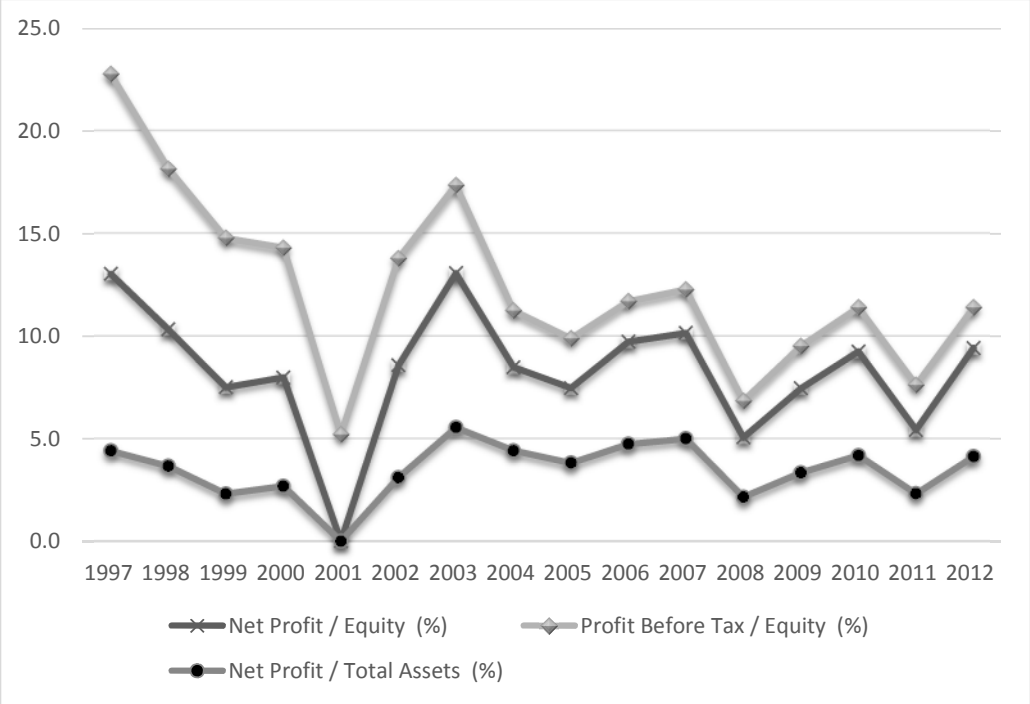


Source: CBRT Company Accounts

II.2.3.2 Profitability

Next figure plots three different measures of NFC profitability. Net profit as a percentage of equity, profit before tax as a percentage of equity and net profits as a percentage of total assets. The decline in profitability during the 2001 crisis is very visible. There is a recovery in profitability afterwards with another visible but not as sharp decline in 2008 during the global financial crisis.

Figure II.3: Profitability of nonfinancial corporations



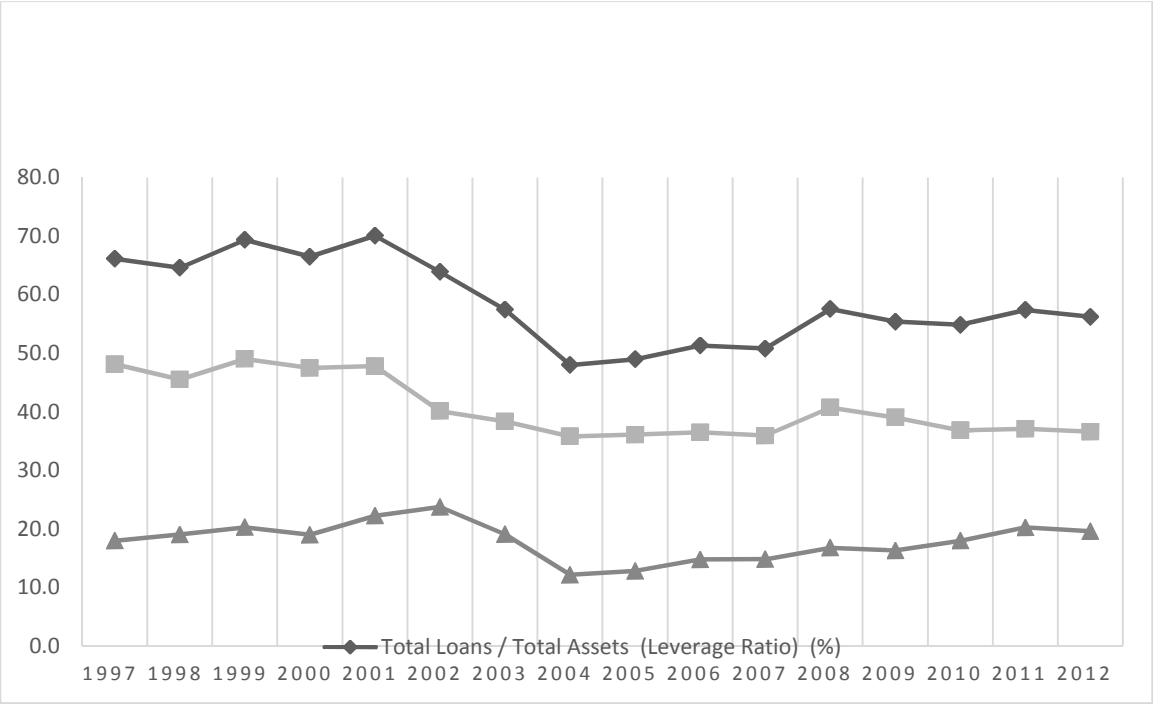
Source: CBRT Company Accounts

II.2.3.3 Liabilities

Figure II.4 presents the liabilities side of NFCs. Three measures are presented. Total loans as a percentage of total assets, short-term liabilities as a percentage of total liabilities and long-term liabilities as a percentage of total liabilities. The leverage ratio defined as total loans as a percentage of total assets declined significantly following the 2001 crisis. This decline was reversed by mid-2000s but still remained lower than the pre-

crisis levels. We observe that the leverage ratio is the highest during the 2001 crisis. There is a slight decline in this ratio during the 2008 global financial crisis, too. Short-term and long-term components of liabilities do not show significant change over time.

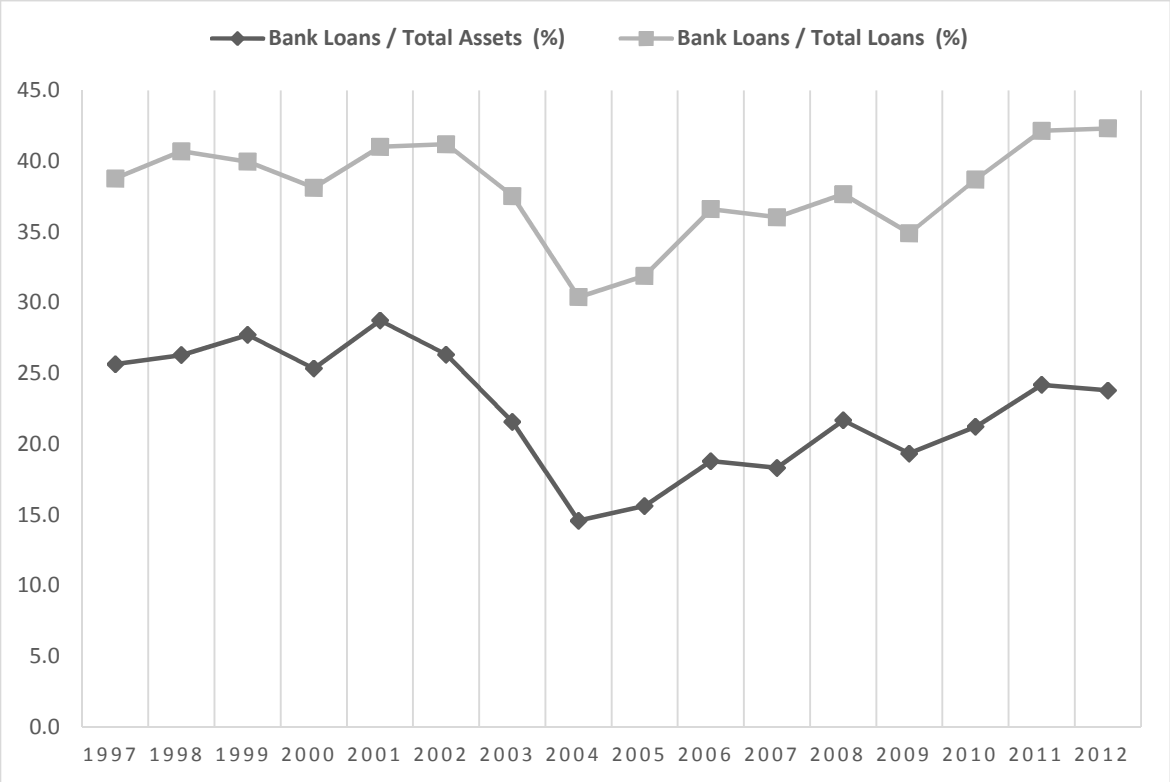
Figure II.4: Liabilities of nonfinancial corporations



Source: CBRT Company Accounts

Figure II.5 presents the share of bank loans first as a percentage of total assets and then as a percentage of total loans. There is a sharp decline in this ratio following the 2001 crisis, mostly due to the problems banks had in this period. Bank loans constitute more than 40 percent of total loans of the NFCs at the end of the period, showing that bank finance is an important channel for NFCs.

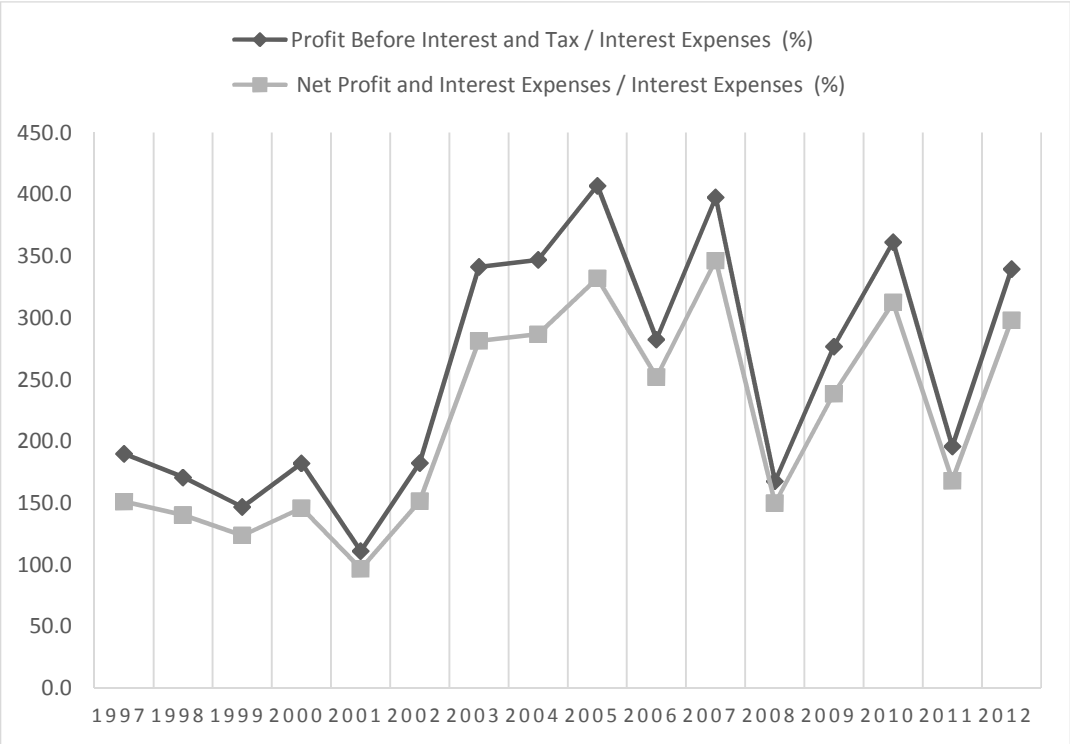
Figure II.5: Bank loans of nonfinancial corporations



Source: CBRT Company Accounts

Figure II.6 presents two interest coverage ratios. Two interest coverage ratios are provided. The first one is defined as profit before interest and tax as a percentage of interest expenses and the second one as net profit and interest expenses as a percentage of interest expenses. The improvement in this ratio after 2001 reflects, on the one hand, declining interest rates and on the other hand the movements in the profitability.

Figure II.6: Interest coverage ratios

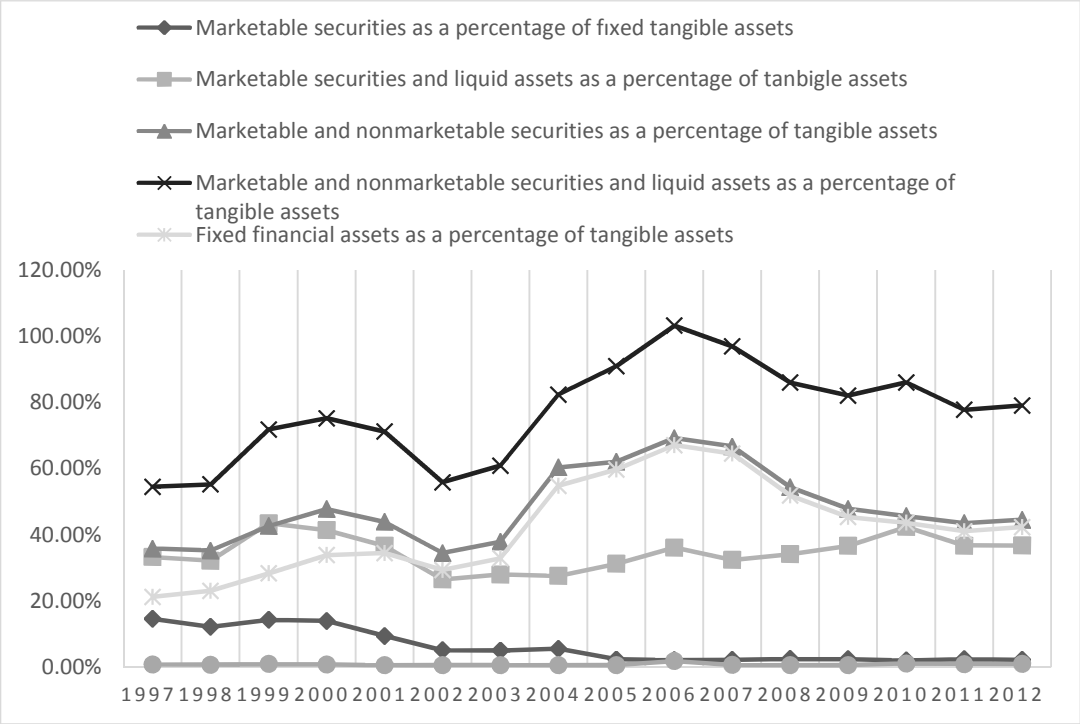


Source: CBRT Company Accounts

II.2.3.4 Financial assets and incomes

Figure II.7 presents different measures of financial assets as a percentage of fixed tangible assets. These include marketable securities as a percentage of fixed tangible assets, marketable securities and liquid assets as a percentage of tangible assets, marketable and nonmarketable securities as a percentage of tangible assets, marketable and nonmarketable securities and liquid assets as a percentage of tangible assets, fixed financial assets as a percentage of tangible assets, cash to tangible assets.

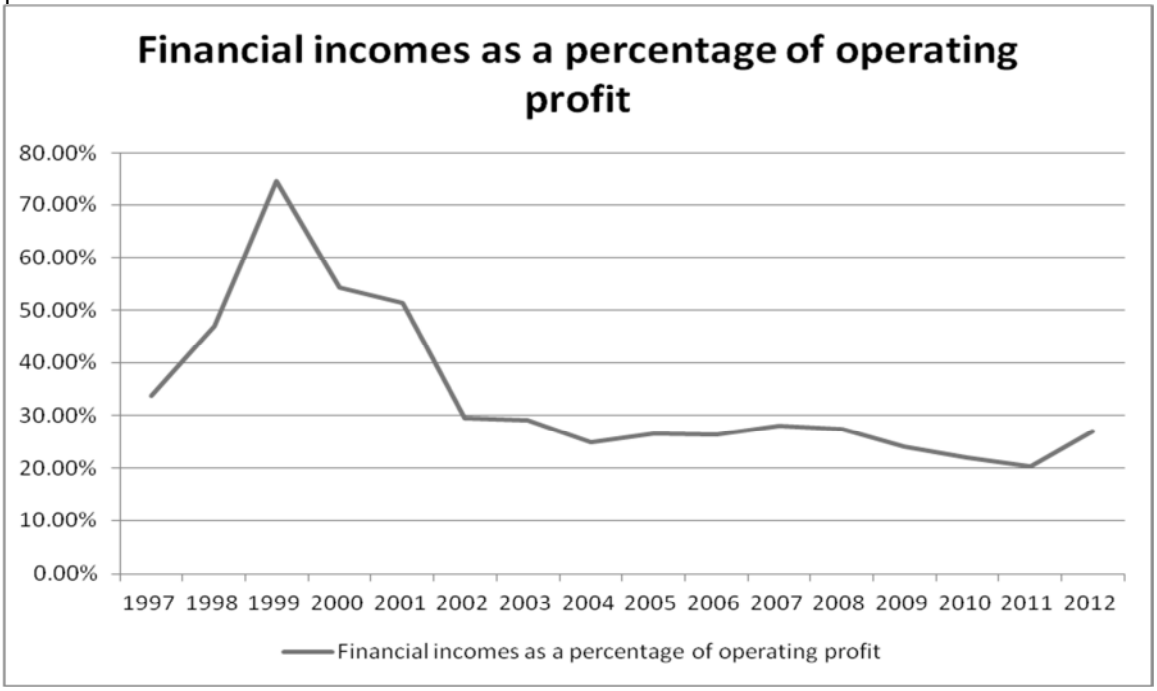
Figure II.7: Financial assets of nonfinancial corporations



Source: CBRT Company Accounts

Figure II.8 presents financial incomes as a percentage of operating profits. There is a significant decline in this ratio starting in 2000.

Figure II. 8: Financial incomes of nonfinancial corporations as a percentage of operating profits



Source: CBRT Company Accounts

II.2.4. Final Remarks

Detailed aggregate statistics on nonfinancial corporate sector of Turkey was presented in this section. While the aggregate data show macroeconomic tendencies, use of firm-level data would enhance our understanding of the linkages between investment and the financialisation process. A couple of observations are in order. First, a hallmark of financialisation in advanced economies has been the increase in payments to the financial markets, especially in forms of dividends and stock buybacks. For the Turkish NFCs, dividend data is limited in our database. However, due to the institutional differences stock buybacks were not possible until very recently. Shareholder pressure was also not visible as shareholder activism has been limited. This is a major institutional difference. Second, bank financing is still a very important channel. Third, there is an increase in financial asset holdings however financial incomes are declining in the post-2001 era. This is partly due to declining interest rates especially on government bonds. In the pre-2001 era Turkish NFCs were earning high short term interest revenues through investments in government bonds.

II. 3. Financialisation and Consumption

II. 3.1. Introduction

The consumer credit usage has shown a remarkable growth in Turkey over the last decade. This is a phenomenon that first and foremost occurred in developed capitalist countries starting in the late 1970s. Later, the first decade of the 21st century witnessed remarkable growth in consumer credit also across many developing countries, albeit from a low base (IMF, 2006). A growing number of studies have discussed the phenomenon of rising household debt levels, as the subject has grown in importance in light of the 2008 global crisis. A diversity of opinions is put forward regarding its implications. Some stress its welfare improving effect suggesting that the rising household debt level is a consequence of relaxation of budget constraints on rational borrowers who want to borrow more based on their cost benefit preferences. Further, it is suggested that increased access to credit can have a wealth effect also through a rise in asset prices as it can allow more asset acquisition through borrowing. Conversely, some see rising debt levels as a further burden on households as it leads to an increase in consumption beyond the limits of incomes, falling saving rates and transfer of income to the financial institutions through interest payments. This section aims to document the current picture of the Turkish household debt indicators and evaluate whether the increased usage of credit has led to an increase in welfare by assessing developments in the both asset and liability sides of household portfolios. The subsection is organized in five parts. Next part presents an overview of trends in consumer credit and household indebtedness in Turkey. This is followed by a literature review on theories of consumer credit. Then this section demonstrates developments in the asset side of the household sector in Turkey in order to have a better assessment of the wealth effect of increased access to credit. The final part gives final comments.

II. 3.2. Trends in Consumer Credit and Household Debt in Turkey

Rising above its pre-2001 levels, private consumption has become a key driver of the Turkish economic growth over the last decade. Accordingly, the share of private

consumption in GDP rose from an average of 68.0 percent in 1990s to 71.0 percent in the post-2001 crisis era. In the high growth period between 2002 and 2007, private consumption contributed 5.2 percent of Turkey's average GDP growth rate of 6.8 percent. Like in many East Asian and Latin American countries, in Turkey as well, consumer credit was utilized as a way to encourage consumption in the aftermath of the crises experienced in the late 1990s and early 2000s (IMF, 2006; Hanson 2005). According to the statistics from BRSA (Banking Sector Regulation and Supervision Agency), the ratio of consumer loans and credit cards to consumption of resident households increased from 3.0 percent in 2002 to 31.0 percent in 2013, demonstrating the increasing penetration of credit into the daily lives of people.[26]

This rising use of credit to finance consumption has been accompanied by a remarkable decline in private savings, which has reached its lowest level since 1998. According to the data from the Ministry of Development, the private saving ratio as a share of GDP declined from 25.7 percent in 1998 to 12 percent in 2012. The data breakdown of private savings by corporate and household sectors is not available. Nevertheless, as Van Rijckeghem and Üçer (2009) stated, based on the household budget survey data released by the Turkish Statistical Institute, household savings can be assumed to follow a similar pattern to that of private savings. Indeed, diminishing household savings largely contributed to the decline in private sector savings. According to the estimations of Van Rijckeghem (2010), household savings as a percentage of household disposable income fell from 17.0 percent in 2004 to 8.0 percent in 2008.[27] A more recent data from the Central Bank shows that from 2008 to 2012, household savings fell even more reaching 7.3 percent in 2012 (CBRT, 2013). It is a fact that low saving levels impose a further constraint on

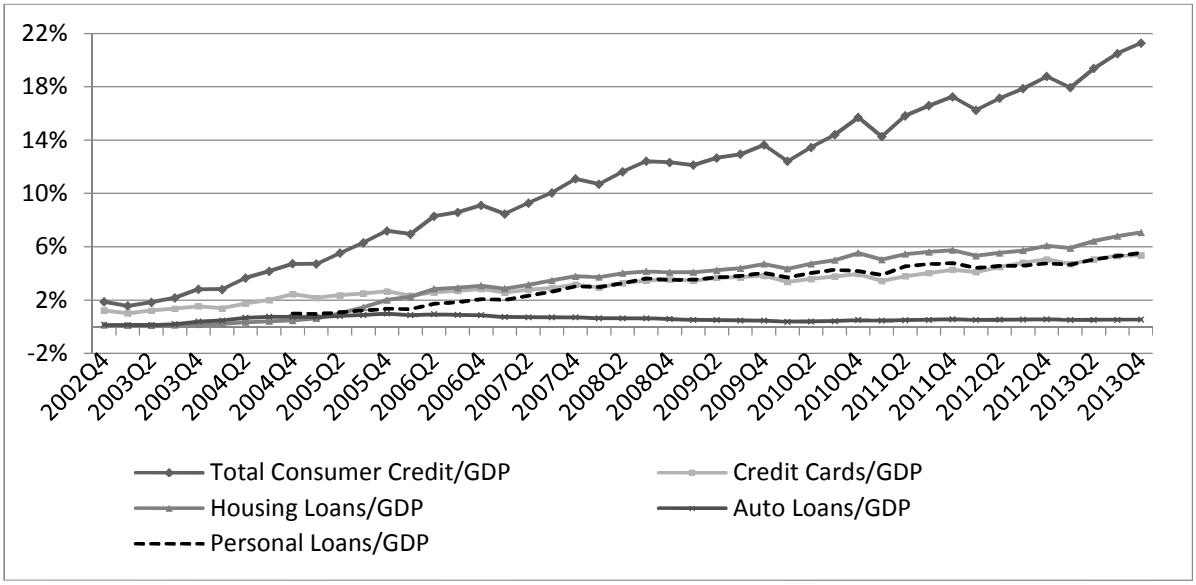
[26] https://www.bddk.org.tr/websitesi/English.aspx

[27] Separate data on corporate and household savings are not available in Turkey. Studies on household savings that use TURKSTAT data estimate saving figures by using data on household consumption expenditure and household disposable income. However, estimates based on these data might lead to inconsistent results because TURKSTAT collects household disposable income figures for the 12-months period prior to the survey month (participants are interviewed at different months during the year and they report on income during the previous 12 months) but it collects data for household expenditures for the last month. Therefore, estimating the savings based on raw data does not give an accurate measure of savings as it combines current information for consumption and prior year information for income. See Van Ricjkeghem (2010) for an explanation of the necessary adjustments that should be made in the raw data in order to obtain accurate saving rates.

accumulation of wealth and future increases in standards of living given high level of indebtedness in Turkey. Further, low savings relative to investment, in the face of increases in consumption, lead to deepening of the current account deficit which is a major concern for the Turkish economy.

