TURKEY

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EXECUTIVE SUMMARY

This comprehensive paper examines the economic landscape of Turkey, analyzing key economic indicators, recent challenges, and the interplay between political decisions and economic outcomes.

Turkey is now facing a dramatic economic crisis due to the domestic currency plunging in value, high inflation, rising borrowing costs and correspondingly rising loan defaults. Additionally, Turkey confronts a multitude of challenges that extend beyond mere economic difficulties, encompassing a complex scenery marked by natural disasters, social disparities, and intricate geopolitical dynamics.

A comprehensive exposition is provided on both the challenges at hand and the policies that have been implemented to handle them in profound detail.

Finally, the paper illustrates the possible strategic interventions to address the economic downturn, clearly outlining their effects by making references to the models studied in class, and consequently selecting the best ones.

INTRODUCTION

Turkey is situated at the crossroads of Europe and Asia, a strategic geographic location that has long granted the region an important role as the bridge between the two continents. An emerging economy, founding member of the OECD and member of the G20. With a population of 85 million people Turkey’s nominal GDP peaked at $1.154 trillion in 2023, making it the 17th largest economy in the world, and GDP per capita also peaked at $13.383. When analyzed through purchasing power parity, Turkey is the 11th largest by GDP at around $3.613 in 2023 and the GDP per capita increases to $41,887. Turkey has a labor force of 34 million people, with an unemployment rate of 9.2% generally and 17.2% youth unemployment rate.

The graph below displays the government debt as a percentage of GDP of OECD countries for the year 2022 according to the OECD. Analyzing the graph, we can visualize that Turkey’s public debt to GDP ratio is one of the lowest among OECD countries at 31.7%, more than half of the OECD average.