Apart from an increase in use of credit for financing consumption, there has been also a rise in housing loans. As can be seen from Figure II.3.1, the growth in credit cards, personal loans and housing loans all significantly contributed to the overall growth of consumer credit in Turkey.

Figure II.3.1: Turkey's Consumer Credit to GDP, (%) 2002Q4-2013Q4

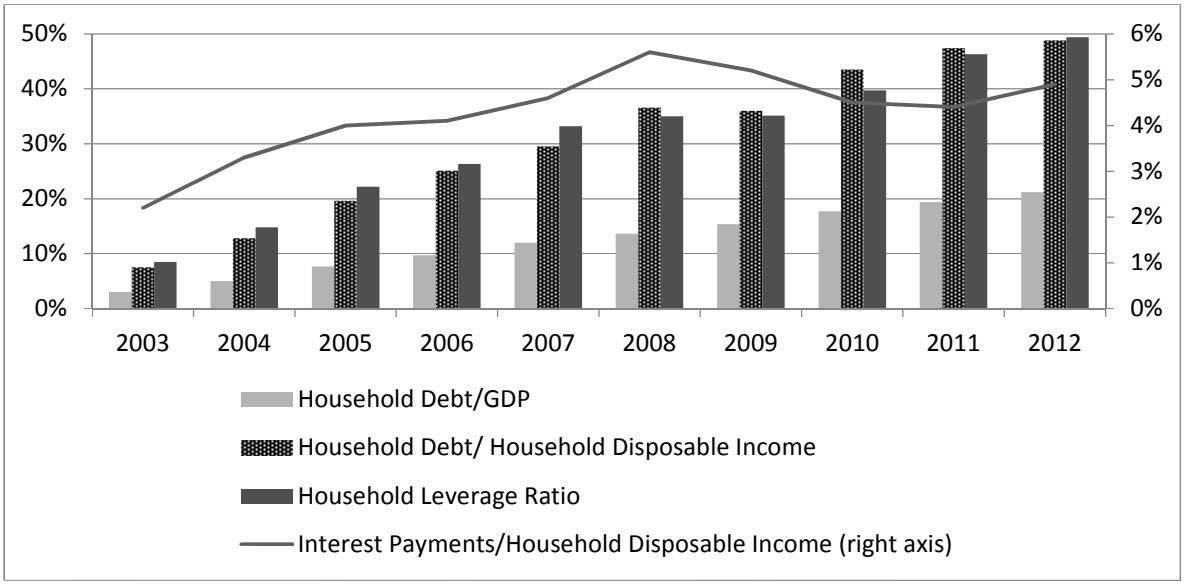


Source: Author's estimation based on data from BRSA and TURKSTAT
Note: GDP data are rolling four-quarter sums. Data on personal loans available after 2004.

Accompanied by a rise in consumer credit and decline in saving rates, there has been a remarkable rise in household debt levels in Turkey, a country where living on debt does not have a long tradition. As Figure II.3.2 shows, as a percentage of GDP, household debt increased from 3.0 percent in 2002 to 21.0 percent in 2012. Strikingly, household debt reached 49.0 percent of disposable personal income in 2012, implying a seven-fold increase

since the end of 2003.[28] Along with the rise in household debt levels, the burden of debt servicing increased as well. The share of interest payments in disposable income of households increased from 2.2 percent in 2003 to 4.9 percent in 2012, indicating increasing transfers of household income to the financial sector. High interest rates, especially on credit cards, were important determinants in the rise in Turkey's consumer debt service burden. In response to rising public discontent against high interest rates on credit cards, there were significant interest rate cuts after 2006, contributing to the decrease in debt service burden after 2008. Nevertheless, although the interest rates fell, the rising debt levels led to a rise in debt service burden again.

Figure II.3.2. Household Debt Indicators



Source: CBRT, Financial Stability Reports, various issues.
Note: Household debt consists of gross consumer credit and credit card balances extended by banks and consumer finance companies. The data for the period after 2008 also include liabilities related to TOKI's (Housing Development Administration) housing sales. Household disposable income data is generated from the "Household Budget Surveys" conducted by the TURKSTAT.

[28] It is important to insert a caveat here. Private disposable income data is estimated either through macro aggregates or Household Budget Surveys released by the TURKSTAT. It is well known that there is a discrepancy between two data sets. This mainly derives from an implicit tendency of households to under-declare their incomes. Disposable income data in Figure II.3.2 comes from the Household Budget Surveys. Therefore household debt to disposable income ratios in the figure might be higher than real ones. Nevertheless, the ratios are still important in showing the remarkable increase over a short period of time.

Throughout this period, banks have increasingly turned towards consumer credit as an alternate way of making profit (Karacimen, 2014). The share of consumer loans in the total loans of the banking sector increased remarkably, rising from 13.0 percent in 2003 to 34.0 percent in 2012. As can be seen from Figure II.3.1, the growth in credit cards, personal loan and housing loans all significantly contributed to the overall growth of consumer credit in Turkey.

II.3.3. A Critical Review of Theories and Empirical Studies on Turkey

One of the key questions that need to be addressed related to the rising usage of consumer credit is that whether this increased access to credit is welfare improving. In the mainstream studies, consumer credit is mainly analysed as a tool to increase welfare and facilitate budget management by releasing constraints on a budget in a given time. The theoretical foundation of the neoclassical approach to consumer credit is based on both the permanent income and life-cycle hypotheses.[29]

Permanent income and life cycle consumption hypotheses were questioned when they proved to have flawed empirical findings.[30] In the case of Turkey, for instance, examining household income and its components over the life cycle of the households by using micro data obtained from the 2003 Turkish Household Budget Survey, Cilasun and Kırdar (2012) find little evidence for the hump-shaped life-cycle profiles of household income. Using the same data source between 2002 and 2006, Cilasun and Kırdar (2009) find that saving rates slightly increase with age. It is commonly stated that this inconsistency of the household income profile in Turkey with the life-cycle hypothesis is very much related

[29] These theories were developed in the 1950s when consumer debt was not a major issue (Scott, 2007). The central idea of the permanent income hypothesis developed by Milton Friedman (1957) is that people's consumption decisions are determined not by their current income but by their expectations regarding their future income. Thus, small changes in current income would not have a big impact on the consumption decisions of individuals. A similar idea can also be found in the life cycle hypothesis which presents a linkage between consumption patterns of individuals and their income and income expectations. According to the hypothesis, individuals aim to maintain a constant level of consumption and to this end smooth out fluctuations in income over their lives.

[30] For the U.S. economy, see, for example, Deaton (1987, p. 121), who drew on "aggregate time series data from the United States…suggest[ing] that simple representative models of life cycle are unlikely to be very helpful, at least without substantial modifications". For a more recent study in a similar vein, see Dynan et al. (2004, p. 435), in which they provided evidence on the inconsistency of the life cycle explanation.

to the peculiar characteristic of the household structure where multiple generations of households living together in the same household (Cilasun and Kırdar, 2012; Van Rijckeghem and Üçer, 2009). Similarly for the permanent income hypothesis, Ceritoğlu (2013) asserts that empirical results reject the strict version of the hypothesis because there is a positive and statistically significant relationship between the growth of consumption and expected income changes, suggesting that households do not aim at maintaining a constant level of consumption.

Indeed the key problem related to the life-cycle and permanent income hypotheses is not whether they hold or not on the basis of the existing data. The real problem is related to the shortcomings of the methodology that they are applying. Life-cycle and permanent income hypothesis were developed at a time when linear optimisation techniques were used to analyze consumer debt. In these hypotheses, consumer credit is explained from a microeconomic perspective by taking utility maximisation behavior as the starting point. In order to model consumer debt mathematically, several assumptions were made regarding individual behavior, such as rational choice, perfect information, and well-defined preferences (Scott, 2007). This is an inadequate understanding of the phenomenon, mainly because it does not consider the social content of consumer credit. An accurate understanding of the theory of choice needs to consider the dialectic relation between people and their institutional environment (Crotty, 1994). The preferences of individuals are not only based on economic calculations of the self-interest agents as the neoclassical theory puts forward. Accordingly, the easy availability of credit cannot be seen simply as a relaxation of constraints on rational borrowers who want to borrow more based on their cost benefit calculations, as often done in mainstream analyses (Barba and Pivetti, 2009).

In an environment where consumption goods and services have increasingly becoming more available, efforts to stay current with the proliferation of commodities that are increasingly perceived as a necessity for self-recognition seem to be leading to increases in consumption. Further, people not only increasingly define themselves by consuming more but they also concern with their consumption relative to other social segments in the society (Cynamon & Fazzari, 2008). This last point is often discussed in the

literature a la Veblen (1899) and Duesenberry (1949). Veblen (1899) puts forward the idea that consumption plays a determining role in attaining or maintaining social status. In a similar vein, according to Duesenberry (1949), consumption behavior should be analyzed by considering psychological effects such as habit formation and social interdependences. Based upon the idea that individuals care about status, in his relative income hypothesis, Duesenberry asserts that individuals are concerned more with their relative level of consumption rather than its absolute level. Further, due to the habit ratchet effects, household will try to maintain their acquired standard of consumption. So, as opposed to the mainstream understanding of consumption theory, people will not react to a temporary decline in income by decreasing their consumption level in order to maintain a constant level of consumption. Evidence from the U.S. economy shows that consumption is inelastic with respective to decrease in income. Barba and Pivetti (2009) showed that as the inequality in the income distribution increased over the past 25 years in the U.S., low and middle income households borrowed more and allocated a higher share of their income to consumption in order to imitate upper classes. In relation to Turkey, as though these arguments seem convincing based on observations regarding increasing consumption of low and middle income households, to our knowledge no comprehensive study so far has investigated their validity. There is, therefore, a need for a study on the link between relative levels of consumption and income levels of different segments of society.

A further point that needs to be regarded in assessing the welfare implications of the increased access to consumer credit is related to the developments in the asset holdings of households. Especially in core capitalist countries, the financialisation of household income has taken place both through increased borrowing from financial institutions and asset acquisition. Under the circumstances, more emphasis started to be placed on the necessity to consider both the changes in the liability and asset sides of household balance sheets in order to assess the welfare effect of increasing access to credit. The argument is that growing debt levels can contribute to a wealth effect as borrowing facilitates asset price appreciation and creation of new avenues of wealth (see Montgomerie, 2013). The next part

demonstrates the developments in the asset holdings of households in Turkey over the last decade in order to assess the validity of the wealth effect.

II.3.4. Trends in Household Sector Assets in Turkey

The wealth effect in the literature is often discussed with reference to the impact of rising housing and stock prices on consumption a la advanced capitalist countries where there has been a considerable rise in household assets. Analyzing the Turkish economy, we see that the evidence in relation a rise in financial wealth is rather weak. There are only a limited number of studies that look at the link between stock market prices and consumption. For instance, developing an error correction model by using data for the 1987-2006 periods, Akin (2008) shows that in the long run stock market wealth does not significantly affect consumption of non-durable goods but has an impact on durables consumption. Indeed, in Turkey the rise in household financial assets is well below the rise in household liabilities as evident in the sharp increase in household leverage ratio, as seen in Table II.3.1 below.

Table II.3.1. Composition of Household Financial Assets in Turkey (percent)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
TL Deposits	29.1	33.3	41.2	40.6	45.5	51.2	49.9	52.7	51.9	50.7
FX Deposits	35.2	32.2	27.2	26.8	25.0	24.2	23.3	20.1	20.6	20.1
Currency in Circulation	6.4	6.5	8.3	8.8	8.4	8.3	8.4	9.3	9.1	9.0
Government Securities and Eurobond	22.4	20.5	14.8	10.1	6.3	5.3	3.3	2.0	1.9	1.0
Mutual Funds	n.a	n.a	n.a	6.3	7.2	5.6	6.2	5.9	4.7	4.3
Stocks	5.1	6.5	7.1	5.6	5.6	2.9	5.9	6.8	5.5	6.3
Private Pension Funds	0	0.2	0.5	1.0	1.5	1.7	2.1	2.5	2.6	3.4
Repos	1.78	0.8	0.7	0.7	0.6	0.6	0.5	0.3	0.3	0.6
Precious Metal Deposits	n.a	n.a	n.a	n.a	0.0	0.1	0.3	0.5	2.5	2.9
Total Assets (Billion TL)	157.6	190.5	219.5	279.7	313.6	368.3	420.4	481.7	543.2	605.1
Household Leverage Ratio (percent)	8.5	14.8	22.2	26.3	33.2	35.0	35.1	39.7	46.3	49.4

Source: CBRT (2006, 2008, 2010, 2011, 2013)

The table shows that households hold their financial assets mostly in deposits. It is striking to see that while the importance of deposits has declined in many countries in the age of financialisation, this has been the reverse in Turkey. The total share of TL and FX deposits increased from 64.3 percent in 2003 to 70.8 percent in 2012. Another important observation is that, together with the introduction of the private pension system in 2003, there has been a steady, albeit small, increase in the share of private pension funds in the

household portfolio. On the other hand, there has been a decline in the share of government securities and Eurobonds, due to their declining yields. Overall, it is seen that there has not been a remarkable increase in the asset holdings of households in Turkey. The financialisation of household income has mainly taken place through a rise in liabilities. As a result, household leverage ratio increased from 8.5 percent in 2003 to 49.4 percent in 2012, as can be seen from the table above.

Looking at the wealth effect, a reasonable way might be to consider the link between housing prices and consumption given the increased usage of housing loans, high rate of home ownership and rising house prices in Turkey. Over the last decade, there has been a rapid growth in real estate sector in Turkey very much related to the state-led urban regeneration projects (Yener, 2013). Throughout this period, homeownership has been encouraged through various state policies. According to the statistics from the TURKSTAT, the homeownership rate in Turkey was 60.6 percent by 2012, a ratio which is much higher than many European economies. In the meantime, conditions for accessing to housing credit were eased as well. The monthly interest rates on housing loans, dropped from 2.6 percent in mid-2004 to 1.0 percent by the end of 2005 and maturities for housing were extended (BRSA, 2006). There has been a sharp rise in housing loans afterwards. As shown in Figure II.3.2, as a percentage of GDP housing loans increased from 1.0 percent to 7.0 percent between 2002 and 2013. The remarkable growth in the housing market has led to many concerns about real estate bubble risk in the domestic and international media (Colombo, 2014; Roubini, 2013; Sönmez, 2013), a phenomenon of paramount importance. Although the subject is out of the scope of this study, it is important to note that there has been a steady rise in house prices. According to our own estimations from the house price index which started to be released by the Central Bank in 2010, between January 2010 and December 2013, the housing prices increased by 14.0 percent in real terms for the whole country. More strikingly, for Istanbul where the property market is the largest, the index rose by 26.0 percent over the same period.

Studies that have looked at the wealth effect of rising house prices on consumption in Turkey generally find a positive relation. There are various ways through which housing

wealth can affect consumption behaviour in an economy. For instance, home-owners can consume more as an increase in real estate price will lead to an increase in the value of their assets. Although one can talk about a psychological factor here, as feeling wealthier could induce an increase in spending, it is hard to justify that people will spend more just because their houses are worth more (Rijkecghem, 2010). A more plausible explanation is that as a home can be used as collateral it can provide households with easier and more access to credit.

Binay and Salman (2008) estimate housing wealth effect in Turkey by using rent price index for the 1990-2005 period. They observe positive and significant wealth effects in Turkey. According to their results, one percent increase in real estate wealth increases total consumption by 0.2 percent and semi-durables by 0.13 percent. However they observe no positive impact of higher real estate wealth on durables consumption. In another study, attracting attention to the importance of considering for widespread unauthorized housing in Turkey, Akın (2008) estimates the wealth effect only for legal urban authorised housing wealth. Using time series data for 1987- 2006 period, in a similar vein, Akin (2008) observes that an increase in housing wealth raises consumption of non-durable goods in the long run but has no effect on consumption of durables. As the wealth effect is mostly expected to lead to an increase in consumption due to the using homes as collateral to borrow from financial institutions, it is important to analyze it by deconstructing data for homeowners and tenants. In carrying out such an exercise by using Household Budget Surveys for 2004 and 2008, Van Rijckeghem (2010) suggests that a wealth effect appears to be positive for households who own their houses as they respond strongly to the business cycle compared to tenants. Overall, studies on Turkey suggest that there is a wealth effect on consumption through rise in house prices. As both the rises in consumption and real estate prices continue in Turkey, if there is data available covering recent period it would probably document similar results. However, these studies should be interpreted with caution. There are various studies in the literature which strongly question the validity of the wealth effect (see Van Rijckeghem, 2010). The argument is that during an economic prosperity, housing wealth and consumption can increase independently from each other, without suggesting a

correlation between the two. More importantly, one should keep in mind that the wealth effect does only hold for homeowners. The rising house prices have a negative effect on tenants. It is well known that rent puts a considerable burden on household budgets in Turkey.[31] In a recent study, analyzing household budget surveys for the period between 2003 and 2011, Duman (2013) states that spending of tenants increased much more than homeowners in nominal terms. As Turkey did not experience a rise in real wages over the period, he suggests that the excessive spending of tenants should have been financed by borrowing. Evidence on the usage of consumer credit especially by lower income people supports this argument. The data are available from 2006, as seen in Table II.3.2. Nevertheless, the percentage of borrowers in the Unclassified category is very high until 2009. So, if considering the 2009, 2010 and 2011 figures, it is striking to see that in all three years, around 42.0 percent of consumer loan borrowers are people who earn less than 1000 TL per month. Twenty-six to 28 percent of the borrowers are those whose average monthly income is between 1000 TL and 2000 TL. These two groups together are those who are most prone to indebtedness and constitute almost two thirds of the total consumer loan borrowers.

Table II.3.2. Percentage of Consumer Loan Borrowers by Income Groups

monthly incomes	2006	2007	2008	2009	2010	2011
0 - 1.000 TL	31.4	31.0	37.6	42.4	41.0	42.9
1.001-2.000 TL	16.8	21.7	23.9	28.2	27.9	25.8
2.001-3.000 TL	5.9	6.6	8	10	11.4	11.7
3.001-5.000 TL	4.8	5.7	5.5	6.2	6.0	5.6
5.001 + TL	7.8	5.8	6.6	6.8	6.3	5.4
Unclassified	33.0	28.9	18.1	6.1	6.5	8.5
Total # of Borrowers	4,978,965	5,337,247	5,838,184	6,540,736	8,041,700	8966,464

Source: BAT (Banks Association of Turkey)

[31] According to the household budget survey released by the TURKSTAT, rent and house expenditure constitute 25 percent of total household consumption expenditures as of 2012.

The evidence regarding the major expansion of consumer credit to wage earners and low-income households suggests that the deterioration in the financial situations of wage earners might be an important determinant of the rising demand for consumer credit, in an environment where consumption has been increasingly promoted through various mechanisms.[32]

II 3.5. Final Comments

An overemphasis on the welfare improving effects of the growth in consumer credit is first and foremost problematic as it leads to an underestimation of the problems associated to the rising household debt levels. What an analysis of the household dynamics in the Turkey points out is that the rising debt levels put a considerable burden on people -especially low income groups- through a rise in their debt stock and debt service burden. As the rise in financial assets does not show a similar increase, the burden of increased debt levels is not seem to be compensated by a rise in gains from asset acquisition. The potential macro problems regarding a growth strategy that relies on credit financed consumption already started to the find its place in the agenda of the government, given low levels of savings and potential difficulties in financing the high current account deficit. New regulations introduced in Turkey throughout 2013 in order curb the explosive credit growth. Although, regulations seem to be effective in reducing the credit growth so far, it remains an important question in Turkey whether there could be a recovery without an increase in real wages, as the rising cost of credit would lead to a shrinking in the aggregate demand, ultimately affecting the industrial sector and the economy as a whole.

[32] This part can refer to the unequal income distribution in Turkey that will be addressed as a part of the project?

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II. 4. Financialisation and the current account

II.4.1. Introduction

Turkey experienced large current account deficits in the last decade, financed mostly by short-term private capital inflows. The current account deficit as a percentage of GDP reached to a record level of 9.7 percent in 2011 and 7.9 percent by the end of 2013. This deficit is financed mostly through short-term capital inflows. Chronic and large current account deficits render the economy vulnerable to slowdowns in capital inflows, which could create problems in terms of financial stability and economic growth.

Various explanations have been put forward to explain the chronic and large current account deficit of the country. Domestic imbalances such as low domestic savings rates as well as trade imbalances are among the often cited explanations (Rodrik 2009; Van Rijckeghem and Üçer 2009; World Bank 2013). We argue that, in addition to these factors, the widening of the current account deficit can be understood in conjunction with the private foreign capital inflows. That is, there are two dynamics behind the chronic and large current account deficits of Turkey. The first one is the structure of Turkey's trade with the rest of the world and the composition of exports and imports. Turkey imports large amounts of energy items, intermediary and capital goods; while it exports, to a large extent, low-value added products. Export competitiveness is mostly supported by relatively low labor cost. The second one is the impact of capital inflows. Capital inflows have direct and indirect effects on the current account deficit. The direct effect is through the exchange rate. Periods of large capital inflows appreciate the currency and lead to increasing imports while holding back export growth. The indirect effect of capital inflows on the current account deficit works through the domestic dynamics of the economy. Large capital inflows lead to an expansion of domestic credit, increased asset prices, and decreased interest rates. As a result, domestic economic activity increases and, given the high import content of domestic production, this leads to an increase in imports of both consumption goods and investment goods (energy, intermediary goods, and capital goods) imports.

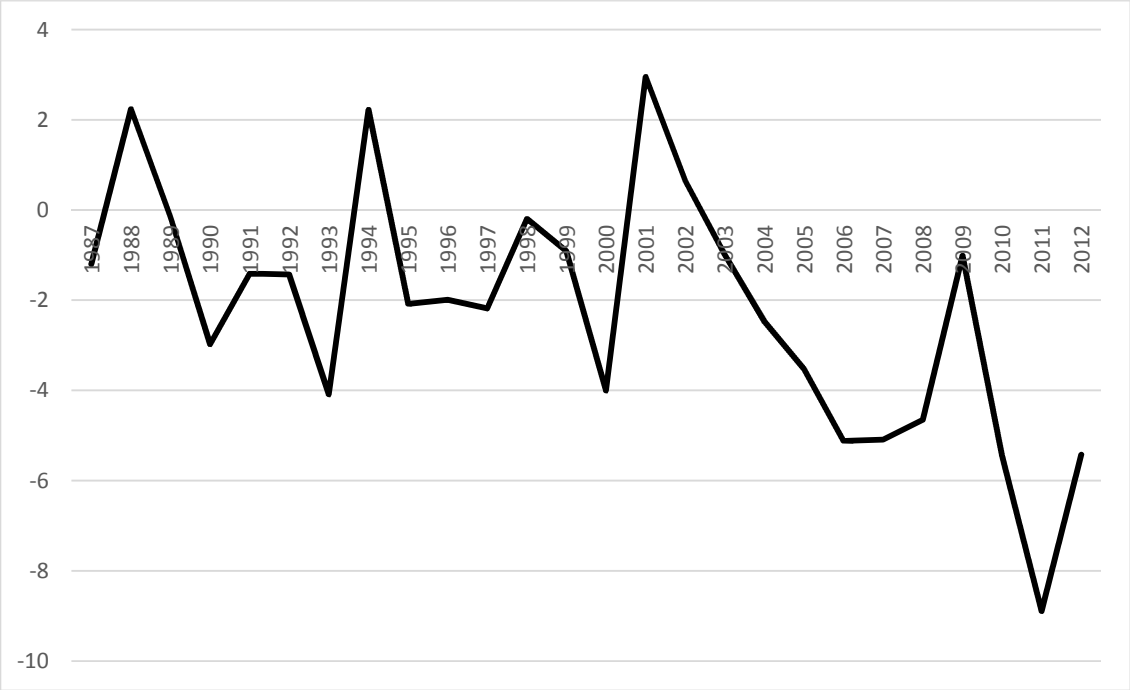
The structure of this subsection is as follows. First, we present detailed balance of payments statistics to depict the evolution of the current and financial accounts. Then, we

discuss the main determinants of the large current account deficit focusing on the structure and composition of Turkey's exports and imports, the investment saving relationship, and the effects of capital inflows. In the final part, we summarize the main findings and discuss their implications for economic and financial vulnerabilities of the Turkish economy.

II.4.2. Historical overview of the balance of payments account

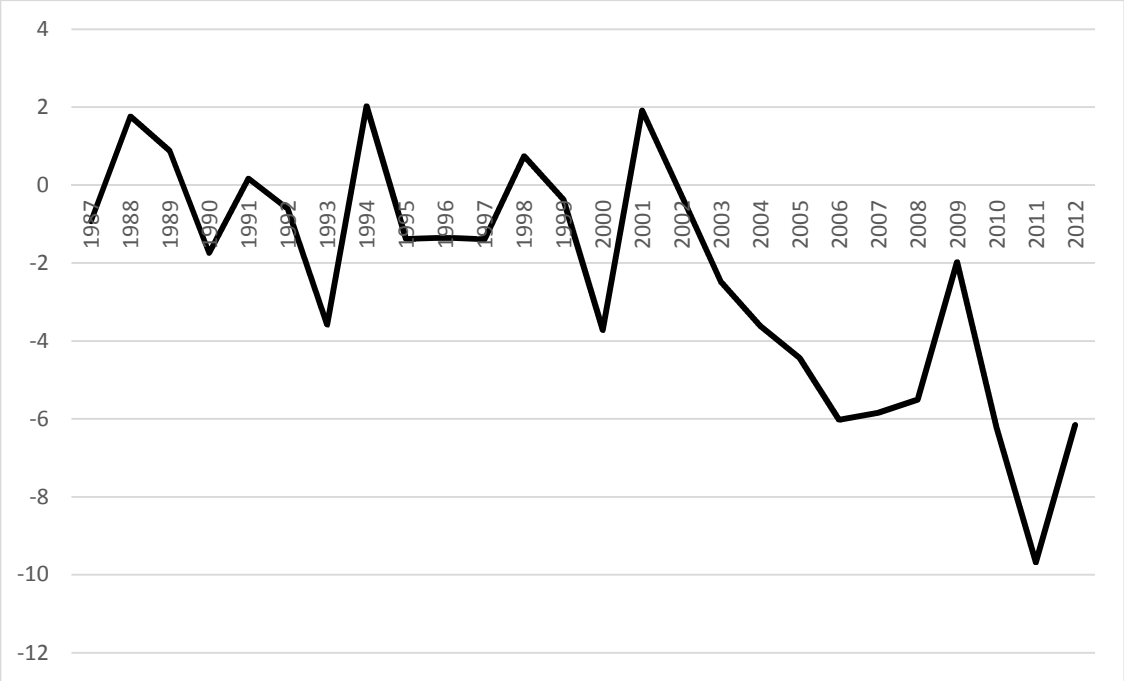
The import substitution industrialization strategy was replaced by an export-oriented growth strategy in the 1980s. This was followed, in 1989, by financial account liberalization, after which Turkey experienced bouts of speculative capital inflows followed by sudden stops and financial crises. We begin our analysis with an empirical overview of the trade and current account balances of Turkey. Figure II.4.1 shows the balance of goods and services as a percentage of GDP and Figure II.4.2 shows the current account balance as a percentage of GDP. We observe that following the financial account liberalization of 1989, the trade account and the current account tended to be in deficit, except around recession years of 1994, 1998 and 2001. The current account deficit began growing after 2002. The recession of 2009 led to a contraction in the current account deficit, however, unlike previous recessions, the current account still remained in the deficit. In 2011, the current account deficit as a percentage of GDP reached the record level of 9.7 percent. Even though it contracted a little bit in the following years, it stood at 7.9 percent of GDP by the end of year 2013.

Figure II.4.1. Balance of goods and services as a percentage of GDP



Source: The Central Bank of the Republic of Turkey

Figure II.4.2. Current account balance as a percentage of GDP

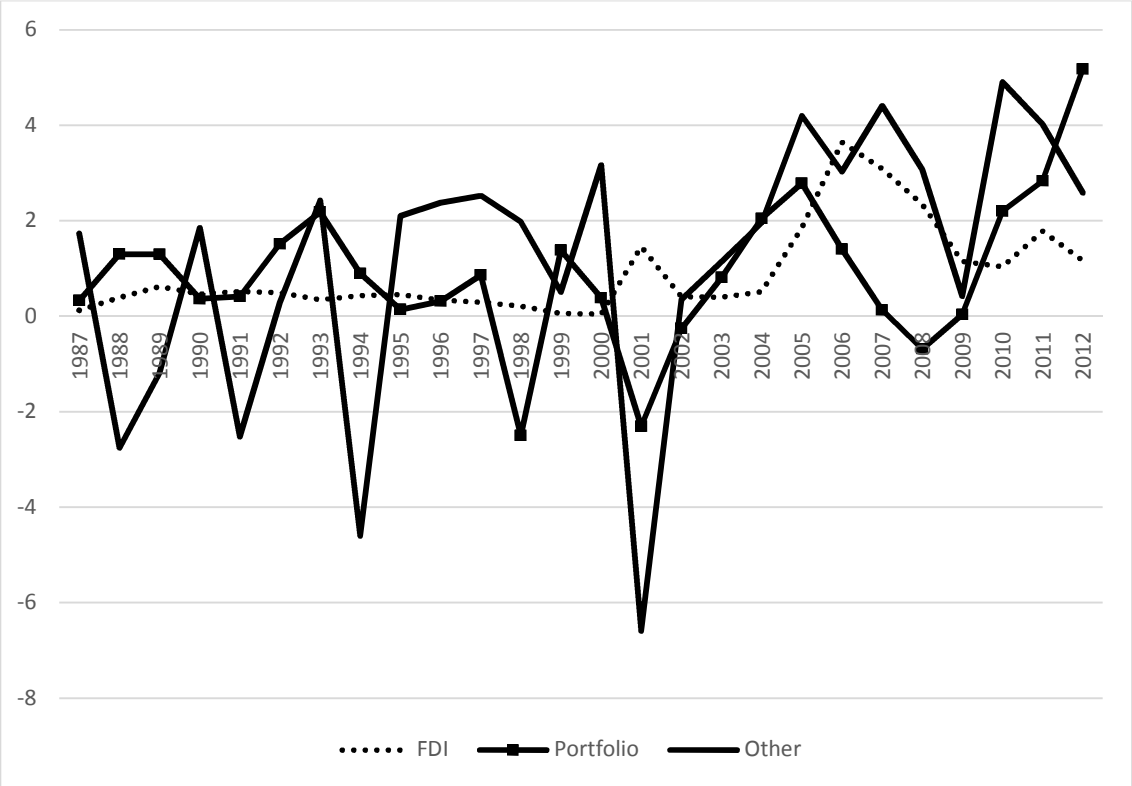


Source: The Central Bank of the Republic of Turkey

Next, we look at the course of capital inflows in the same period. Figure II.4.3 shows (net) capital inflows into the Turkish economy together with its components. We observe that in the post-2002 era there is a significant increase in the capital inflows. Most of the

increase is in short-term capital inflows,[33] while the share of foreign direct investment remains low.

Figure II.4.3. Capital inflows as a percentage of GDP, net.



Source: The Central Bank of the Republic of Turkey

II.4.3. Understanding the current account deficit

In this part, we first discuss the two structural drivers of the current account deficit; trade imbalances and the saving investment relationship. Then we move on to discuss the direct and indirect effects of private capital inflows on the current account.

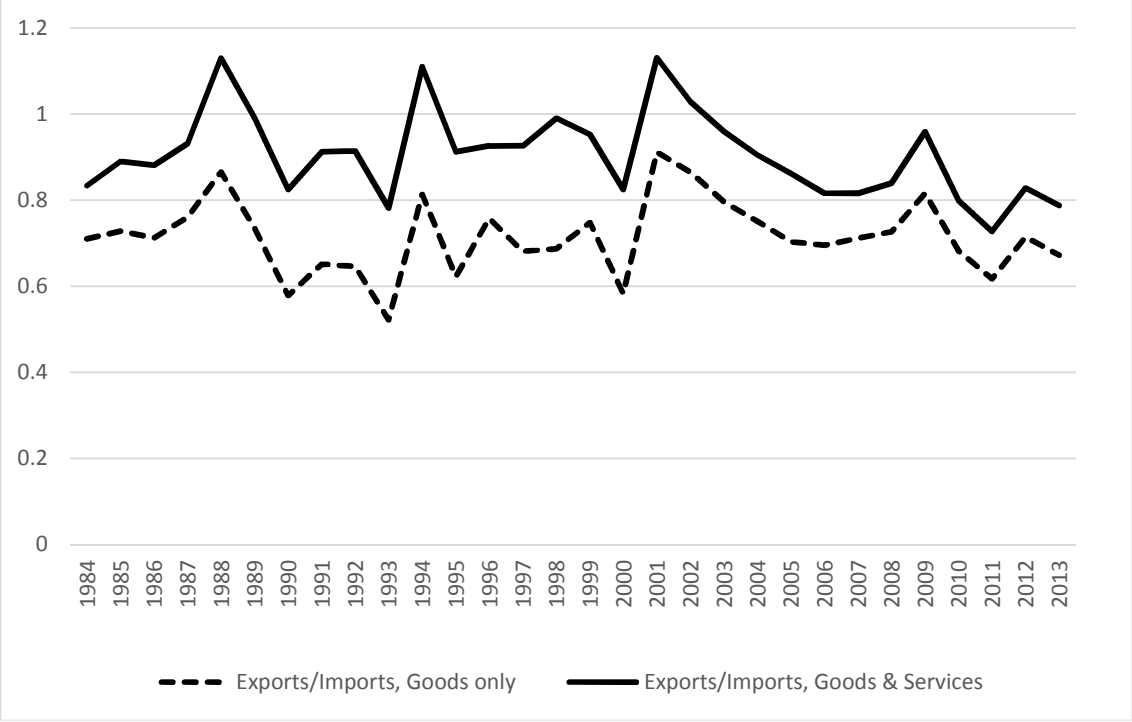
[33] The composition of short-term and long-term capital inflows are not directly visible from these net numbers. However, *portfolio* investments are short-term and *foreign direct investments* are long-term; *other* flows can be both short-term and long-term. And according to Central Bank of Turkey's detailed "Balance of Payments-Yearly Detailed Presentation" the share of short-term capital inflows within "*other*" inflows declined between 2001 and 2007 and started to rise after that. If we consider total short-term flows as the sum of portfolio investments and short-term other inflows, these two items constitute almost 100 percent of gross capital inflows. The details of gross flows can be supplied upon request. (http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+EN/TCMB+EN/Main+Menu/STATISTICS/Balance+of+Payments+and+Related+Statistics)

II.4.3.1 Structural drivers

II.4.3.1.1 Trade imbalances

First of all, the trade deficit shows that the volume of exports is less than the volume of imports. Even though as trade volume increased in the last decades, export-import ratio did not significantly change and there are structural economic reasons for this lack of significant increase. Figure II.4 shows the export-import ratio. The turn towards export-oriented growth strategy in 1980 accompanied by suppressed labor incomes, led this ratio increase until around 1987. However, the trend was reversed soon afterwards. Periods of crisis when the Turkish lira lost value led to increases in this ratio. However, these rises were short-lived.

Figure II.4.4. Export-Import ratio

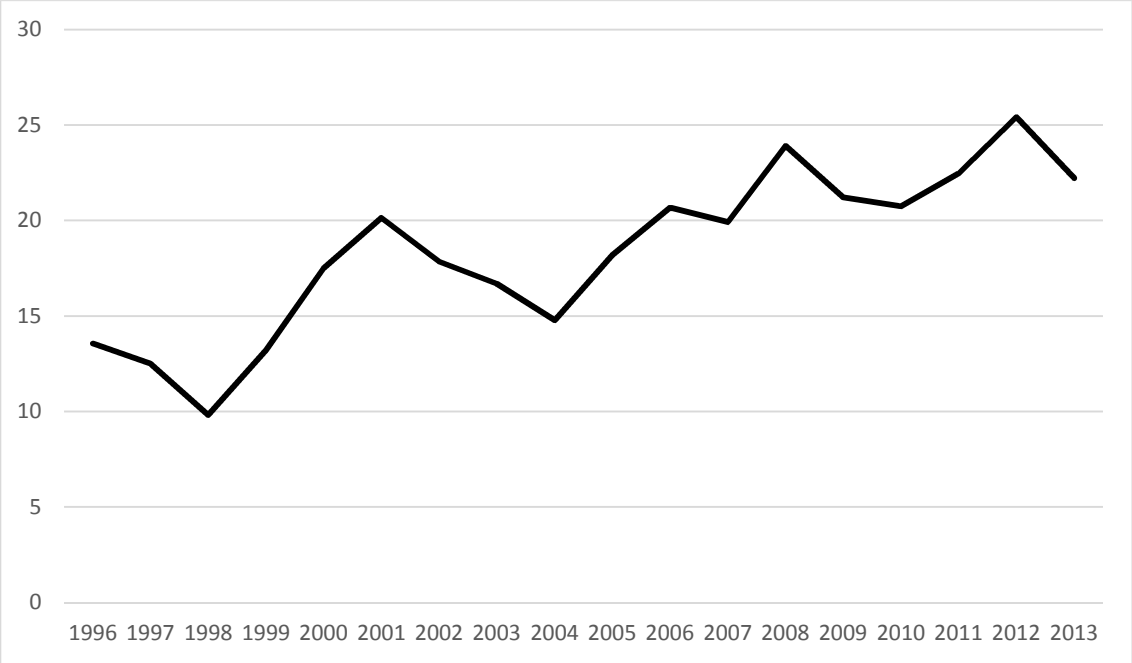


Source: The Central Bank of the Republic of Turkey

Contrary to common fallacy, intermediate and capital goods, not consumption goods, have the largest share in Turkish imports. Energy items such as oil and natural gas also occupy a significant place in the import basket. Figure II.4.5 shows energy item imports as a percentage of total imports and Figure II.4.6 depicts intermediate and capital goods

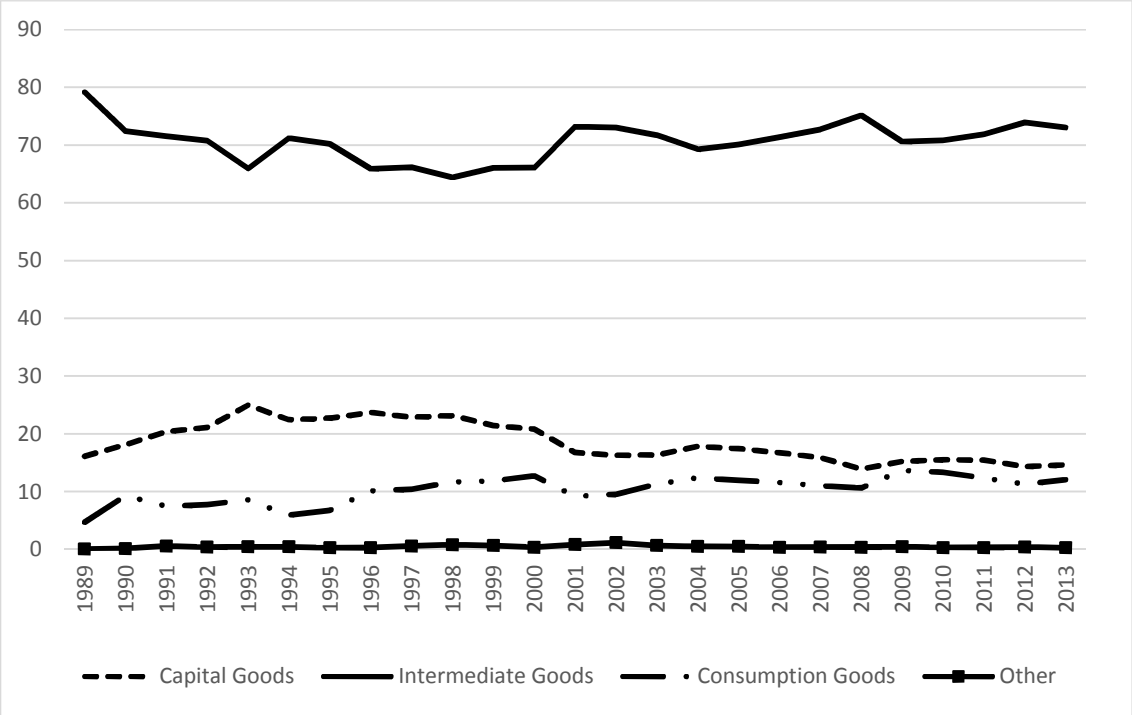
imports as a percentage of total imports. When we look at the components of imports, we observe that the largest share goes to intermediary goods and capital goods. Imports of consumption goods constitute only a little bit more than 10.0 percent of total imports.

Figure II.4.5. Energy imports as a percentage of total imports



Source: Turkish Statistical Institute & the Central Bank of the Republic of Turkey
Note: For energy imports Chapter 27. Mineral fuels, minerals oils and product of their distillation of Turkish Statistical Institute Imports by chapters data is used.

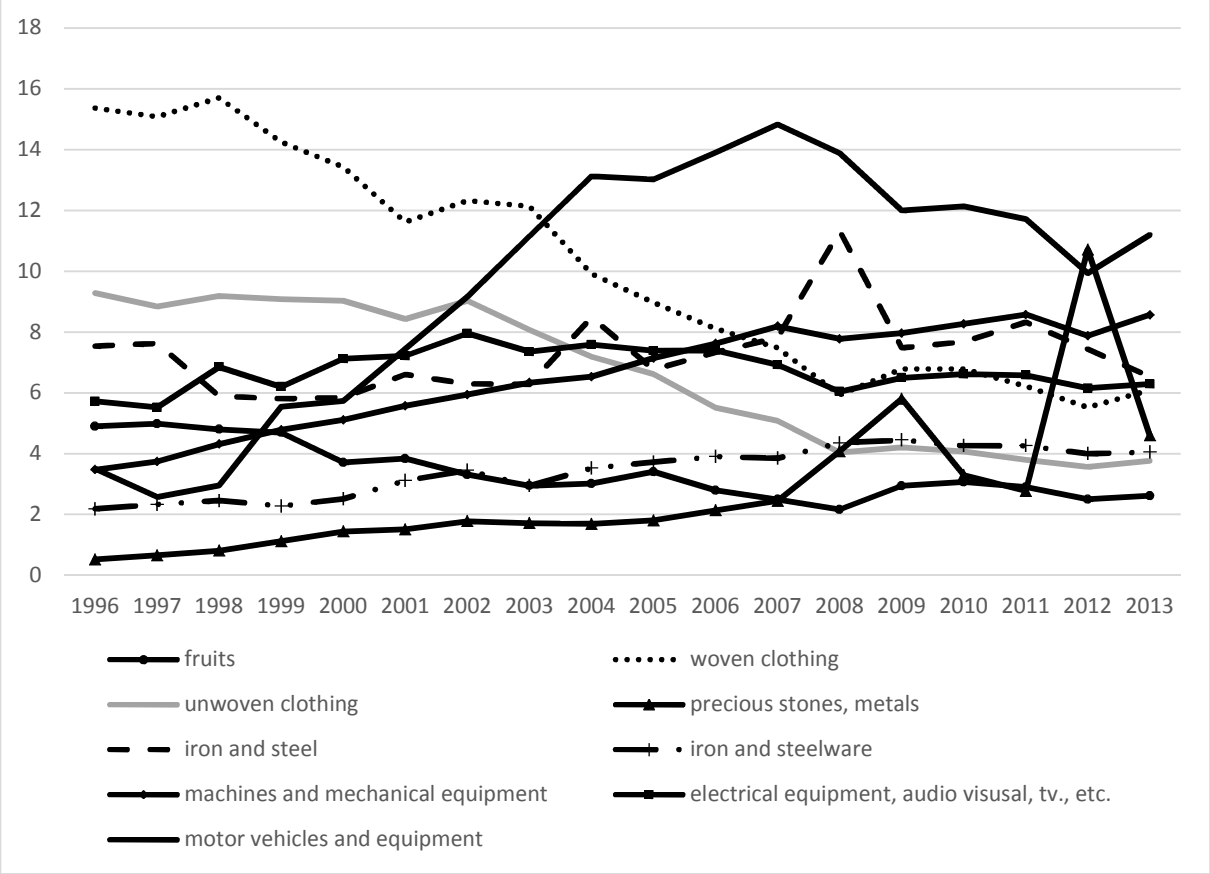
Figure II.4.6: The components of imports



Source: Turkish Statistical Institute

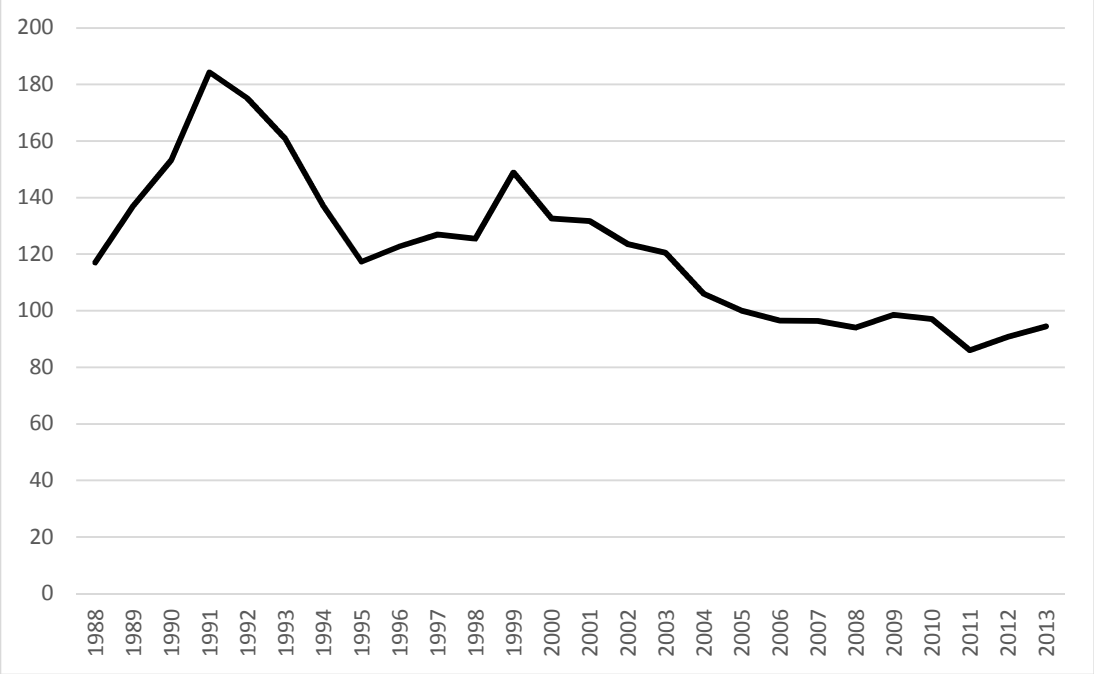
In the export side of the economy, Turkey has managed to update its product variety and adapted itself to changes in developing economies. However, the rank of Turkish economy in the global value-chain production has not changed since the 1950s; Turkey could not improve its rank in international markets, yet it could keep its position (Taymaz *et. al.* 2011). Even though Turkey managed to transform its production base, the export sector specialized in mid-level technology products with relative low market growth potential (Taymaz *et. al.* 2011). One important contributor to this trend has been the squeezing of labor as can be observed from real unit labor cost figures.

Figure II.4.7. Main export items



Source: Turkish Statistical Institute

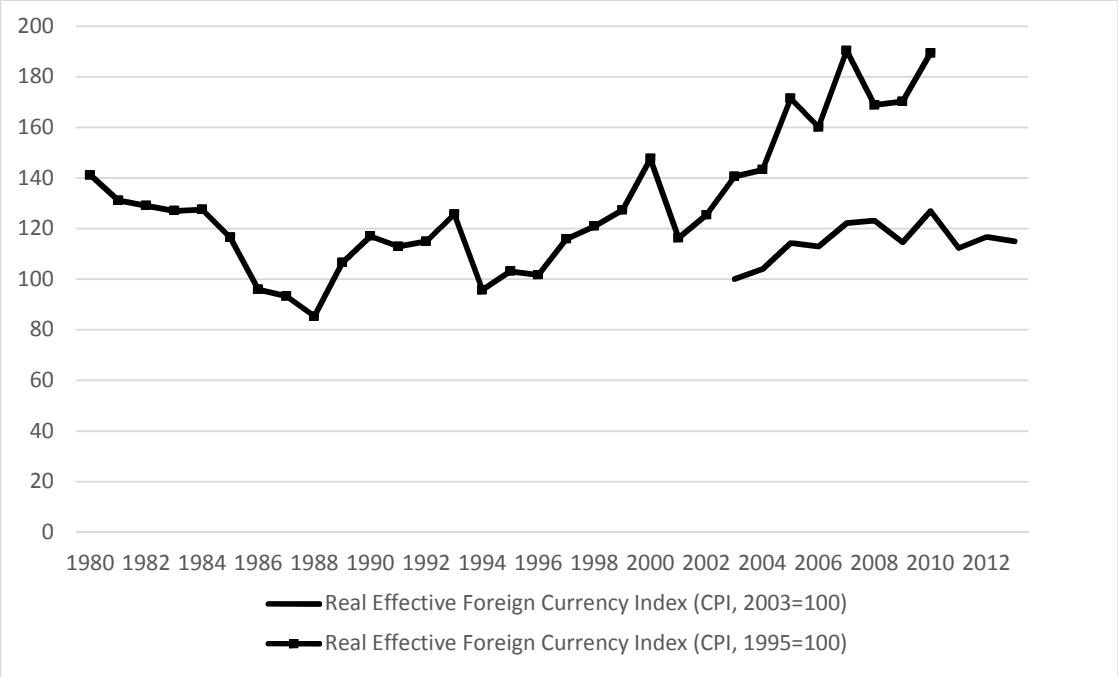
Figure II.4.8. Unit labor cost



Source: Annual Macro-Economic Database (AMECO), European Commission

Turkish economy's competitiveness in international markets depended on labor costs and currency depreciation in these years; however, such improvements have always been short-lived. Figure II.4.9 shows the evolution of the real exchange rate in these years.

Figure II.4.9. Real effective exchange rate



Source: The Central Bank of the Republic of Turkey

II.4.3.1.2 Savings and investment

According to basic accounting principles, the sum of all items in balance of payments (BOP) must be equal to zero. If we assume that net errors and omissions and change in reserves are zero, current account and financial (and capital) accounts cancel each other. In a current account deficit (surplus) economy, financial account must be in surplus (deficit). As these two main items of the BOP have the same value with opposite signs, the line of causation is disputable. Mainstream views argue that current account deficit leads to financial account surplus. Even though this view has validity to a certain degree, the relationship between these two items is more complicated if we consider the role of capital flows and their effect on exchange rates as well as domestic dynamics.

In the case of Turkey, it is often claimed that low savings rate is the main reason for rising current account deficits (e.g. Rodrik 2009; Van Rijckeghem and Üçer 2009; and World Bank 2013). This issue is not only raised for the Turkish economy. For example, Bernanke's famous "savings glut" argument is built on similar ideas. According to this view, economies with less than sufficient saving levels need to import capital from the rest of the world, and thus, the remedy of current account deficits is straightforward: spending less and saving more.

However, there are some problems with this way of thinking. First of all, current account balance is not a homogenous unit, it is the monetary expression of economic transactions. As shown in Figure II.4 and II.5, most of Turkish imports are intermediate products and spending less cannot automatically lead to domestic production of these products. With a reduction in spending, an improvement in current account deficit can only be achieved at the expense of economic recession as the former crises had shown. Similarly, on the export side, spending less cannot automatically help Turkish economy to produce high-value added products that are competitive in international markets. Second, according to the IMF (2013), gross national saving is calculated as "gross disposable income less final consumption expenditure…" and for "many countries, the estimates of national saving are built up from national accounts data on gross domestic investment and

from balance of payments-based data on net foreign investment." Thus, aggregate savings data are not independent of aggregate expenditure and spending data, and savings are a balancing item or merely a residual. Finally, according to the *System of National Accounts of 1993* [SNA 1993], which sets international guidelines for data collection, each economic unit whether it is a firm, household sector or a national economy can always spend more or less than its income. In a modern economy, these economic units can increase their assets (liabilities) if they spend less (more); and saving is not a constraint unlike "a corn economy." Because in a modern economy and its accounting system saving is not a *stock* but a *flow* variable, this flow variable can be positive as well as negative.[34]

II.4.3.2 Role of capital inflows

II.4.3.2.1 Currency appreciation

The structure and composition of exports and imports can explain why Turkish economy has experienced chronic current account deficits for a long time, but to explain the growing deficit in the 2000s and 2010s we need a second factor. This second factor is the effect of capital movements. Capital inflows can lead to rising current account deficits by making the local currency appreciate as well as by stimulating domestic economic activity which then leads to increased imports. If the opposite was true, that is if current account deficit was the cause of capital account inflows, then rising deficits should go with depreciating local currency and/or rising interest rates. Yet, Turkish economy experienced both currency appreciation and interest rates falls in this era of widening current account deficits (as shown in Figure II.4.9 above and Figure II.4.10 below).

These developments in Turkish economy are related with the changes in the global economy. According to Boratav (2010: 24) as U.S. current account deficits started to grow in the late 1990s, many developing economies benefited from rising current account

[34] Also, this view is, either explicitly or implicitly, based on *the loanable funds theory*. We will not go into the details of this theory and its shortfalls but interested readers can refer to Bibow (2000). World Economic Outlook 2014 of the IMF devotes a chapter to this issue, and with a causality test it concludes "...even though the causality between saving and growth runs in both directions, the observed positive correlation between growth and saving must be driven by the effects of changes in growth on saving rates, not the other way around" (IMF, 2014: 107).

surpluses. However, a small group of developing countries took a different path and benefited from rapid growth through foreign capital inflows in the 2000s; these economies were Eastern European economies, Turkey, South Africa and some of Latin American economies. In this respect, according to Boratav (2010: 25), financial liberalization changed the causality between current account deficits and capital flows. Before liberalization, economic growth was responsible for rise in imports and current account deficits, and thus need for foreign capital inflows through foreign debt. However, in the era of financial liberalization, capital flows become *autonomous* from current account as these flows are determined by international financial system. Thus, a surge in foreign capital boosts domestic demand and economic growth (of excess capacity), and these developments give way to rise in imports and current account deficits (Boratav, 2010: 25).

However, once economic growth becomes possible through capital inflows, it also increases imports and the size of current account deficits. As most of the capital inflows to Turkish economy have been in terms of foreign debt, a chain-reaction emerges out of these developments: greater capital inflows will be needed for further economic growth in the following years (BSB, 2008: 131-132). Capital inflows in terms of foreign debt stimulates economic growth but it also creates further need for foreign capital for debt service and further economic growth. Thus, the fate of Turkish economy, similar to other fragile economies, is directly linked to global interest rates and credit conditions. A stress in these areas can send shockwaves to Turkish economy as experienced in 2009 and briefly in the summer of 2013. The main fragility here that is, Turkish economy not only needs uninterrupted capital inflows but also greater amounts compared to previous years for economic growth (BSB, 2008: 132).

As a result, after 2008 Turkish economy, like many other developing and emerging economies, benefited from a wave of capital inflows caused by the monetary easing at the center, high global liquidity and carry trade activities. These inflows deteriorated the Turkish economy's competitiveness in international markets through currency appreciations. What made these developments worse was the reaction of policy-makers; as the local currency appreciated the local prices of imported inputs declined and inflationary

pressures eased. In this macroeconomic environment policy-makers did not see a reason to worry about the rising current account deficits and a potential reversal of capital flows in the future.

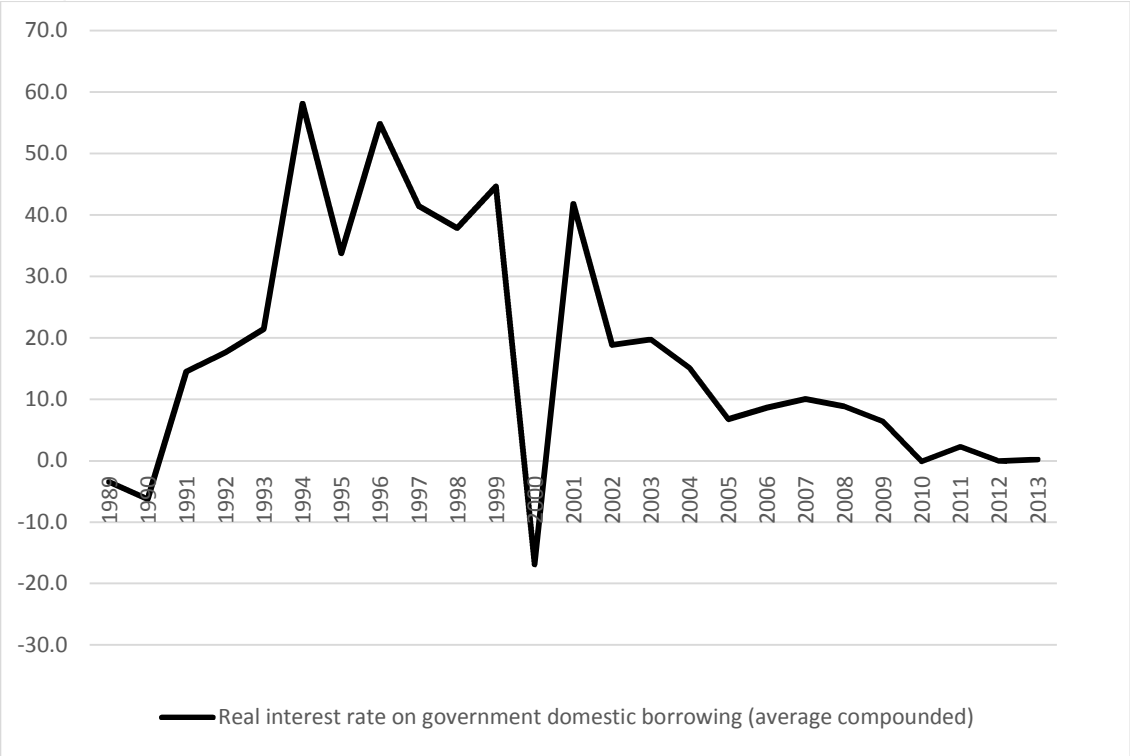
II.4.3.2.2 Domestic expansion

Now we turn our attention to the impact of capital flows on the domestic dynamics of the Turkish economy. Capital inflows have the following impacts on the domestic dynamics. First, capital inflows lead to credit expansion which increases demand,[35] consumption and imports (and hence contribute to the current account deficit). Second, capital inflows lead to appreciation of assets, especially the stock market index. Third, periods of surges in capital inflows are associated with appreciating currency and this by making imported capital goods cheaper contributes to increased investment. As a result domestic economic activity increases. Moreover, lower interest rates also gave a further stimulus to overall economy.

For the Turkish economy, Figure II.4.10 shows the real interest rates calculated as nominal interest rates minus the rate of inflation. The real interest rates declined, thanks to global liquidity and increasing capital inflows, especially in the 2000s.

[35] According to endogenous theory of money, the banking system can expand credit endogenously and thus it is not constrained by the level of deposits. However, once an individual bank makes a new loan it needs to find reserves and if the central bank is not accommodating, the interest cost of this extra reserve becomes important for the individual bank. In accordance with the stand-by agreement of 2002 with the IMF, the Central Bank of Turkey did *not increase* its net domestic assets since 2002, which simply means that it did not accommodate commercial banks. Thus, banks had to look elsewhere for reserve needs and as interest rates in foreign markets were significantly lower than domestic rates, these markets become a cheaper source for reserve needs. In sum, foreign investors' willingness to lend to domestic banks directly affected domestic banks willingness to expand credit.

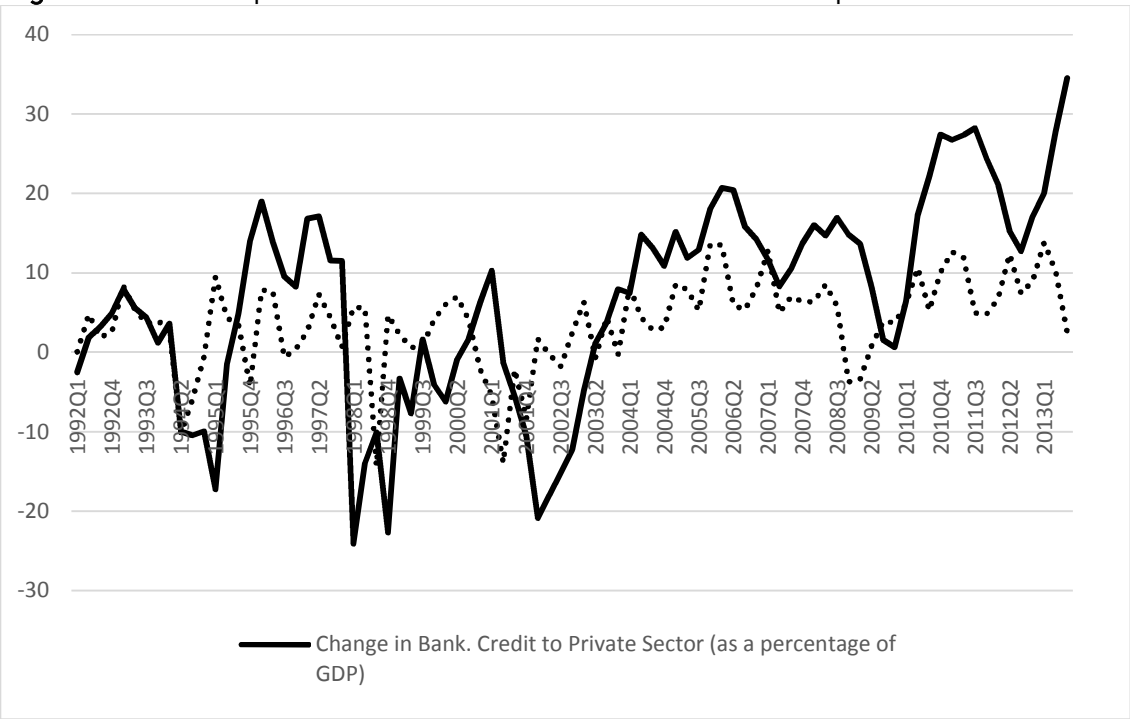
Figure II.4.10. Real interest rates on government domestic borrowing (average compounded)



Source: International Financial Statistics, IMF and Economic and Social Indicators, Ministry of Development, Republic of Turkey

Capital inflows could lead to expansions in the bank credit to private sector through two channels. First, capital inflows lead to appreciation of asset values, which increases the net worth in the economy that could be used as collateral and hence leads to increased borrowing. Second, a portion of capital inflows could directly go into the banking system and then get converted into credit. Akyüz (2012), for example, notes that surges in capital flows to developing and emerging economies could lead to credit and asset bubbles. Credit expansion can occur when domestic banks borrow from abroad and use these funds for domestic lending. In this case, full sterilization of currency market interventions may not be possible and capital inflows lower long-term interest rates (p. 113). While Akyüz (2012) stresses the possibility of a link between capital movements and asset markets, when credit expansion is also involved, a reversal of capital flows has the potential to create a credit crunch as well as asset deflation which might have significant macroeconomic consequences (pp. 113-4). Orhangazi (2014) finds that surges in private capital inflows are associated with periods of rapid credit expansion.

Figure II.4.11. Capital inflows and domestic bank credit to private sector

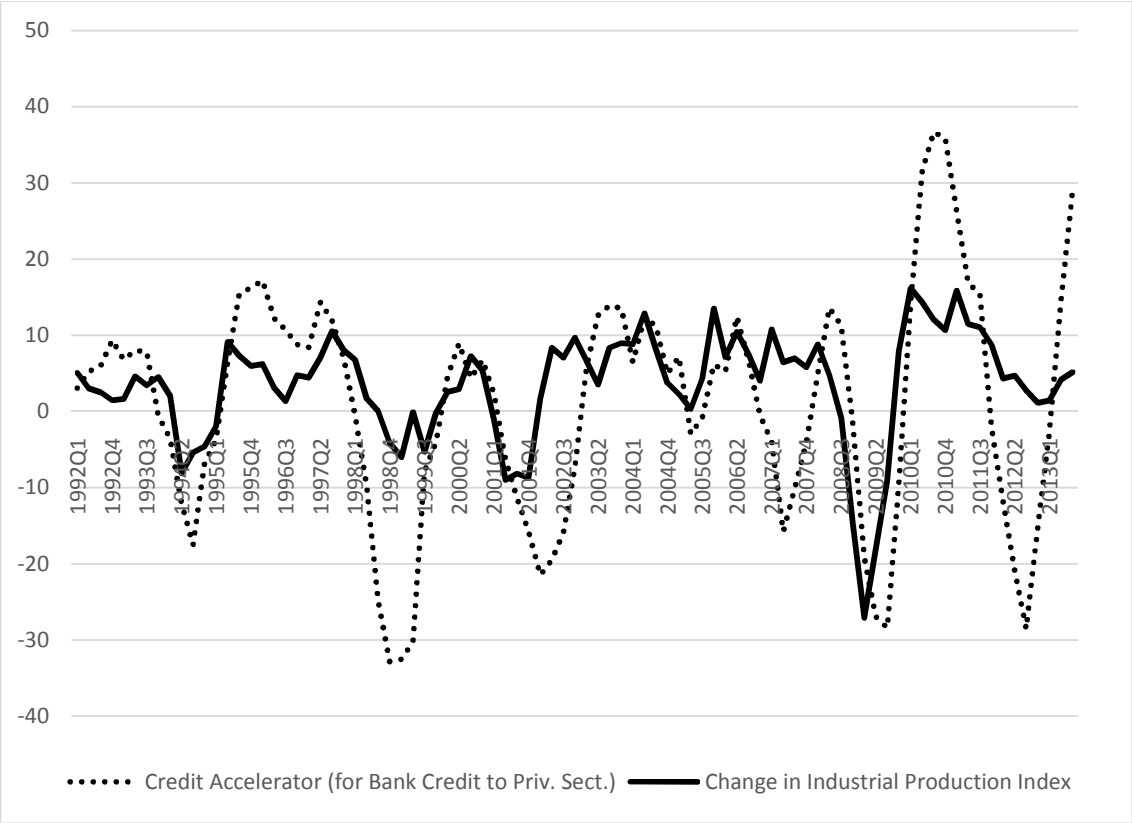


Source: Estimated from the Central Bank of the Republic of Turkey

At the same time, a change in new bank credit as a percentage of GDP (credit acceleration)[36] to private sector is closely correlated with the industrial production index. While capital flows contribute to declining interest rates and credit expansion, these in turn induce consumption and investment. Declining interest rates enables firms to borrow more. If we look at the evolution of capital inflows and industrial production index, we observe a similar picture. Furthermore, capital inflows lead to the appreciation of domestic currency which in turn leads to the import of investment goods and intermediary goods used in production.

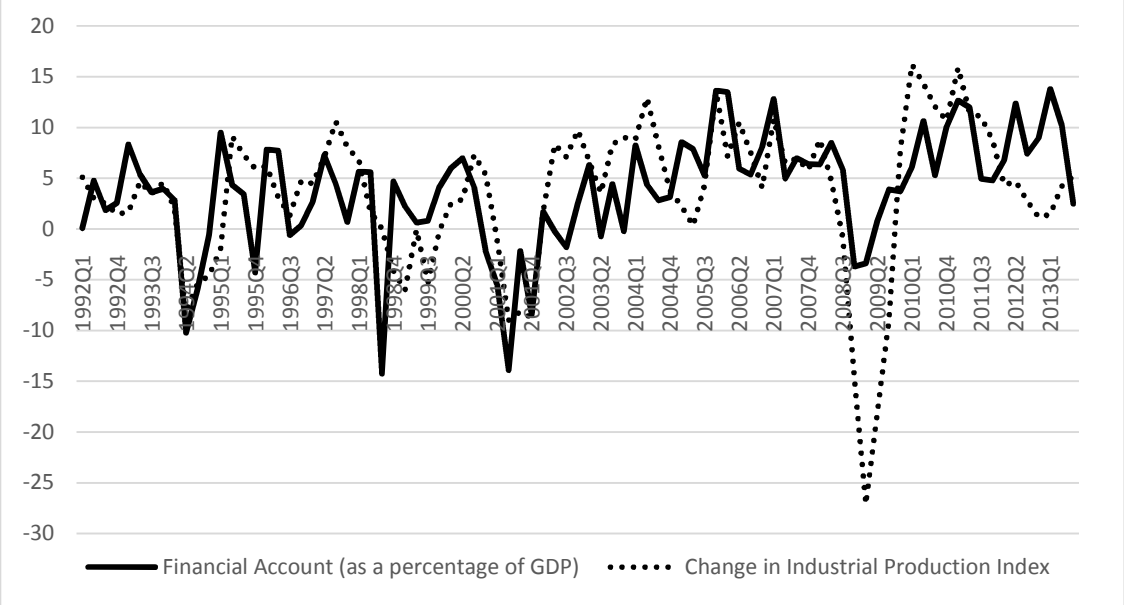
[36] Credit acceleration was first defined in Biggs and Mayer (2010), and also in Biggs, Mayer and Pick (2010) as a credit impulse. According to this logic, the debt stock is irrelevant to explain aggregate expenditure and GDP as Bernanke and Gertler (1995) had mentioned. For this approach, a change in new debt (as a percentage of GDP) -or the second derivative of credit stock- is more useful to explain changes in expenditure. The term, credit accelerator is used by Keen (2011) in a similar fashion; however, Keen also proposes that credit acceleration is useful to explain changes in expenditures as well as changes in asset prices.

Figure II.4.12. Credit acceleration of private sector and change in industrial production index



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

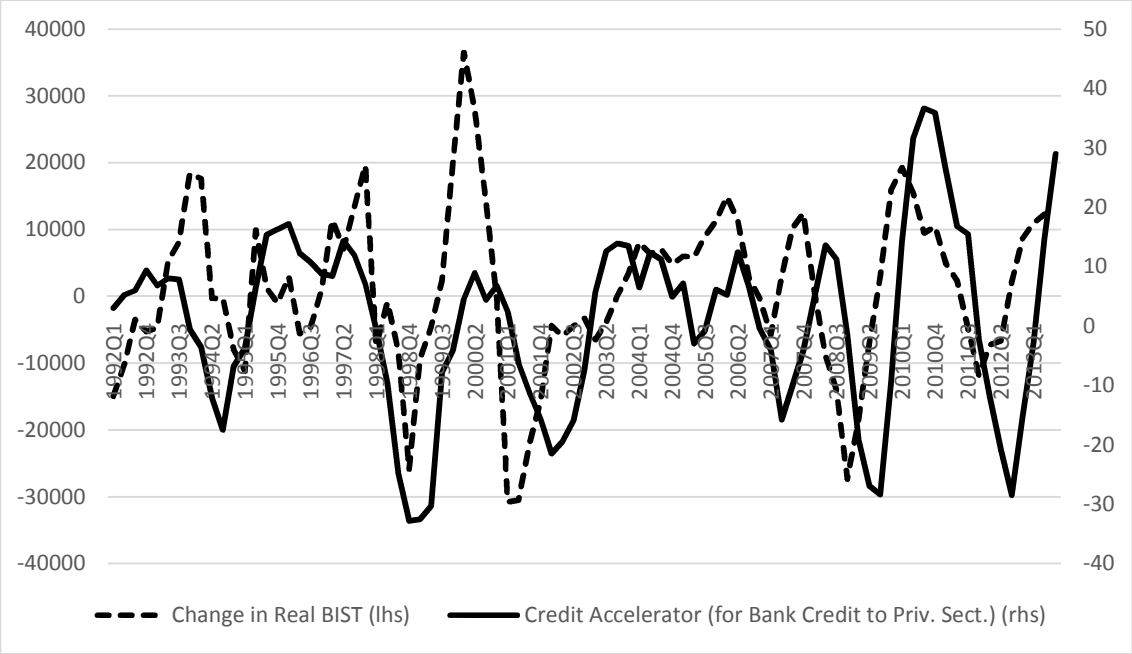
II.4.13. Capital inflows and industrial production index



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

Another impact of capital inflows takes place is through asset prices. An increase in capital inflows could lead to appreciation of asset values. Increases in asset prices lead to decreased leverage ratios, allowing firms and households to increase their borrowing. For example, Figure II.4.14 shows that credit expansion was accompanied by a rise in the stock market index.

Figure II.4.14. Credit acceleration of private sector and change in BIST100



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

In short, capital flows contribute to credit expansion, asset price increases, appreciation of local currencies, and declines in interest rates. These factors contribute to on the one hand an increase in import volume and on the other hand an increase in domestic economic activity.

II.4.4. Vulnerabilities of the Turkish economy

The discussion so far focused on the evolution of the current and financial accounts of Turkey within the last couple of decades and the determinants of the large current account deficits. After presenting detailed balance of payments statistics, we made the argument that the growing current account deficit of the Turkish economy can be explained

mainly by two factors. The first factor is the structure of Turkey's trade with other countries. Turkey imports large amounts of energy items, intermediary and capital goods; while it exports, to a large extent, low-value added products. Exports competitiveness is mostly supported by relatively low labor cost. Private foreign capital inflows have a direct and an indirect effect on the current account deficit. The direct effect of capital inflows is through currency appreciation. The indirect effect is through changes in the domestic economic activity. Capital inflows affect domestic economic activity by having a positive impact on domestic credit expansion, by leading to asset price increases and especially lately by lowering domestic interest rates. Increased economic activity in turn contributes to increases in imports of both consumption and investment goods. Hence, capital inflows have an indirect impact on the current account deficit as well.

The latest wave of capital flows into "developing and emerging economies" since 2009 led to currency appreciations, growing current account deficits, credit expansions and asset bubbles. As Akyüz (2013) has noted, this boom "has been creating or adding to macroeconomic imbalances and financial fragility in several recipient countries in large part because they have been shy in applying brakes on them" (p. 89). Our analysis suggests that Turkey is a case in point. While in the last decade it gained praise for its strong growth performance, more recently it began to be considered among the "fragile five," together with Brazil, India, Indonesia, and South Africa. The biggest concern is the large current account deficit and the short-term and volatile nature of capital inflows. The boom in the capital inflows after 2008 is clear. Between 2002 and 2013 Turkey received a total of 467 billion dollars capital inflows. As capital inflows reached record levels, total bank credit to the private sector as a percentage of GDP increased from around 10.0 percent in 2002 to more than 50.0 percent by the end of 2013. Expansion of credit was one of the main drivers of economic performance in this era. However, starting right after the Fed's announcement in May 2013, the Turkish lira began losing its value. The lira lost about 30.0 percent of its value, forcing the Central Bank, which had been resistant to hikes in interest rates, to sharply increase interest rates at midnight after an emergency meeting on January 28, 2014.

This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

This has created a situation where the future of the economy is directly tied to what happens to the capital inflows. While the Central Bank's sharp interest rate hike stopped the free fall of the lira, fragilities have already built up in the economy. Foreign investors have about $54 billion in shares and about $50 billion in government bonds. Unless private capital restarts flowing into the Turkish economy in massive amounts and appreciates the currency, here is what the country can expect in 2015: First, the depreciation of the lira will create serious problems for the firms that have borrowed in foreign currencies. Short-term external debt stock is close to $130 billion. Of this, $91 billion belongs to the banking sector and $35 billion to the nonfinancial corporate sector. Worse yet, the difference between the nonfinancial corporate sector's foreign currency liabilities and assets reached $165 billion by the end of October 2013. This is likely to lead to, at the very least, payment problems; and most probably to many bankruptcies—especially for firms that have borrowed in foreign currency but have earnings predominantly in liras. Second, banks have begun tightening credit conditions. A slowdown in credit due to this and to higher interest rates will directly reduce demand and is likely to hit the booming construction and housing sectors. Some of the banks might also get hit by the interest rate hike due to duration mismatches. Third, the depreciation of the lira will have pass-through effects and lead to an increase in the overall price level, especially through its effect on energy prices. The Central Bank has already revised its inflation expectations upwards. Fourth, the depreciation is unlikely to create a significant increase in exports as Turkish exports include a high-degree of imported content.

III. The Impacts of the Global Crisis on the Turkish Economy

III.1. Introduction

The liberalization of the domestic economy and balance of payment transactions began after the 1980s in Turkey. In parallel to these liberalization attempts, the Turkish economy has had many fluctuations since the 1980s. The frequency and magnitude of the fluctuations in the Turkish real GDP growth have been higher relative to the previous period since the 1980s. The performance of the Turkish economy have become more and more dependent on the movements of international finance as in the case of many developing countries. The periods of high financial inflows have coincided with high credit and high overall economic growth. Whenever the Turkish economy experienced reversals in its financial account, the credit boom and economic growth faded away. Indeed, just after 1990 the Turkish economy experienced four big crises (Figure III.1) which were mainly related to reversals of financial flows.[37] The last crisis hitting the Turkish economy began in the third quarter of 2008 and inflicted a heavy toll on the economy till the last quarter of 2009. The crisis mainly stemmed from the shock waves of the global crisis originated in the US.

This section focuses on the impacts of the recent global crisis on the Turkish economy and the policy measures taken in response to the crisis. Turkish economy was adversely affected by the crisis through mainly three channels, namely expectations channel, trade channel and financial channel. The distinctive characteristic of the crisis was a severe export shock which can account for an important part of the decline in production in Turkey. Beside this, a significant sudden stop in financial flows worsened the credit conditions in the economy. As a result, the Turkish economy witnessed one of its worst economic down-turns after the Second World War. In fact, the Turkish growth performance was one of the worsts among developing countries. However, as opposed to previous crises, the financial markets in Turkey and many other developing countries did not experience a collapse. We argue that this is mainly related to the small magnitude and short duration of the financial shocks hitting Turkey and other developing countries relative to the ones in the previous decades. In this sense, the Turkish economy might not have

[37] The years of the crises are determined by annual negative real GDP growth rates.

been fully tested during the last global crisis. How the economy will behave in case of a larger financial shock is still unknown.

The outline of the section is as follows. The first part gives a brief account of important macroeconomic developments in the Turkish economy after the 1980s and during the recent crisis. The second part discusses the channels through which the recent global crisis has hit the Turkish economy. In order to have a more complete picture, the second part investigates financial flow movements in a selected set of other developing countries as well. The third part discusses fiscal and monetary policies implemented by the government and the Turkish Central Bank in response to the crisis. The last part concludes.

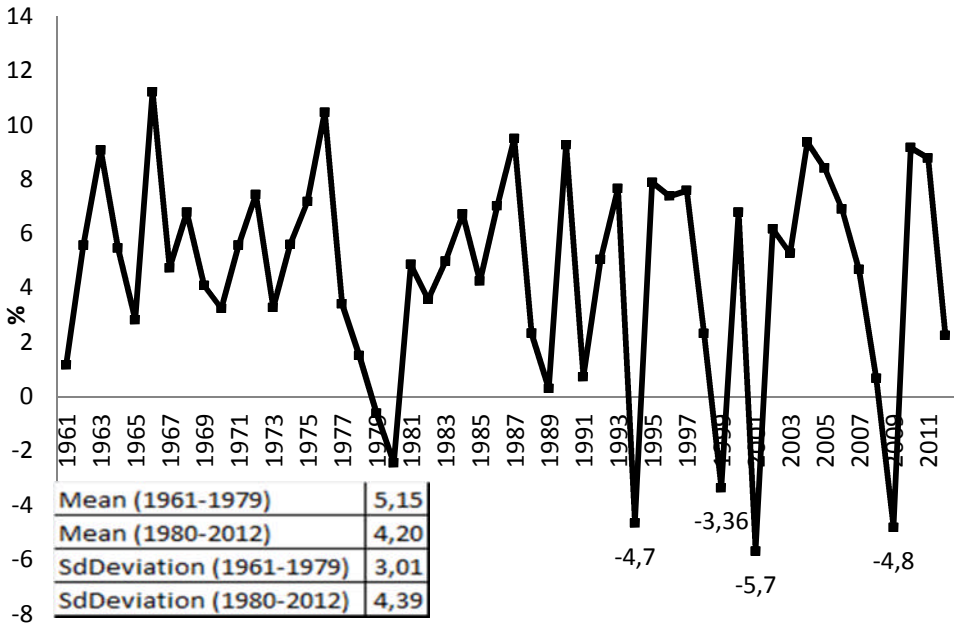
III.2. Turkish Economy before and during the Global Crisis[38]

As in the case of many developing countries, the growth rate became erratic and low in the Turkish economy after 1980 relative to the period 1961-79. The average growth rate was 5.2 percent in the period of 1961-79 whereas this ratio declined to 4.2 percent in the succeeding period. Furthermore, as an indication of a more erratic growth performance, the standard deviation of the growth increased from 3.0 percent to 4.4 percent after the 1980s. In this vein, as shown in Figure III.1, the Turkish economy has experienced several crises since the 1980s. The first major crisis which hit the Turkish economy after the 1980s was the crisis of 1994. An unsustainable budget deficit with very high interest rates and very high inflation led to a sudden financial reversal resulting in the collapse of the Lira. The contagion impacts of the Asian and the Russian crises affected the Turkish economy adversely in 1999 as well. The devastating earthquake of August 1999 worsened the situation. As a result, Turkish GDP fell by 3.4 percent in that year. After this crisis, the Turkish coalition government started implementing a structural reform package under the auspices of the IMF. The program was mainly based on an exchange rate peg policy which

[38] Since the evolution of several important macroeconomic developments in Turkey after the 1980s was extensively discussed in the previous FESSUD country report called "*Perspective on Financial System in the EU: Country Report on Turkey,"* here, we will briefly summarize important developments in the Turkish economy especially by focusing on the crises hitting the economy.

was supposed to curb very high inflation by reducing tradable goods prices. Although the exchange rate peg policy reduced inflation rate from high rates to moderate rates, it also caused the over appreciation of the Turkish Lira vis-à-vis foreign currencies which contributed to the widening of the Turkish current account deficit. As a result of sudden reversals of financial flows, the pressure on the exchange rate increased significantly in the late 2000 and the beginning of 2001. The Turkish Central Bank's foreign exchange rate interventions and high interest rate policy did not produce desirable outcomes. After losing almost half of its reserves, the bank had to leave the currency to float in February 2001. The balance sheets of fragile banking system deteriorated adversely due to high interest rates and high depreciation of the currency. Many banks went bankrupt and the Turkish economy experienced its worst downturn in its history after the Second World War.

Figure III.1: Turkish Annual real GDP Growth



Source: World Development Indicators

After the crisis of 2001, a new program, again under the auspices of the IMF, was put into practice. This new program included many structural changes in financial markets and the governance of the economy. In this sense, privatization attempts were accelerated, new financial regulatory bodies were introduced and some regulations in the banking sector were tightened. Meanwhile, the independence of the Central Bank was granted. After 2002,

the Bank began implementing an implicit inflationary targeting regime which became an explicit one in 2006. In this monetary policy regime, short term interest rates became the main policy instrument accompanied by a relatively flexible exchange rate system.[39]

In the international arena, the change in institutional structure of advanced financial markets together with expansionary monetary policies conducted in advanced countries led to an increase in the credit generation capacity of financial institutions and a decrease in interest rates in these countries. This attracted global funds into developing countries such as Turkey which had higher returns (Mohan and Kapur, 2009). Along with the "global great moderation", Turkish economy did not experience a large financial account shock in 2002-8. In fact, the Turkish economy benefited from financial flows through both their positive impacts on inflation and credit growth. On the one hand, the bonanza of financial flows caused an appreciation in TL which worked as an implicit exchange rate peg (Benlialper ve Cömert 2013). On the other hand, economic growth was boosted by cheap credit borrowed by banks and non-financial firms. The acceleration of privatization led to higher level of foreign direct investments too. As a result of positive domestic and very benign international conditions, although many important economic and social problems such as high unemployment rate could not be addressed, the Turkish economy experienced its "great moderation" from 2002-8 with high growth and low inflation.

However, the global financial crisis ended this honeymoon. Turkish economy fell into a significant recession. The capacity utilization rate in manufacturing sector declined from 80 percent to about 60 percent (see Figure III.A1 in appendix).[40] Overall, the Turkish economic growth significantly deteriorated and the economy experienced one of its worst recessions after the Second World War. As will be elaborated below, in line with deterioration in expectations, investment expenditures started to decline as early as the second quarter of 2008 (Table III.1). Likewise, the fall in consumption expenditures began in the third quarter of 2008. Negative export growth was first observed in the third quarter in

[39] The Turkish Central Bank has frequently intervened in foreign exchange markets. Indeed, as pointed out in the next subsections, the Bank seems to have tolerated the appreciation of the currency whereas it tried to decrease the amount of depreciation in order to use exchange rate as an implicit anchor during this period.
[40] Although the quarterly capacity utilization in manufacturing sector data set shows some seasonality, it does not affect the overall conclusion much.

the same year as well. As a result of massive decline in consumption expenditures, investment and exports, imports expenditures were adversely affected. The government expenditure figures demonstrate that the Turkish government was hesitant about its responses to the crisis. Overall, as will be discussed in the third subsection, government expenditures were not used effectively to insulate the economy against the impacts of the global crisis.[41]

Although the crisis began in advanced economies, it quickly spread all over the world and caused negative GDP growth and significant increases in unemployment rate in Turkey and in many other developing countries. The Turkish GDP growth began to decline in the third quarter in 2008. The fall in GDP continued until the third quarter of 2009. The Turkish economy experienced 0.7 percent annual real GDP growth in 2008, it shrank by -4.8 percent in 2009. Indeed, the Turkish economic performance was one of the worsts in the world in this period (see Table III.2). Excluding very small countries from the sample, Turkish economic performance was just better than a few ex-eastern bloc countries and raw material exporters. The negative growth performance of the economy deteriorated the already weakened employment conditions further. In this sense, unemployment rate rose to record levels of 15.0 percent in April 2009. Annual unemployment rate became 14.0 percent in 2009.

[41] For example, while the advanced countries decided to implement huge stimulation packages in the second quarter of 2008, the Turkish government cut its expenditures by about 3.5 percent.

Table III.1. Growth[42] of Gross Domestic Products and its Components (%)

	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1
GDP	7.01	2.63	0.86	-6.97	-14.74	-7.77	-2.77	5.86	12.59
Consumption Expenditure of Resident Households									
Growth	5.72	0.62	-0.35	-6.67	-10.23	-1.75	-1.91	4.98	7.92
Share in GDP**	71.6	68.8	65.7	69.9	75.3	73.3	66.3	69.3	72.2
Government Expenditure									
Growth	5.52	-3.44	2.65	2.83	5.26	-0.14	5.11	18.20	0.52
Share in GDP	9.1	9.9	9.0	12.7	11.2	10.7	9.7	14.2	10.0
Gross Fixed Capital Formation Growth	7.33	-2.04	-8.66	-18.75	-27.86	-24.46	-18.21	-4.23	17.21
Share in GDP	24.9	25.1	21.1	23.1	21.0	20.5	17.8	20.9	21.9
Change in Stocks Growth	-95.48	-140.88	18.73	149.50	11790.91	-517.15	1.76	-32.94	-94.85
Share in GDP	-0.1	0.7	5.3	-6.0	-9.2	-3.4	5.6	-3.8	-0.4
Exports of Goods and Services Growth	12.95	4.26	3.85	-8.16	-11.06	-10.78	-5.22	7.24	-0.85
Share in GDP	25.5	25.5	25.6	25.4	26.6	24.6	24.9	25.8	23.4
Imports of Goods and Services Growth	14.03	2.01	-3.84	-24.89	-30.99	-20.60	-11.66	11.02	21.99
Share in GDP	30.9	29.9	26.7	25.1	25.0	25.8	24.3	26.3	27.1

Source: CBRT

Table III.2. Real GDP Growth Rates of 15 developing countries hit hardest by the crisis (Annual)

	2002-07 average	2007	2008	2009
Latvia	9.09	9.6	-3.27	-17.72
Lithuania	8.31	9.79	2.91	-14.84
Ukraine	7.46	7.6	2.3	-14.8
Armenia	13.39	13.74	6.94	-14.15
Botswana	5.76	8.68	3.90	-7.84
Russia	7.03	8.53	5.24	-7.8
Kuwait	9.11	5.99	2.48	-7.07
Croatia	4.77	5.06	2.08	-6.94
Hungary	3.52	0.11	0.89	-6.76
Romania	6.19	6.31	7.34	-6.57
Moldova	6.17	2.99	7.8	-6
Bulgaria	6.03	6.44	6.19	-5.47
Turkey	**6.79**	**4.66**	**0.65**	**-4.82**
Mexico	2.82	3.13	1.21	-4.52
Paraguay	3.45	5.422	6.35	-3.96
Emerging Markets	7.15	8.701	5.87	3.11
World	4.48	5.348	2.705	-0.381

Source: IMF, WEO, October 2013

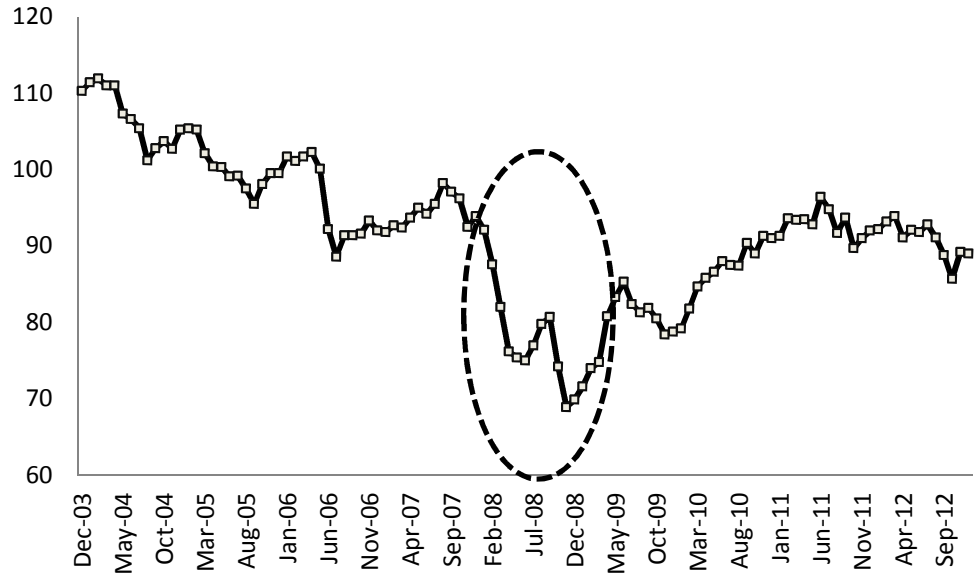
[42] Growth rates represent percentage changes in real GDP relative to the same quarter in previous year.
**Share in GDP represents the percentage share of the level of each variable in GDP.

The global crisis has affected the Turkish economy through three channels, namely expectation channel, trade channel and financial channel. However, although financial flows to the Turkish economy significantly declined, the financial shock hitting the Turkish economy in the recent crisis was low relative to the previous shocks the economy had been exposed to. Therefore, this is one of the reasons behind the fact that the financial system did not collapse in the form of a banking system crisis or other forms amid a very sharp decline in GDP and employment. We will discuss each channel separately below.

III.2.1 Expectations Channel

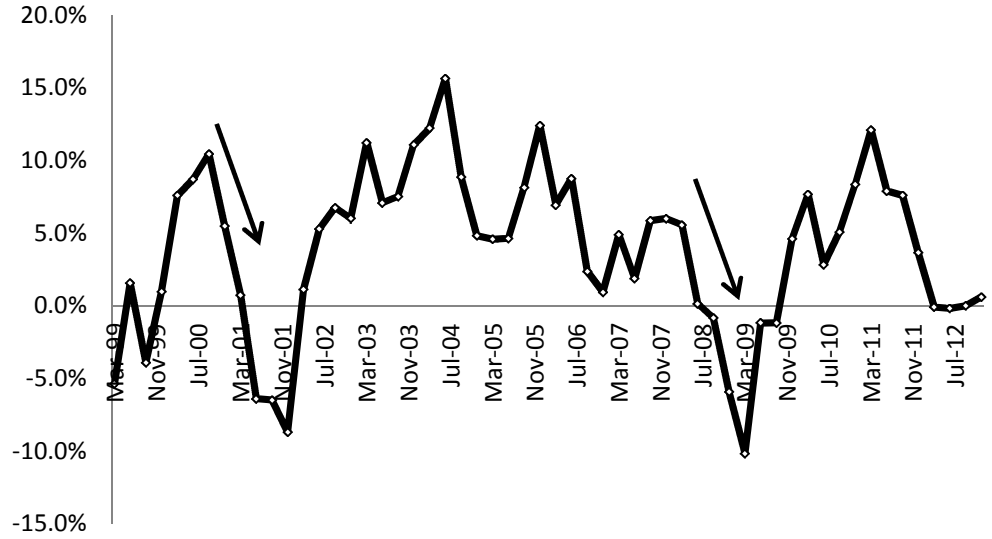
In Turkey, the initial impact of the crisis was felt as falls in consumption and investment spending due to the worsening expectations of investors and consumers. It is very difficult to measure the exact influence of exogenous direct effects of turmoil in the US financial markets on the expectations of Turkish investors and consumers. Although there are some problems with the existing data, the fact that, the expectations quickly started to decline in Turkey just after the emergence of crisis in the US can be considered as an indicator (Figure III.2). Negative developments in consumer confidence about the future of the economy adversely influenced consumption expenditures. In turn, total consumption declined significantly (Figure III.3). The dramatic decline in consumption was even larger than the decline during the 2001 crisis.

Figure III.2: Consumer Confidence Index (2005= 100)



Source: CBRT

Figure III.3: Quarterly Annual Consumption Expenditure (constant 1998 Prices)

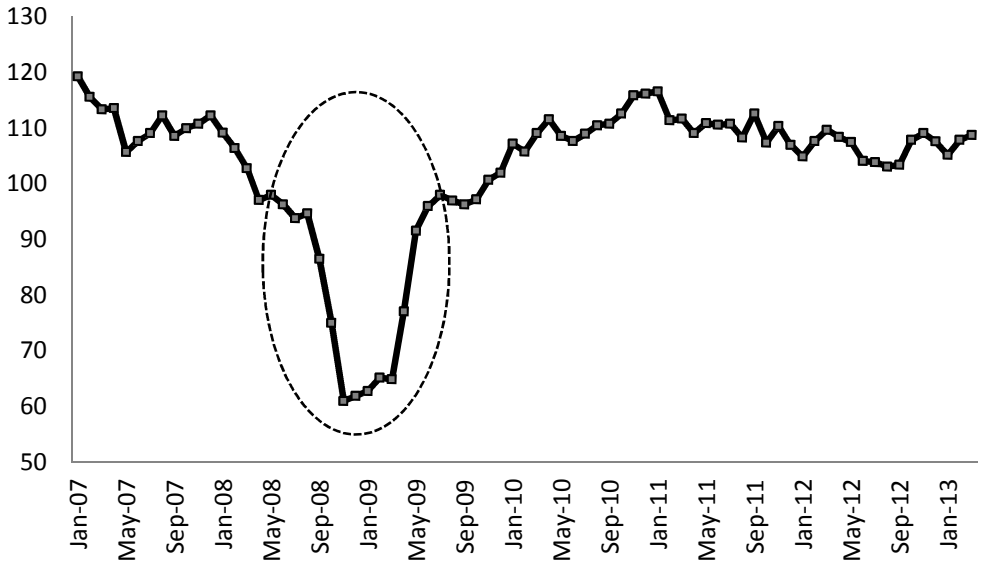


Source: CBRT
Note: This figure shows percentage change in consumption expenditures relative to corresponding quarter in previous year.

In addition to the consumers, confidence of the producers sharply deteriorated in response to the global developments. Real sector confidence index, which reflects the expectations of producers tended to fall from December 2007 to November 2008 and remained low for a while (Figure III.4). Similar to the picture in consumer expectations, this

development demonstrates that rising risks in the global markets seemed to influence producer expectations negatively before the crisis was fully felt in the Turkish economy.

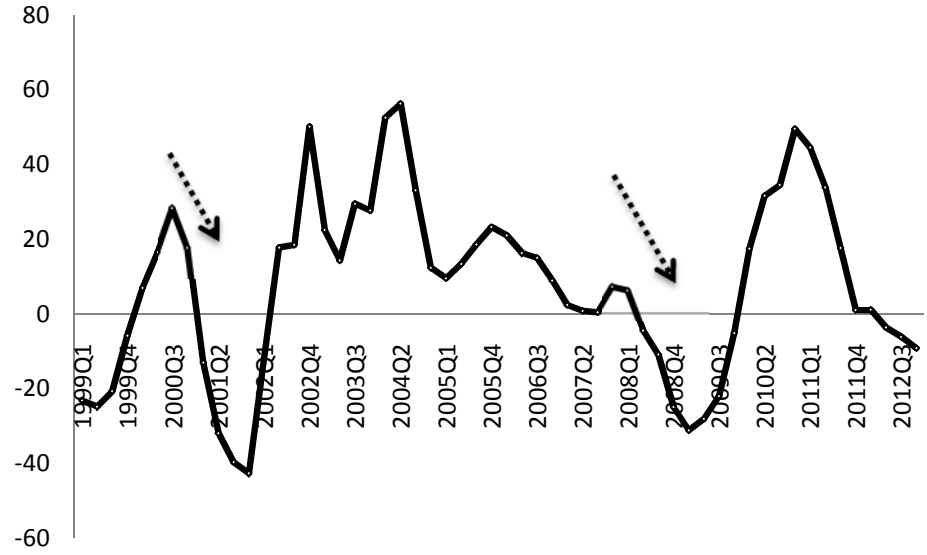
Figure III.4: Real Sector Confidence Index



Source: CBRT

As Figure III.5 suggests, the negative growth in investments was maintained for 7 consecutive quarters. This investment shock was as large as the shock during the 2001 crisis. This sizeable contraction in investment expenditures inevitably had a significant role in the recession of 2009 in Turkey.

igure III.5: % Change in Total Fixed Private Investment Spending, 1998 Prices,



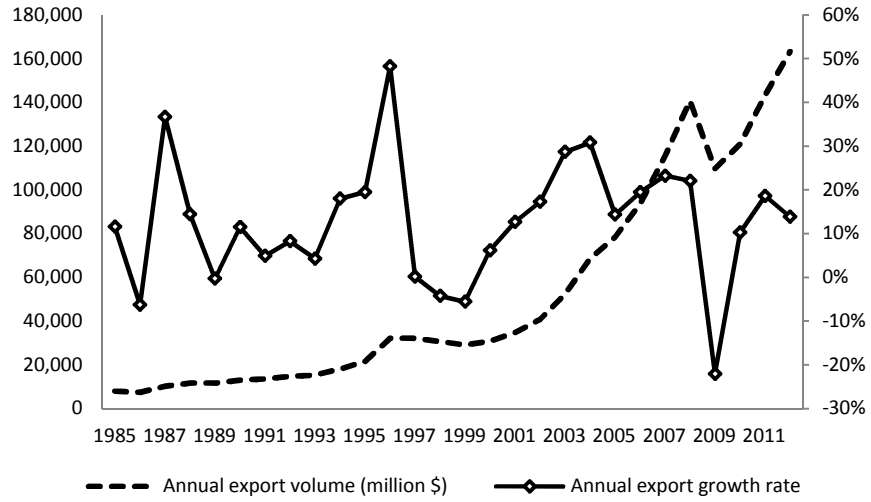
Source: CBRT

Note: This figure shows percentage change in total investment expenditures relative to corresponding quarter in previous year

III.2.2. Trade Channel

Another channel through which the Turkish economy was hit by the global crisis was the export channel. Even though the crises of 1994 and 2001 increased the export volume of Turkey due to mainly large depreciations in TRY during the global crisis, we observed a substantial fall in export earnings. Export earnings halted by more than 20.0% in 2009 (Figure III.6). The main reason of this shock was that the biggest export partner of Turkey, the EU was in a deep crisis and hence, the demand from the European area largely stopped.

Figure III.6. : Export Performance of the Turkish Economy

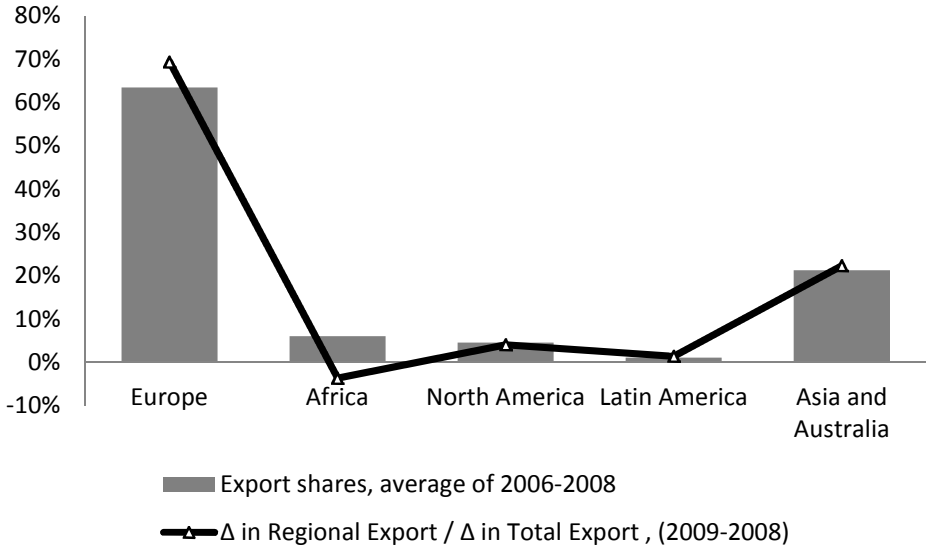


Source: IMF

In Figure III.7, the shares of different regions in total Turkish exports and the contribution of change in exports to these regions to the total Turkish export performance are depicted. It is evident from the figure that, the biggest export partner of Turkish economy is Europe. The average share in Turkey's total export was 63.0 percent, exceeding the sum of the shares of other regions. Also the figure demonstrates that, 70.0 percent of the decline in total exports in 2009 stemmed from the decline in exports to Europe. In other words, the decline in exports to Europe in 2009 much exceeded Europe's average share in Turkish exports in the period of 2006-8. This is caused by the fact that although overall

Turkish export growth decreased by 22.0 percent, the Turkish exports to Europe declined by 26.0 percent[43]. The contribution of the export fall to the negative GDP growth of 2009 was around 25.0 percent. By analogy, the fall in exports to Europe explains directly about 20.0 percent of the recession in 2009.[44] We should also bear in mind that all these impacts of export reduction were solely through the direct impact of the fall in export revenues. Considering the contagion impact of export reduction to other items of GDP (multiplier effect), we may confidently claim that the fall in exports, specifically to Europe, accounts for the large part of the recession in 2009 in Turkey.

Figure III.7: Turkish Exports by Regional Classification



Source: Turkstat

The literature discusses that the contagion of the shifts in exports to GDP occurs via mainly two channels. One is the Keynesian multiplier mechanism. In developing countries which, in general, have idle capital and high unemployment, export variations have large impact on growth (Bilgin and Sahbaz, 2009). In other words, a reduction in exports may bring about a large GDP decline due to multiplier effects. The second important channel implies that developing economies are in need of imported intermediate goods for their

[43] There was an increase in the exports to African countries in 2009. This is an indication that the Turkish economy tried to widen its export market in order to compensate its loss through the falling demand from Europe. However, in general, there was a significant reduction in the exports to all other regions too

[44] Considering the -4.5 percent real GDP growth rate at the time, the depression in Europe cost Turkey nearly 0.9 percent of its GDP.

production sector. And these economies often need export incomes in foreign currency in order to import these vital intermediate goods. Moreover, countries like Turkey always are in need of intermediate goods imports for their exports since their exports are mainly in the form of final goods. Hence, a fall in exports leads to a contraction in import demands. In some cases, this would prevent developing countries from importing very crucial intermediate goods which would improve the production capacity of these countries. In relation to the second channel, a third channel can be considered as well. Export oriented firms would have serious balance sheet problems when their foreign currency earnings decrease because many of these firms borrow heavily from the rest of the world. Therefore, an export shock can directly deteriorate financial health of the export oriented firms which can bring about lower investment levels.

In the global crisis, especially the first and third channels might have been influential in the Turkish case. As we presented in the previous subsection, the worsening consumption and investment spending started considerably after 2008. In this declining trend, export channel was as effective as the expectations channel. The 20.0 percent fall in export revenues naturally caused income of investors and consumers to decline which brought about a dramatic decline in Turkish GDP in 2009. During the crisis, in conjunction with the exports, import spending of Turkey declined as well. This decline was directly related to the fall in exports and overall decline in total income.[45] In fact, the correlation coefficient between the trend in export and import revenues is 0.99 in the period from 1989 to 2012 in Turkey. Furthermore, our Engle-Granger causality analysis states that exports in Turkey statistically significantly causes imports, while imports do not explain the movements in exports. The other studies which investigated the export-GDP growth relation in Turkey show us there is a close relationship between growth and exports revenues in Turkey. For instance, Karahasan (2009) analyzes the causality between exports and GDP growth in Turkey for the years 1950-2008 and concludes that there is bidirectional causality between them. The causality analyses conducted by Halıcıoğlu (2007) for the years

[45] Historically, a reduction in Turkish GDP always coincides with an improvement in its current account.

1980-2005 and Bilgin and Sahbaz (2009) for the years 1987-2007 concludes that changes in exports have a uni-directional impact on industrial production and GDP growth.

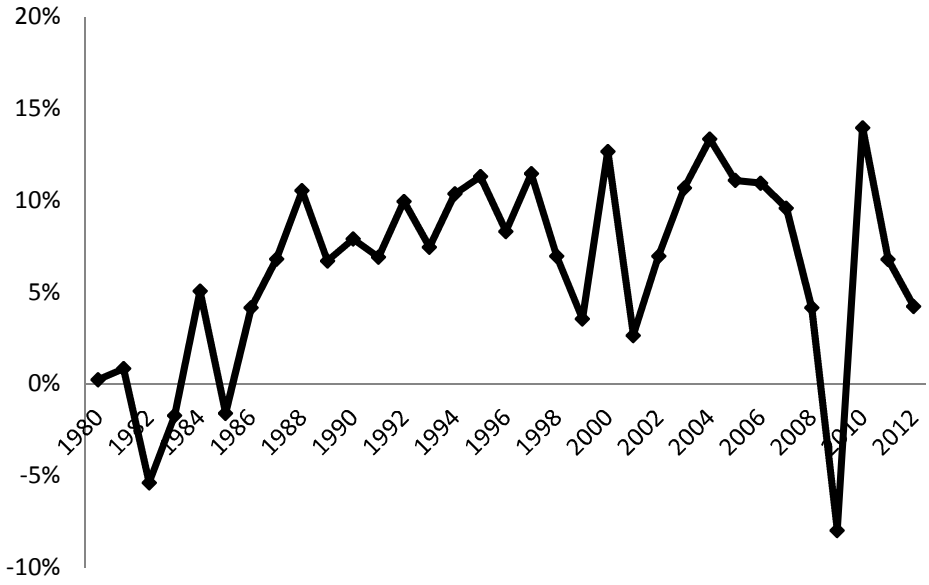
Trade channel was also effective in many other developing countries in the global crisis and the trend observed in their exports was similar to that in the Turkish export. Figure III.8 demonstrates, with the exception of the lowest income group countries, all other groups of countries experienced a fall in their export levels by more than 20.0 percent in 2009. The drop in the export growth rates in these groups was as high as the drop of exports in the north, which was at the center of the crisis.

Figure III.8: Exports in Goods and Services, income groups, growth rates

Source: IMF

The best way to interpret the magnitude of this decline properly is to compare the level of this shock with the trade shocks observed in the past crises on a global scale. It is obvious that the export shock in the recent crisis was much greater than the past shocks (Figure III.9). For example, a similar export squeeze was observed in 1982 when the developed countries experienced a slowdown; however, the magnitude of this export decline was much lower than the one in 2009. Similarly, during the Asian financial crisis, the export growth rate of developing countries declined but never became negative. In this vein, the recent crisis should be treated different than the ones in the 80s and 90s which were mainly triggered by financial reversals and brought about financial market collapses.

Figure III.9 Exports of goods and services, all developing countries, growth rate



Source: IMF

III.2.3 Financial Channel

Another channel through which the crisis transmitted into developing countries is the financial channel. This channel is described as the liquidity or exchange rate shocks experienced by the financial system of developing countries, which are closely linked to developed countries. In general, the majority of developing countries did not experience a financial system collapse. Likewise, the Turkish economy was not caught by a severe financial turmoil as well. Particularly, relative to 1994 and 2001 crises, the financial system of Turkey recovered from the global crisis very fast. For instance, while 18 banks bankrupted in the crisis of 2001, no single bank collapsed in the global crisis. Moreover, the profitability of banking sector did not even decline and their capital to asset ratios further increased during the global crisis (Uygur, 2011; Yorukoglu and Atasoy, 2010).

The literature ties the resilience of the financial system of developing countries during the crisis to a lot of factors. Large accumulated reserves and flexible exchange rate regimes are the most significant factors according to the existing literature. In addition to these, financial stability policies, banking reforms and strong balance of payments are considered to be responsible for the relatively better performance of developing countries in the recent crisis.

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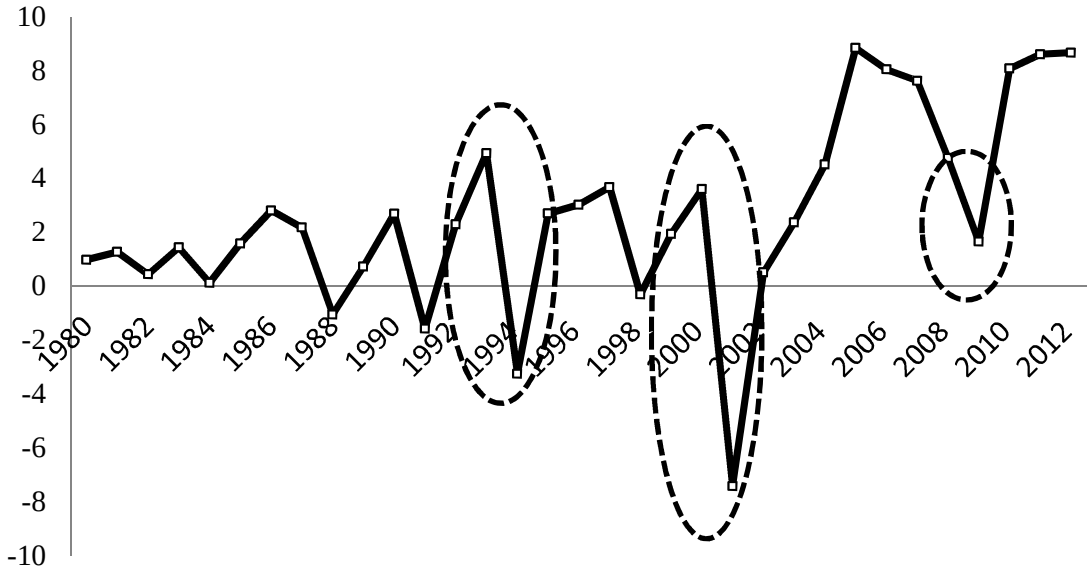
We believe that all these factors mentioned in the literature might have served some roles in mitigating the impacts of the crisis on developing countries. However, there is another important factor that has been mostly ignored by the literature. We believe that Turkish financial system as in the case of many other developing countries was not tested substantially in the global crisis. The shock that Turkish economy was exposed to in the global crisis was actually smaller than the shocks observed in both 1994 and 2001 crises. Similarly, as will be shown below, the magnitude of the financial shocks that the Turkish economy and majority of developing countries faced in the recent crisis was much smaller than the shocks observed in previous developing country crises.

Financial shocks can basically be assessed by looking at the magnitude of sudden stops or capital reversals. As a first approximation, analyzing the trend in the net financial flows can provide us with very useful information about the magnitude of the shock a country encounters through its financial account. According to Figure III.10, net financial flows as a percentage of GDP were 7.2 percent in Turkey in 2007 and in the third quarter of 2008 it started to decline due to the turmoil in the financial markets in markets in US. And in 2009, the net flows halted by a large amount and net flows as the share of GDP became 1.7 percent. This clearly indicates that Turkish financial system faced an extensive sudden stop but global funds continued to come to Turkey with smaller amounts in 2009 compared to previous years.

Figure III.10: Net financial flows, % of GDP

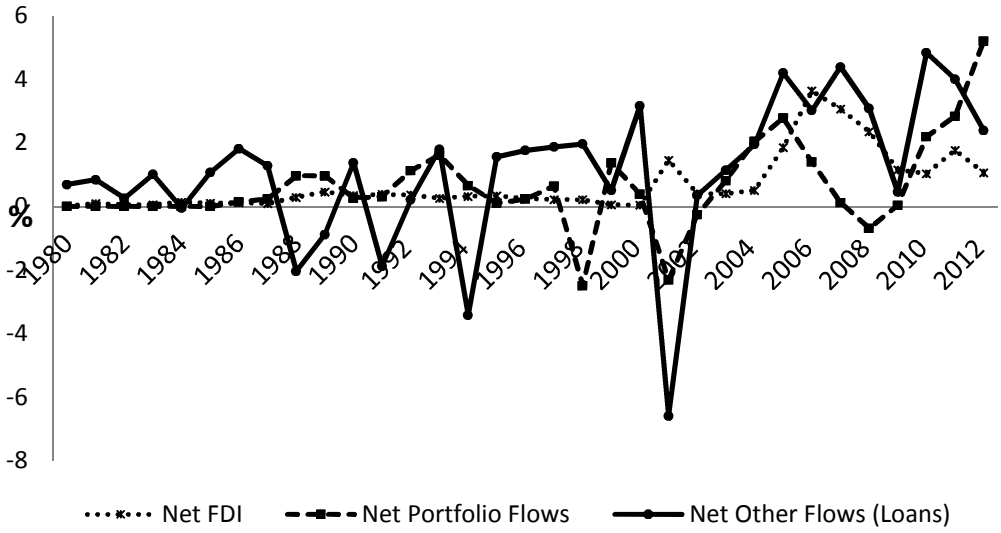


Source: CBRT

In terms of the financial shocks, the picture in Turkey during the global crisis was different from that of previous crises. In 2001, the net flows scaled by GDP were 7.5 percent, meaning that global funds left Turkish economy by substantial amounts. Likewise, in 1994, the annual exit of the funds was nearly 3.0 percent of GDP. All these mean that there were large financial account reversals during these two crises, which were much harsher than the sudden stop observed during the global crisis. This can be verified by investigating the composition of net financial flows relative to GDP as well. As can be seen in Figure III.11, although net portfolio flows became negative in 2008, the other flows and net foreign direct investment did not show any sign of reversal during this year. Furthermore, overall, all three types of financial flows were low but positive in 2009. This can be considered as a sudden stop rather than a reversal. The reversals would have qualitatively different implications than sudden stops, particularly for developing countries. Reversals put a great strain on central bank reserves and foreign exchange markets. The need for foreign currency increases in the existence of current account deficits. A massive financial reversal brings about a financial collapse by causing sudden depletion of foreign exchange reserves and unsustainable depreciations in the domestic currency which may weaken balance sheets of domestic agents. Although a sudden stop also brings about

similar problems, if the central bank reserves are not very low to trigger a panic, most likely, a sudden stop would bring about credit restraints rather than a financial collapse. Furthermore, the impacts of sudden stops or reversals do not only depend on magnitude of the shocks but also the duration of the shocks.

Figure III.11: Composition of Capital Flows to the Turkish Economy, net (% of GDP)

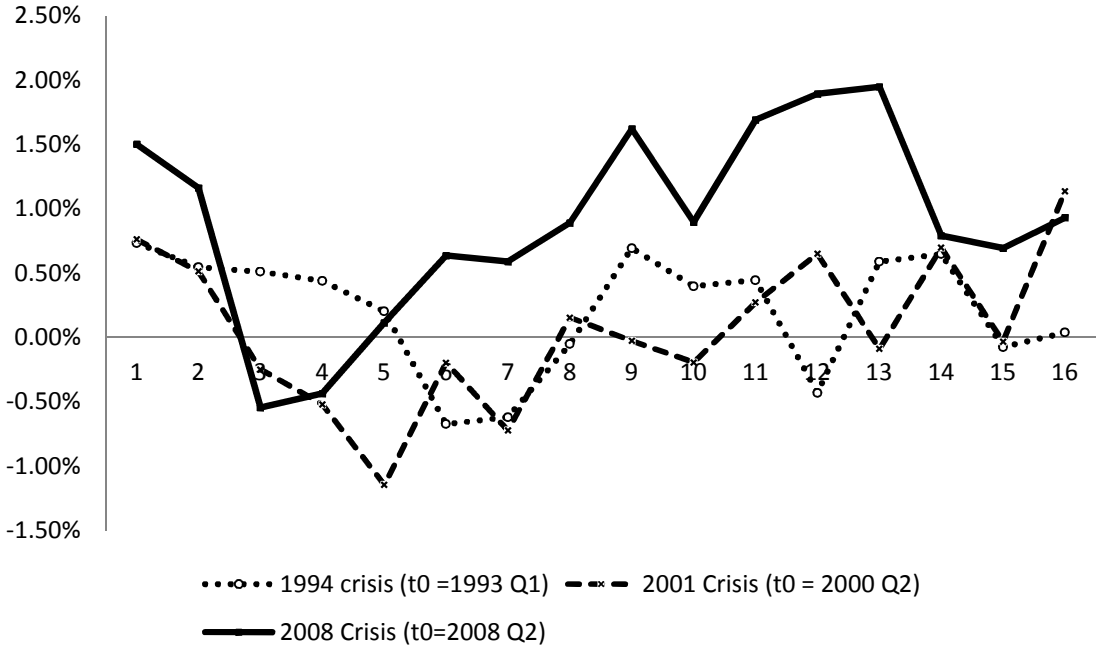


Source: CBRT, World Bank

Quarterly net flows data can be more explanatory to investigate both magnitude and duration of the shocks during different crises. Figure III.12 shows the quarterly trend of net financial flows as a share of annual GDP in the corresponding quarter in the Turkish economy during the last three biggest crises. It starts from the quarter when the share of flows initially began to decline. T_0 shows the quarter just before the flows started to fall. In 1994 crisis, first sudden stops appeared in the first quarter of 1993 and during the following 5th and 8th quarters, reversals occurred, which indicates that financial shock was maintained for 8 quarters. In 2001 crisis, just after 3 quarters from T_0, financial account reversals took place and lasted till the 10th quarter, meaning that the duration of the shock was 10 quarters. For the global crisis, in the 3rd quarter of 2008, net flows started to decline and after the 3rd and the 4thquarters, we observed a net reversal. Following the 5th quarter, the share of net flows started to rise. This shows that the duration of the shock was about 5

quarters, which was relatively shorter than the other two crises. Even though there was a 2-quarters-long of a financial reversal in Turkey during the global crisis, as we indicated above, annually there was not a financial reversal in 2009. In this sense, it is obvious that both the duration and magnitude of financial shocks in the global crisis were shorter and weaker than other two earlier crises in Turkey.

Figure III.12: Quarterly Net Financial Flows during Crises Periods, (% of GDP)

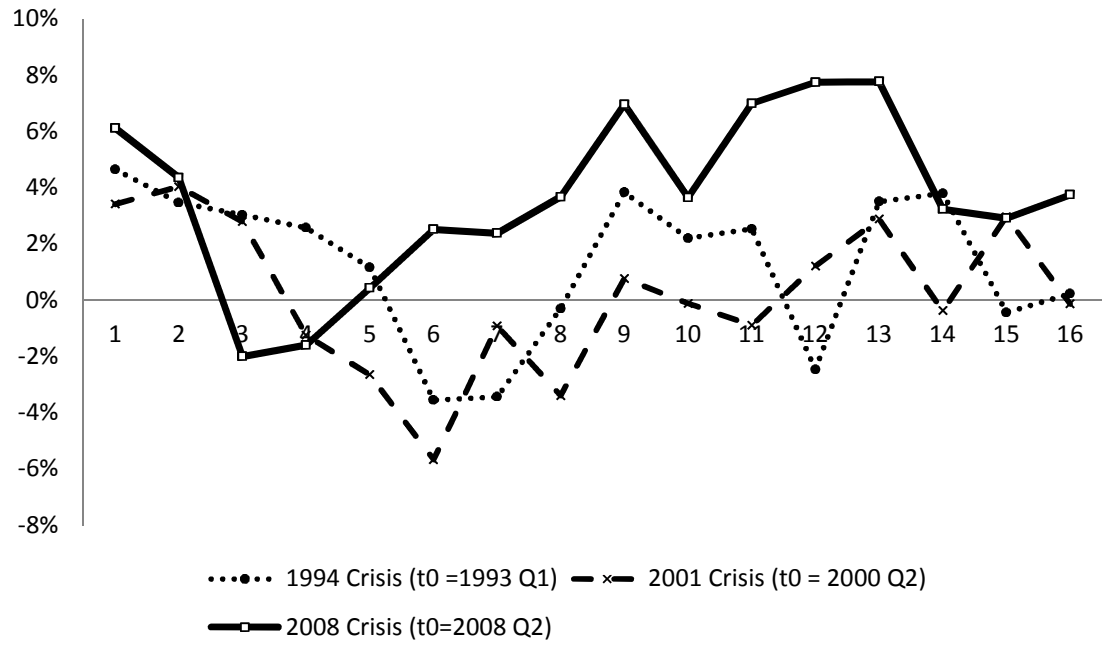


Source: CBRT

The net flows relative to total stock of foreign funds in an economy is another indicator to see the magnitude of the shocks the economy faced during crises.[46] This indicator shows the size of net financial flows relative to accumulated foreign liabilities. On annual basis, that in the earlier crises, large portion of foreign investment stock left Turkish economy, while during the global crisis, foreign investment continued to flow in, albeit in small proportions. And on a quarterly basis, the shock scaled by the total foreign liabilities in global crisis was shorter in duration and smaller in magnitude compared to previous crises (Figure III.13).

[46] Total stock of foreign funds is the existing foreign investment in Turkish assets in a given quarter. It is represented by the foreign liabilities in the international investment position data.

Figure III.13: Quarterly Net Financial Flows during Crises Periods, % of Total Foreign Liabilities, Turkey



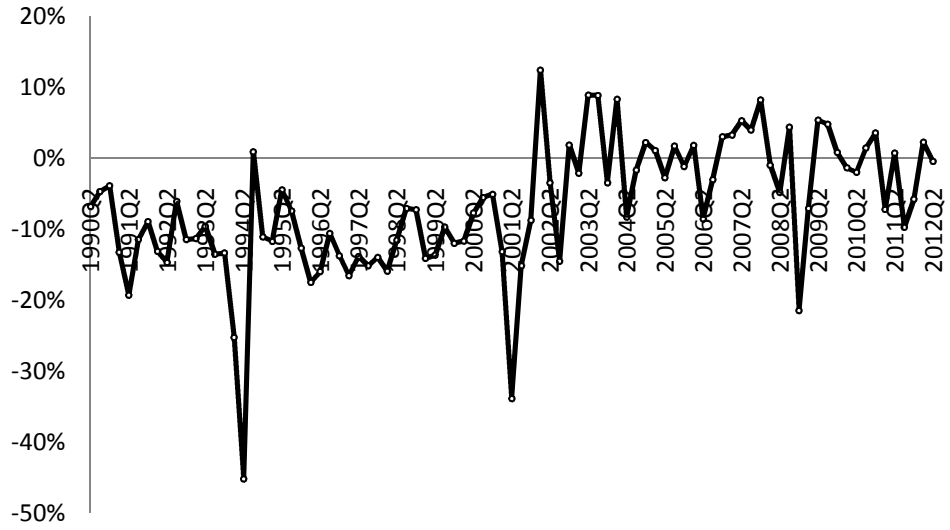
Source: CBRT

Since some of the pressure related to financial flows can be absorbed by exchange rates movements, exchange rates can be also utilized to examine the magnitude of pressure related to financial shocks. Figure III.14 shows that the depreciation pressure was much milder during the global crisis than during previous crises. Here, it could be argued that due to the reserve operations the exchange rate pressure might have been calmed down in the global crisis. In Table III.3, we give the ratio of quarterly net financial flows in quarter *t* to the existing international reserves amounts and quarterly import spending in the quarter *t-2*. The shaded areas in the table depict that the pressure on central bank reserves in the last crisis lasted shorter and also the magnitude of the pressure was lower. In other words, the reserve depletion during the global crisis was also less than the depletion during other crises.[47] In the 3rd quarter of 2008, the reserves of central bank amounted to be $76 billion and it reached at minimum value of $63 billion in 2009. The

[47] By depletion, we mean the reserve loss occurred from the beginning of the crisis till the reserves reached minimum levels in the crisis period. It is the difference between maximum amounts and minimum amounts of reserves achieved in the course of crisis.

reserve loss was 17.0 percent of total reserves. Nevertheless, reserve depletion in 2001 crisis was 36.0 percent and in 1994, more than 50.0 percent.

Figure III.14: Quarterly change in the value of TL against USD (%)



Source: CBRT

Similar to the case of Turkey, developing countries in general did not experience a destructive financial account shock in the global crisis (Comert and Colak 2013). For example, if we compare the magnitude of the financial shock in the recent crisis with the 1998 Asian crisis, the shock to net financial account was shorter and smaller during the global crisis compared to Asian crisis (Comert and Colak 2013). The comparison between the magnitudes in the Latin America crisis in the 1980s and the recent global crisis yields more striking results.[48] The net private flows were amounted to be 3.0 percent of GDP in all developing countries in 1981. Starting from the debt crisis in 1982, net private flows began to fall. And for three years, we observe negative net private flows, indicating that private investors left these economies in the middle of the 80s. This shock is clearly much larger than the shock occurred in 2008. Overall, all indicators demonstrate that not only Turkey but also developing countries in general experienced relatively milder shock during the recent crisis.

[48] Due to data constraints, this comparison is made through the net private financial flows.

Table III.3. Net Flows at time t / Foreign Reserves at t-2

	Net Financial Flows / Reserves		
t	1994 Crisis (t0=1993 Q1)	2001 Crisis (t0=2000Q2)	2008 Crisis (t0=2008 Q2)
0	50%	19%	22%
1	36%	13%	17%
2	29%	-6%	**-7%**
3	27%	**-13%**	**-5%**
4	12%	**-29%**	2%
5	**-40%**	**-6%**	10%
6	**-73%**	**-23%**	10%
7	**-5%**	5%	14%
8	42%	-1%	26%
9	24%	-5%	15%
10	17%	7%	29%
11	-14%	15%	30%

Source: Authors' calculations based on CBRT data

Among other reasons such as the contribution of some policy reforms put into practice in the previous period, there are two distinct reasons behind the mild shocks Turkish economy and other developing countries experienced in the recent crisis. First, financial markets in developed countries could not fully serve their safe heaven roles in the recent crisis as opposed to the crisis in emerging markets in the 80s and the 90s. Second, the massive quantitative easing accompanied by very low interest rates in developed countries rejuvenated financial flows to developing countries very soon.[49]

III.3. Policy Responses to the Crisis

The authorities adopted wide range of policy measures in order to mitigate the impact of financial crisis, albeit criticisms that they were too late to respond. These measures might be grouped into three categories; fiscal policy measures, monetary responses and financial sector measures. Initially, starting from the beginning of 2008, monetary measures were adopted. Later, in March 2009, first fiscal package was introduced. Additionally, Banking Regulation and Supervision Agency (BRSA), in

[49] The details of this discussion can be found in Comert and Colak 2013 and Comert and Colak 2014.

coordination with the Central Bank, implemented several measures in order to control the possible risks that might have occurred in the banking sector during the crisis. Here we will not go into every detail of these policies, but we will broadly explain what is targeted by each policy.

III.3.1 Fiscal Policies

Fiscal responses to the crisis came into place, in the form of announcing the first comprehensive fiscal measure package in March 2009, when the crisis already became influential in Turkey (Uygur, 2010).[50] After this package, subsequent fiscal actions were taken over time. Table III.4 depicts the types of fiscal measures, their target and general characteristics. Fiscal measures mainly targeted to recover main macroeconomic fundamentals (Table III.4). Change in tax regulations and tax reductions aimed at decreasing the tax burden on consumers and firms to stimulate consumption and investment which can stir the economy.[51] Through some incentives specifically for firms, the government attempted to mitigate the losses of firms resulting from export squeeze and financing constraints at the time of the crisis. Since already high unemployment continued to rise, government tried to directly create employment opportunities as well. And as stated in previous subsection, the sudden stop in capital inflows resulted in credit shortages and financing issues for investment projects. In order to tackle with this challenge, government enacted several policies to keep global savings in Turkey and also call for the resident's investment abroad.

[50] Many blamed government for being very late in comprehending the severity of the crisis and in its response to the crisis (Uygur, 2010; Öniş and Güven, 2010).

[51] Besides expanding expenditures, Turkish government enacted several tax reforms as demonstrated in Table III.5 above. These reforms resulted in a decline in the growth rate of tax revenues in 2009 compared to 2008 (Figure III.16). However, albeit a decline in growth rate, tax revenues continued increasing in 2009 by 3.0 percent. Considering the income effect of falling GDP in 2009 by 4.9 percent, Turkish government did not seem to face a tax income shock in the recent global crisis.

Table III.4. Fiscal Policy Responses

Types of Fiscal Measures	Characteristics	Target
ax Policies	✓ VAT and Special Consumption Tax reductions ✓ Cuts in corporate tax rates varying to the regions and sectors.	Encouraging consumption and investment
Private sector incentives	✓ Interest rate subsidies ✓ The payment of employers' share in employees social security payments by Treasury	Protecting firms against bankruptcy and promoting them to invest
Employment support	✓ Exemptions in the social security payments of workers ✓ Employing part-time workers whose allowances were paid by Turkish Employment Organization ✓ Hiring nearly 200 thousands people as temporary workers or interns in public sector.	To counteract against rising unemployment and its social costs.
Access to global capital	✓ Tax amnesty for all unrecorded assets if they are declared ✓ Tax relief on credits obtained from foreign sources ✓ Tax exemptions on the foreign assets held by the residents providing that these assets were transferred to Turkey	Softening the impact of sudden stops in capital account.

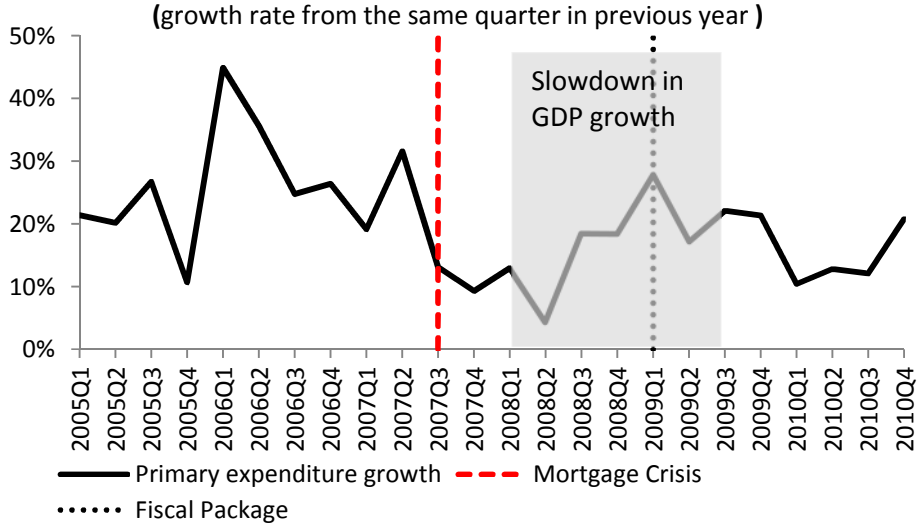
Source: Authors compilation based on various reports

Compared to advanced countries and many other developing countries, Turkish government was reluctant in its fiscal response to the crisis. For example, while the advanced countries decided to implement huge stimulation packages in the second quarter of 2008, the Turkish government did not adopt countercyclical fiscal policy in 2008. The only apparent direct significant fiscal measures took place in the first quarter of 2009, when the crisis had already affected Turkish economy. Figure III.15 depicts the year-on-year change in the quarterly non-interest government expenditure from the same quarter a-year-ago[52]. The beginning of subprime mortgage crisis is dated back to the third quarter of 2007 and the slowdown in economic activity in Turkey started in the second quarter of 2008 with 2.7% GDP growth. In the subsequent quarters till the fourth quarter of 2009, GDP growth

[52] Real primary expenditure is calculated as the nominal expenditure over CPI taking 2003 as base year. Since there is a high seasonality in the government expenditures, the growth rate was calculated not from the previous quarter but the a-year-ago quarter in order to deal with the seasonality problem. Government spending usually tends to increase as the year ends.

remained negative in Turkey (Table III.1). Nevertheless, despite low growth since the 2nd quarter of 2008, Turkish government seemed to be inactive in stimulating government spending in these early periods of crisis. Besides, the year-on-year growth rate of quarterly primary expenditure plummeted till the third quarter of 2008, even become negative in the 2nd quarter, and only substantial increase in the expenditure growth rate was observed in the first quarter of 2009 (Figure III.15). With the comprehensive stimulus package in the first quarter of 2009, a high level of increase occurred in primary government expenditures by nearly %15 percent. Taking the implementation and response lags of these stimulus measures into account, the fiscal response of government spending seems to be quite delayed in Turkey.

Figure III.15: Quarterly Government Primary Expenditure
(growth rate from the same quarter in previous year **)**

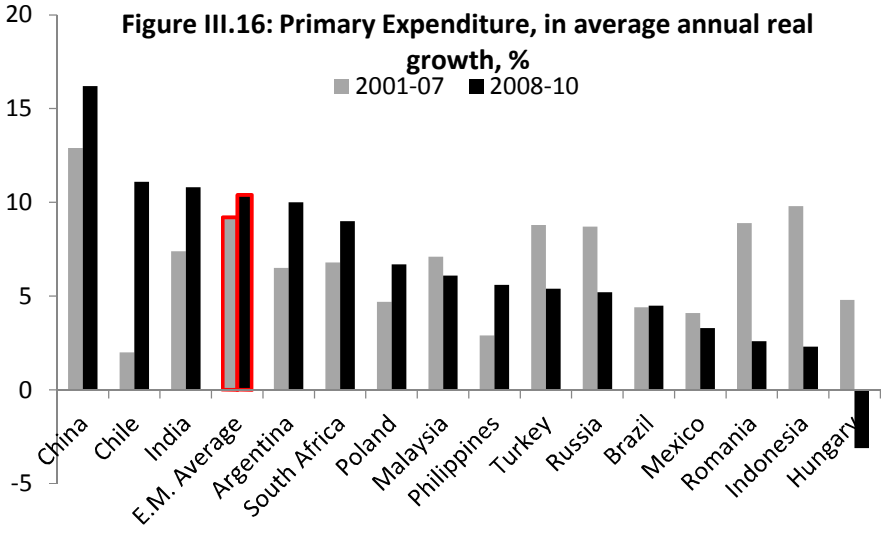


Source: Undersecretariat of Treasury

Furthermore, several reports by the OECD and the IMF reveal that Turkey was among the latest respondents in terms of fiscal stimulus compared to other countries. And besides delayed response, the costs of adopted fiscal measures as a ratio of GDP were among the lowest considering other advanced and developing economies. An OECD report (2009) on countries' fiscal stimulus in the crisis indicates that Turkey and Greece were only two OECD economies having no fiscal stimulus package till the March 2009. An IMF report (2009) on G-20 economies' fiscal measures in crisis demonstrates while the average cost of fiscal measures already amounted to 0.5% of G-20 GDP, Turkey did not announce any

measure in 2008. And the costs of discretionary fiscal measures enacted in 2009 in Turkey were among the lowest in G-20 economies and much below the G-20 emerging markets average[53] (IMF, 2010). In Turkey, the average annual growth rate of the real government primary expenditure during the crisis (2008-10) was also much below the same ratio in 2001-07 period. Figure III.16 demonstrates the averages of annual real growth rate of primary spending in 2001-07 and 2008-10 periods in several emerging markets. In many emerging markets, as expected, this growth rate was larger in the crisis years than the prior-to-crisis average. However, in Turkey this ratio declined unexpectedly from 8.8 percent in 2001-07 to 5.4 in 2008-10. Besides, the primary government expenditure growth in Turkey was significantly lower than the emerging market average of 9.2 during the crisis years.

Figure III.16: Primary Expenditure, in average annual real growth, %



Source: IMF (2010)[54]

Overall, the fiscal response to the global crisis was relatively weaker and late in Turkey compared to other advanced and developing countries. This ended up with a rise in general government budget deficit by 4.2 percent of GDP, which was smaller than that of the OECD average of 6.3 percent (Rawdanowicz, 2010). This might be explained by the fact that Turkish government did not require to bail out its financial market as in the case of

[53] The emerging markets in G-20 group on average spent 2.4% of their GDP on fiscal measures in 2009, and Turkey's fiscal spending amounted to only 1.2% of GDP.

[54] The numbers in the figure collected from the report, "From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies" prepared by IMF(2010).

2001 crisis, because Turkey did not experience a financial collapse in the global crisis, as presented in detail in the sections above. Another factor might be that the government size became significantly smaller after the huge privatization efforts in 2004-6 period. Finally, those countries which were unwilling to use active fiscal measures or/and did not have enough fiscal space witnessed deeper declines in their GDP. Turkey can be considered as one of them. In the Turkish case, although the government had enough fiscal space for an expansionary policy its reluctance in conducting expansionary fiscal measures might have had an important role in the severity of the crisis in terms of both magnitude and duration.

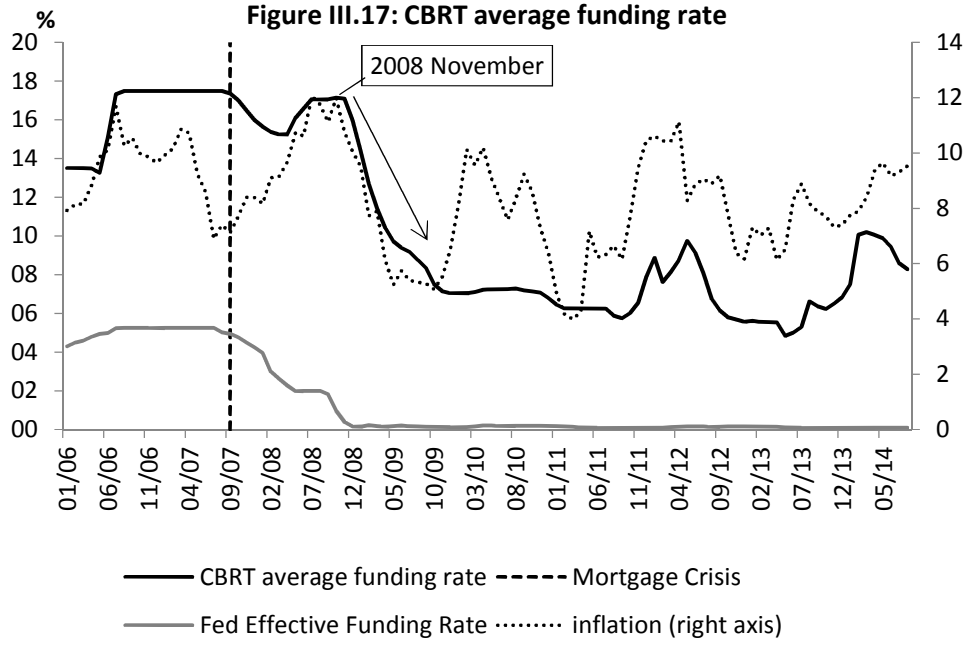
III.3.2 Monetary Measures

Besides these fiscal measures, the Central Bank of Turkey took monetary actions as in the case of majority of crisis-countries. The monetary responses to the crisis preceded the fiscal actions and started to take place in the first half of 2008. The primary objectives of monetary policy during the crisis were to stabilize inflation, meet the FX demand (to ease the pressure on the exchange rates) and TL liquidity needs of private sector. For these purposes several policies were put into practice by the central bank (Table III.5).

Table III.5. Monetary Policy Responses

Types of Monetary Measures	Characteristics	Targets
Interest rate adjustments	✓ Policy rates were increased since first half of 2007 till July 2008 to stabilize rising inflation ✓ The rates sharply declined by 11 times after November 2008 from 16.75 percent to 7.25 percent till September 2009	To meet the inflation target, spur domestic demand and meet the liquidity needs of private sector.
FX interventions	✓ FX purchase auctions nearly stopped in the second half of 2008 ✓ FX selling auctions realized 20 times from late 2008 till mid-2009 ✓ The maturity of FX lending to banks was extended from one week to three months ✓ The interest rate on FX lending was significantly reduced ✓ The FX required reserve ratio was declined from 11percent to 9 percent.	To meet the FX demand of private sector and lessen the volatility in the exchange rate
Other liquidity policies	✓ Liquidity started to be provided via 1-week repo auctions. ✓ Interest payments on TL required reserves were increased ✓ Export rediscount credits were issued to more exporting firms ✓ The upper limit of export rediscount credits was increased from $500 million to $2.5 billion. ✓ TL required reserve ratio dropped	To ease the conditions of banks and firms in reaching the liquidity.

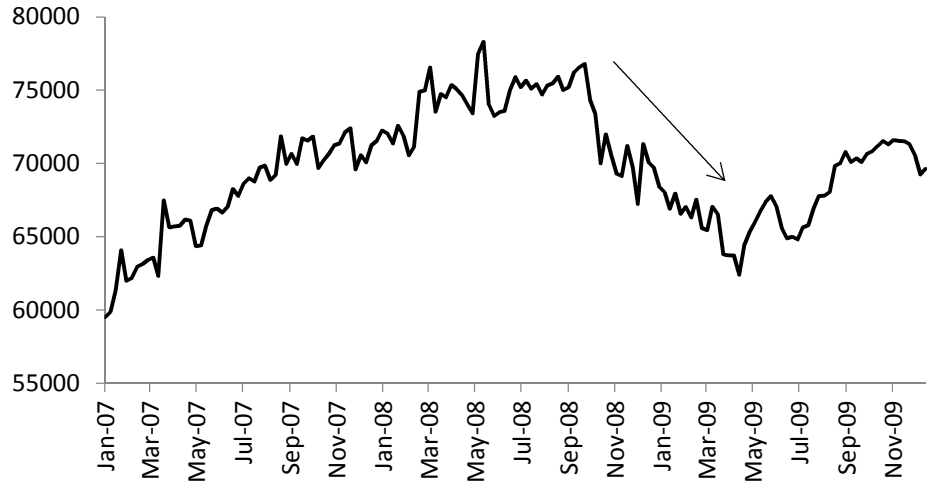
Figure III.17: CBRT average funding rate



Source: CBRT and FED

The expansionary stance of the Central Bank was not only observed in its monetary policy decisions but its several liquidity and FX market intervention policies, which were detailed in Table III.5. Central Bank even added new policy instruments to its arsenal. CBRT stopped FX buying auctions in late 2008 and started to drain its FX reserves by selling auctions and direct FX interventions till the second half of 2009 (Figure III.18). Nearly 15 billion USD worth of reserves were sold in this period. In addition to FX interventions, monetary authorities enacted several FX policies from decreasing FX reserve requirement ratio to extending maturity of FX lending, in order to mitigate the FX illiquidity risk in the financial markets. Furthermore, some policies aiming at helping institutions reach TRY liquidity were put into practice. The amount of export rediscount credits widened, TRY reserve requirement ratio was lowered and interests paid for required reserves increased.

Figure III.18: CBRT FX reserves, million $



Source: CBRT

After the initial shock of the crisis, advanced countries began implementing extreme monetary easing with efforts to recapitalize their destructed financial markets. This led developing economies to welcome cross-border short-term liquidity bonanzas. The illiquidity problem in the early phase of the crisis was replaced by short-term volatile capital flows. Considering the threats of short-term volatile cross-border flows, Turkish monetary authorities started implementing non-conventional monetary policy since 2009. In addition to conventional inflation targeting regime, CBRT targeted financial stability as another objective and utilized non-conventional policy instruments with a particular

emphasis on credit expansion and exchange rate volatility (Kara, 2011). Several macro prudential measures were taken and are still being taken. Since the policy shift in central banking is a significant issue all by itself, we will not go into details of the new monetary framework and leave the discussion for other studies.

III.3.3 Financial Sector Measures

Besides fiscal and monetary authorities, BRSA adapted measures specifically geared towards financial sector stability and health of bank balance sheets. In order to lessen the influence of liquidity tightness in the global economy on banking sector, and hence enable banks to extend more credits, some balance sheet adjustments were made. For this, the amount of provisions set aside for extended loans lessened and the calculation of liquidity adequacy ratio has, to some extent, been adjusted. Furthermore, in order to strengthen the capital structure of banking sector, profit distributions to shareholders were limited and only allowed under the control of BRSA. Also to decrease the amount of risky assets, the risk weights on credit card usage were raised. Finally, in coordination with the central bank, wide ranges of debt relief regulations were put into practice.

Table III.6: Measures related with Banking Sector

Types of Financial Sector Measures	Characteristics	Targets
Banking sector Liquidity	✓ Provision rules are loosened. ✓ Adjustments made in the liquidity adequacy ratio	To mitigate the impacts of liquidity tightness in global economy on Turkish banking sector.
Banking Sector Capital Adequacy	✓ Restrictions on profit distribution of banks ✓ Risk weights of credit-card credits were risen	To strengthen the capital structure of Turkish banks
Debt Relief	✓ The records of bad cheques, protested bills and dead loans by legal entities and households are erased providing that they are paid in six months. ✓ Debts of credit card holders rescheduled	To eliminate the systemic risk that may arise from the liquidity problem in real sector.

Source: Authors compilation based on various reports

This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

III.4. Conclusion

The financial systems in Turkey and in many developing countries were stable in the 2000s. They were not hit by destructive financial crises as experienced many times in the 80s and the 90s. Even though domestic factors might have played some roles for this stability, external factors and policies in the North would account for much of the success in developing countries in the 2000s. The recent crisis ended this honeymoon. It has inflicted a heavy toll on Turkey and many other developing countries through different channels, namely expectation, trade and financial channels. In turn, the Turkish economy experienced one of its worst economic crises in its history. Although there are many similarities between the recent crisis and the crises after the 80s of the Turkish economy, there are some important differences as well. First, as opposed to the recent crisis, a large decline in demand for Turkish goods amid a considerable depreciation of TRY never occurred in the crises after the 80s. Second, there was not a significant financial reversal during the last crisis whereas the previous crises were mainly triggered by massive financial reversals. In this sense, the financial shocks hitting the economy in the recent crisis were very low both in magnitude and duration relative to the shocks in earlier crises. As a result the Turkish financial system, as in the case of many other developing countries, did not experience a collapse. The financial markets in Turkey might not have been tested enough during the last crisis. It is very difficult to know how the Turkish economy would behave under a severe financial reversal.

IV. Conclusion

Capital account liberalization accompanied by decreasing constraints on domestic financial markets has transformed the Turkish economy considerably. However, Turkish financial markets remained shallow relative to those in developed countries. In other words, in Turkey, a classical domestic financialisation trend in the form of exponential growth in financial balance sheets, household debt and non-financial firms' financial activities were not as apparent as in the case of developed countries.

Under these conditions, domestic financial markets have been very sensitive to movements in financial flows. In this sense, we argue that financial integration has shaped the course of the Turkish economy in many ways.[55] Therefore, many of the discussions in this study put substantial emphasis on the role of financial flows in understanding many macroeconomic developments in the period of neoliberalism in Turkey.

Under the influence of financial flows, the Turkish growth has been very erratic. According to the simple decomposition, private consumption has been the main contributor of the Turkish economic growth. Although investment has partially contributed to the growth of the economy, as expected, investment expenditures have been much more volatile than consumption which aggravates growth cycles. Turkish economy has been suffering from current account deficits for a long time. In relation to this, Turkish economy has been relying on foreign borrowings. Furthermore, private sector balance sheets have been deteriorating as well.

After shortly exploring the nature of Turkish economic growth after the 1980s, for the Turkish economy after the 1980s, we elobrated on several important trends regarding income distribution, investment, consumption and current account with a specific emphasis on developments in financial markets, which have been consierably shaped by by financial flows. Furthermore, the report also analyzed the transmission mechanisms through which the recent crisis affected the economy, the impacts of the recent crisis and policy responses taken in response to the crisis.

[55] In other words, although the symptoms of domestically driven classical financialization would not be very apparent in the Turkish economy, the Turkish economy has been greatly shaped by global financialization trends.

Analysing the nature of income distribution itself in an economy is a daunting task. This task becomes much more difficult for developing countries due to lack of relevant data. Therefore, to overcome some of the problems we focused on a specific period of 2002-2011. This period can be considered the most mature period of neoliberalis in Turkey in which a full-fledged neoliberal agenda was implemented.

Our analysis shows that between 2002 and 2011, the distribution of income became less unequal at first sight. However, since these results are derived from a size distribution of income analysis and this analysis, neglects undistributed profits of capitalist firms, this observation should be evaluated cautiously. The inclusion of undistributed profits radically changes the picture.[56] The functional income distribution analysis indicates a reduction of wage share throughout the period. The social-class based income distribution analysis suggests a vast deterioration in the ranks of peasantry which is the main source of the increase in the urban labour force. The dissolution of peasantry and several other classes increased the number of households joining the ranks of working class. The increased proletarianization was a common symptom of neoliberal programmes and Turkey was not an exception. Under these conditions, the retreat of formal welfare system might bring about disastrous outcomes not only for labor, but for capital also. The social and economic reproduction of the increasing labor force necessitates a welfare system. With the retreat of former one, a new welfare regime has been emerging in Turkey. This system uses voluntary transfers to aid social and economic reproduction of labor force, and also to support the sustainability of reserve labor army. Our class-based analysis provides significant insights about this process.

Households in the lowest quintiles and the classes in the lowest echelons of capitalist society experienced increasing deficits in their balance sheets.[57] The share of households' deficit increased for almost all the quintiles. In this pretext, the real consumption of the higher quintiles and upper classes increased.

[56]This is due to the fact that functional income distribution analysis uses national income data rather than household level data.

[57] The section on consumption implies that these deficits were met with borrowings from the banking system.

This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

When we shift our attention to the trends in the balance sheets of nonfinancial corporate sector a couple of observations are in order. First, a hallmark of financialisation in advanced economies has been the increase in payments to the financial markets, especially in forms of dividends and stock buybacks. For the Turkish NFCs, dividend data is limited in our database. However, due to the institutional differences stock buybacks were not possible until very recently. Shareholder pressure was also not visible as shareholder activism has been limited. This is a major institutional difference. Second, bank financing is still a very important channel. Third, there is an increase in financial asset holdings however financial incomes are declining in the post-2001 era. This is partly due to declining interest rates especially on government bonds. In the pre-2001 era Turkish NFCs were earning high short term interest revenues through investments in government bonds

In Turkey, although financial markets have been shallow relative to the advanced countries, households' debt along with deregulation and developments in financial markets has risen considerably for last decades. The rising debt levels put a considerable burden on people -especially low income groups- through a rise in their debt stock and debt service burden. As the rise in financial assets does not show a similar increase, the burden of increased debt levels is not seem to be compensated by a rise in gains from asset acquisition. The potential macro problems regarding a growth strategy that relies on credit financed consumption already started to the find its place in the agenda of the government, given low levels of savings and potential difficulties in financing the high current account deficit. New regulations introduced in Turkey throughout 2013 in order curb the explosive credit growth. Although, regulations seem to be effective in reducing the credit growth so far, it remains an important question in Turkey whether there could be a recovery without an increase in real wages, as the rising cost of credit would lead to a shrinking in the aggregate demand, ultimately affecting the industrial sector and the economy as a whole.

One of the most striking observations regarding the post 1980s Turkish economy is chronic current account deficits which have reached unprecedented levels after the 2002 period. We argue that the growing current account deficit of the Turkish economy can be explained mainly by two factors. The first factor is the structure of Turkey's trade with the

outside world. Turkey imports large amounts of energy items, intermediary and capital goods; while it exports, to a large extent, low-value added products. Exports competitiveness is mostly supported by relatively low labor cost. Private foreign capital inflows have a direct and an indirect effect on the current account deficit. The direct effect of capital inflows is through currency appreciation. The indirect effect is through changes in the domestic economic activity. Capital inflows affect domestic economic activity by having a positive impact on domestic credit expansion, by leading to asset price increases and especially lately by lowering domestic interest rates. Increased economic activity in turn contributes to increases in imports of both consumption and investment goods. Hence, capital inflows have an indirect impact on the current account deficit as well.

After discussing the recent trends in income distribution, balance sheets of firms in relation to their investment behavior, the connections between household debt and consumption and the nature of Turkish current account, we focused on the implications of the recent crisis on the Turkish economy. The Turkish economy was adversely affected by the crisis through mainly three channels namely expectations channel, trade channel and financial channel. The distinctive characteristics of the crisis were a severe export shock which can account for an important part of the decline in production in Turkey. Beside this, a significant sudden stop in financial flows worsened the credit conditions in the economy. As a result, the Turkish economy witnessed one of its worst economic down-turn after the Second World War. In fact, the Turkish growth performance was one of worsts among developing countries. Although there are many similarities between the recent crisis and the crises after the 80s in the Turkish economy, there are some important differences as well. First, as opposed to the recent crisis, a large decline in demand for Turkish goods amid a considerable depreciation in T.L never occurred in the crises after the 80s. Second, there was not a significant financial reversal during the last crisis whereas the previous crises were mainly triggered by massive financial reversals. In this sense, the financial shocks hitting the economy in the recent crisis were very low both in magnitude and duration relative to the shocks in earlier crises. In this sense, the Turkish economy might

not have been fully tested during the last global crisis. How Turkish economy will behave in case of a larger financial shock is still unknown.

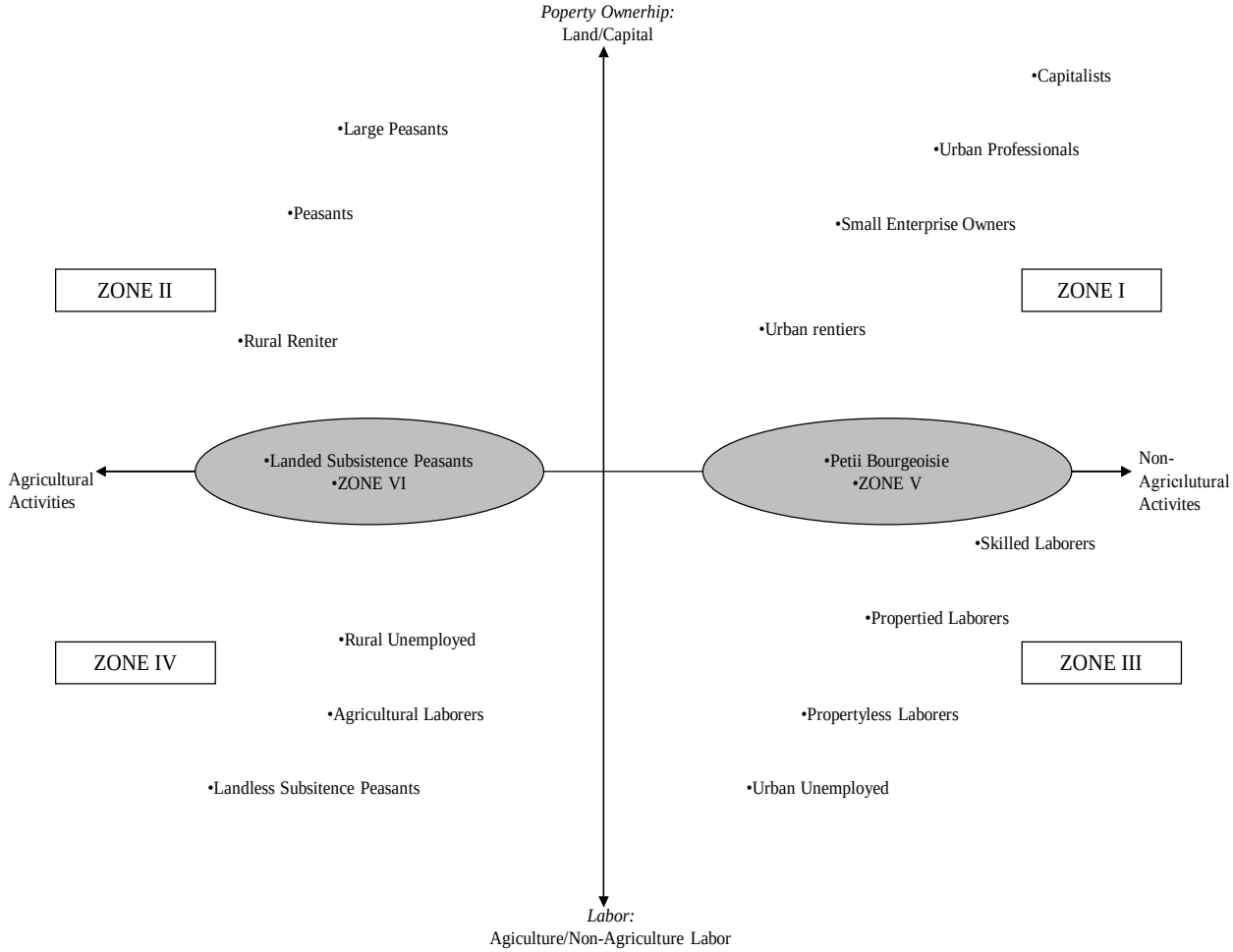
In conclusion, at a higher abstraction level, the overall findings of this report provide considerable supports to four interrelated arguments First, many well established properties of financialisation in advanced countries cannot be found in the Turkish case. Second, as opposed to the dominance of domestically driven financialisation tendencies, financial flows, a part of global financialisation, have dominated important trends in the Turkish economy. Third, under the significant influence of financial flows, in general, the Turkish economy has shown a debt-led consumption boom type growth. Fourth, although the role of the export shock in explaining the impact of the recent crisis on the Turkish economy is very distinctive, the role of financial flows in the recent and especially previous crises are very important as well.

Appendix II.1.1: The Definition Class Status

Household Budget Survey datasets are used to derive the class structure in Turkey. These datasets cover three sub-datasets: individual, household and consumption datasets. Each one can be linked to others using a household identification number. These surveys have been conducted annually since 2002. Each dataset covers nearly 8000-9000 households and nearly 30000-40000 individuals, except for the one conducted for 2003. 2003 dataset covered about 35 thousands households and nearly 135000 individuals. TSI also provides factor weights which can be employed to remap the results to whole population in Turkey. Each factor weight designates the representative power of household. For example a factor weight of 1627 implies there are 1627 similar households in the population.

Our class status derivation scheme proceeds in two steps. First, we define the individual level class identity. Then using this information we pass on the identification of household class status. Class identity derivation is certainly a theoretical construction at first. In this regard, the theoretical background determines the criteria used in the process. We have been using a Marxian framework which also incorporates embedded Weberian themes. A preliminary theoretical construction of class structure which has been the result of selective processing of the facts and tendencies is the proper way to circumvent the falling into the trap of a fallacious and cumbersome empiricism. For this we have been using the theoretical framework which could be best understood from the figure below.

Figure II.1.A.1: Class Composition of Households in Labor Force



The coordinate system depicted in Figure II.1.A.1 is designed to unfold the basic class structure of Turkey. The vertical axis represents the capital/labor nexus; to put it in other words *the nexus of production relations*. The horizontal axis exhibits *the social formation dimension*. The system is divided into six zones. Zone I is the zone of urban propertied classes, Zone II is the domain of rural propertied classes. Zone III and IV are the territories of urban and rural laborers. There are also two transition zones; one for landed subsistence peasants and the other for petit bourgeoisie. Each zone also includes a number of classes. For example, urban propertied classes zone cover capitalists, urban professionals, small enterprise owners and urban rentiers. There are also two household groups which are not shown in this figure. Retiree households and households out of working force (not-working households). For this analysis, we prefer to conduct analysis at zone level rather than at lower level classes.

The identification of household level class status is done according to the theoretical construction shown in Figure II.1.A.1. However, before this step, we ought to find individual level class identities. For individual level, we benefit from three main qualitative indicators; employment status, occupational status and sector of economic activity.

The methodology of determination of class position of urban working individuals and individuals not working is given in Tables II.1.A.1 and II.1.A.2.

Table II.1.A.1: Individual Class Position of Urban Working Individuals

		Employment Status		
		Employee/ Causual	Entrepreneu	Self-Employed
Occupation Status	Law makers and managers	Private Mangement Worker[a]	Capitalist[b]	Small Enterprise
	Professionals	Qualified Labourer	//	Urban Professionals
	Assitant Professionals	Labourer		Petit Bourgeosie
	Office Workers	//		//
	Sales person	//		//
	Qualified Agricultural	//		//
	Craftsman	//		//
	Operators	//		//
	Non-skilled	Non-Qualified Labourer		//

Notes: [a]: The managers working in the private sector. If he/she is working in the public sector, we assume that class position is "Qualified Labourer". [b]: Generally, if the employment status is reported as entrepreneur, the class position is assigned as "Capitalist".

Table II.1.A.2: Class Positions of Individuals not Working

Looking for Job[a]	Reason for not Looking Job	Class Position
1		Unemployed
2	Found a job, waiting to start	Unemployed
2	Student/housewife	Out of Working
2	Old Age	Out of Working
2	Handicapped/Sickness	Out of Working
2	Rentier	Rentier
2	Retiree	Retiree
2	Family Related and Personal reasons	Unemployed
2	Seasoned Employment	Unemployed
2	Other	Unemployed

Notes [a]: For the question "Looking for a job", 1 indicates "yes" while 2 showing "no".

On the other hand, if the individual is a self-employed and working in agriculture sector, he/she is marked as a peasant. If employment status is employee/causual employee and the sector is agriculture, then this individual is assumed to be an agricultural labourer.

After this step is completed, the class structure at individual level is used to derive household level class structure. At this step a sequential method is followed. This sequential path is also theoretically designed. This path defines a hierarchical structure which is very akin to the real hierarchy in a capitalist society. This path starts at the highest echelons of the Zone I, then enters into Zone V. Thenceforth, the theoretical path sequentially traces zones III, II, VI and IV in respective order. By this way, capital has been prioritized over labor and non-agricultural activities have been prioritized over the agricultural activities as well. Tables II.1.A.3 and II.1.A.4 summarize the procedure.

Table II.1.A.3: Sequential Method of Determining the Class Position of Working Households

Class Position	Should Contain At Least One
Capitalist	Capitalist/ Private Management Labourer I[a]
Urban Professional	Urban Professional
Small Enterprise Owner	Small Enterprise Owner
Petit Bourgeoisie	Petit Bourgeois
Skilled Labourer	Skilled Labourer/Private Management
Propertied Labourer	Labourer/Unskilled Labourer
Propertyless Labourer	Labourer/Unskilled Labourer
Agricultural Labourer	Agricultural Labourer
Large Peasants	Peasant
Peasants	Peasant
Landed Subsistence Peasants	Peasant
Landless Subsistence Peasants	Peasant

Notes: [a]: Manager in a firm employing more than 25. [b]: Manager in a firm employing less than 25.

Table II.1.A.4: Sequential Method of Determining The Class Position of Households not Working

Class Position	Should Contain At Least One
Retiree	Retiree
Out of Working Pop.	Children or Old Age (Age>65)[a]
Urban Unemployed	Unemployed/ (Asset Income=0)
Rural Unemployed	Unemployed/ (Asset Income=0)
Urban Rentier	Residually determined
Rural Rentier	Residually determined

Notes [a]: All the members of these households are below or above working age.

The peasant households are divided into subsistence peasants (landed and landless), large peasants and peasants. The threshold for the division between the subsistence peasants and others is the mean per capita income of the agricultural labourer households. If per capita agricultural income of a peasant household is less than this threshold, then the household is a subsistence peasant. Non-subsistence peasants are divided into large peasants and peasants with reference to per capita and per acre productivity variable

(RTY).[58] If the household RTY is above the mean RTY of the group, then that household will be classified as large peasant household.

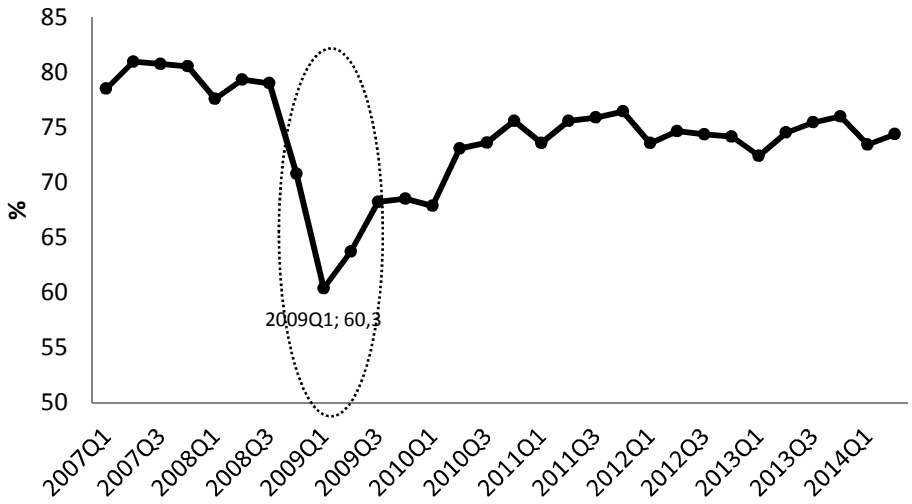
For this study all the households, according to their class status, are grouped under the zones. Hence, six zones correspond to six broad class categories: Urban and rural propertied classes, petit bourgeoisie, landed subsistence peasants, urban and rural laborers. Two non-working groups – not working and retiree – are added to the list.

[58] $RTY = \frac{\text{Household Agricultural Income}}{\text{Total Acres Owned*Number of Individuals in the Household}}$

This measure is defined to capture productivity differentials of land plots in different geographical areas of Turkey. Moreover, since there is no data, we assume that all the acres owned are cultivated.

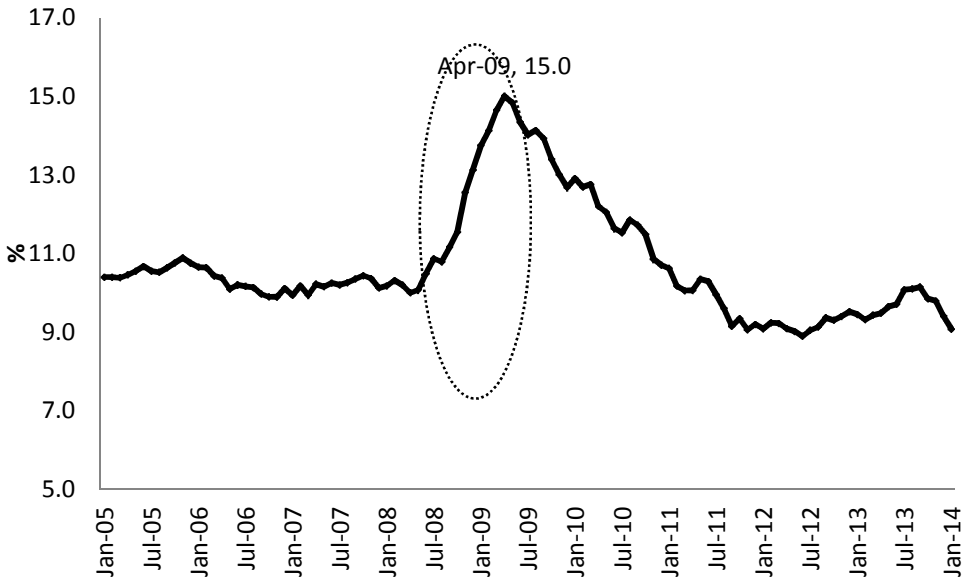
APPENDIX III.A1

Figure III.A1.1: Capacity Utilization Rate in Manufacturing Sector



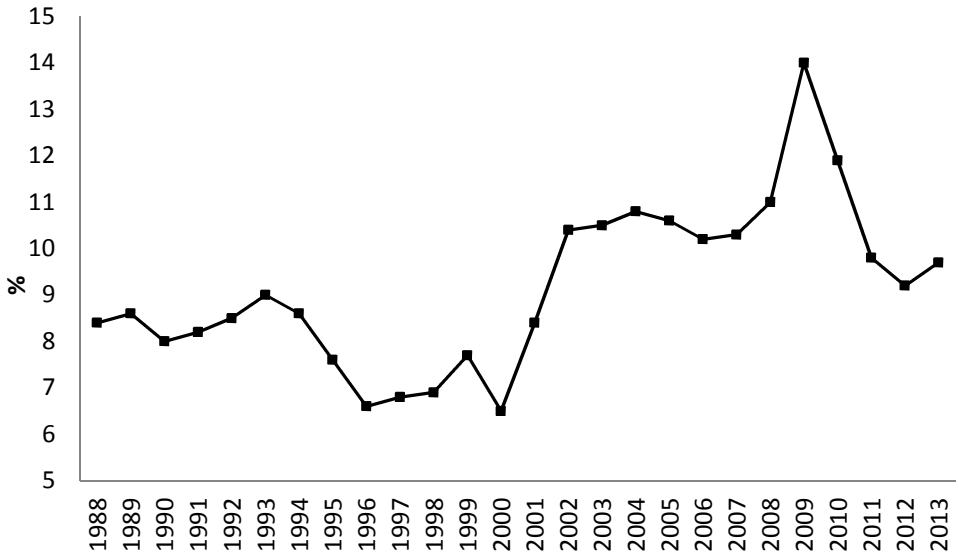
Source: CBRT

Figure III.A1.2:Seasonally Adjuted Unemployment Rate (Monthly)



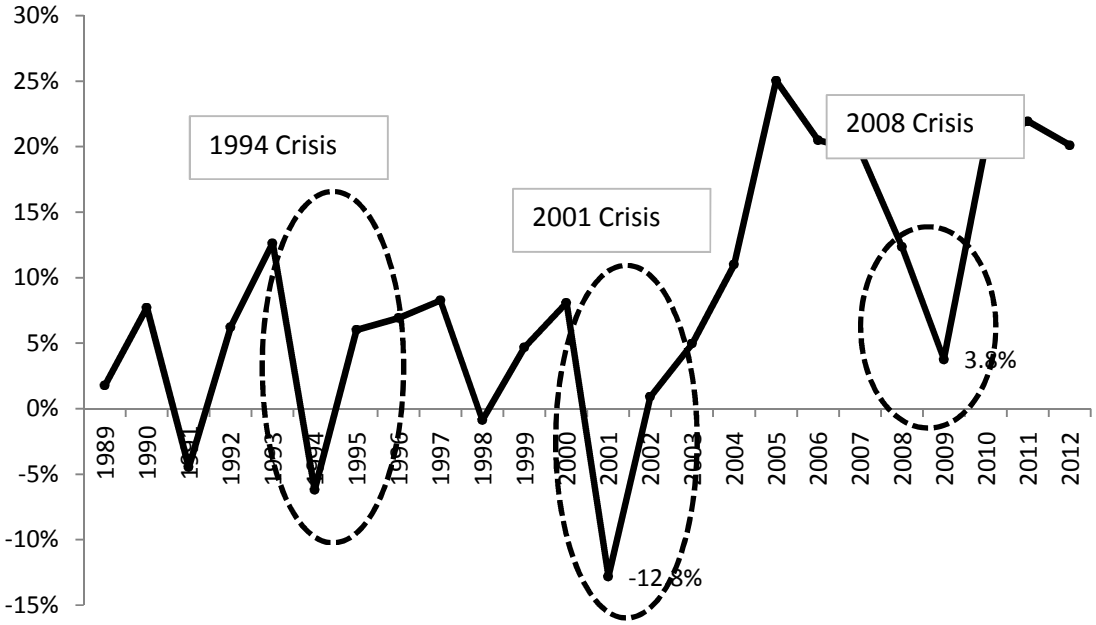
Source: Turkstat

Figure III.A1.3: Annual Unemployment Rate



Source: Turkstat

Figure III.A1.4: Net Financial Flows, % of total foreign liabilities



Source: CBRT

Table III. A1.1

	Net Financial Flows / Imports		
t	1994 Crisis (t0=1993 Q1)	2001 Crisis (t0= 2000 Q2)	2008 Crisis (t0= 2008 Q2)
0	48%	37%	34%
1	33%	27%	26%
2	35%	-10%	-10%
3	23%	-22%	-7%
4	11%	-44%	3%
5	-30%	-10%	24%
6	-41%	-39%	19%
7	-4%	8%	26%
8	53%	-1%	46%
9	24%	-11%	27%
10	28%	13%	45%
11	-22%	28%	50%

Source: CBRT

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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1 (Coordinator)	University of Leeds	UK
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4	Fondation Nationale des Sciences Politiques	France
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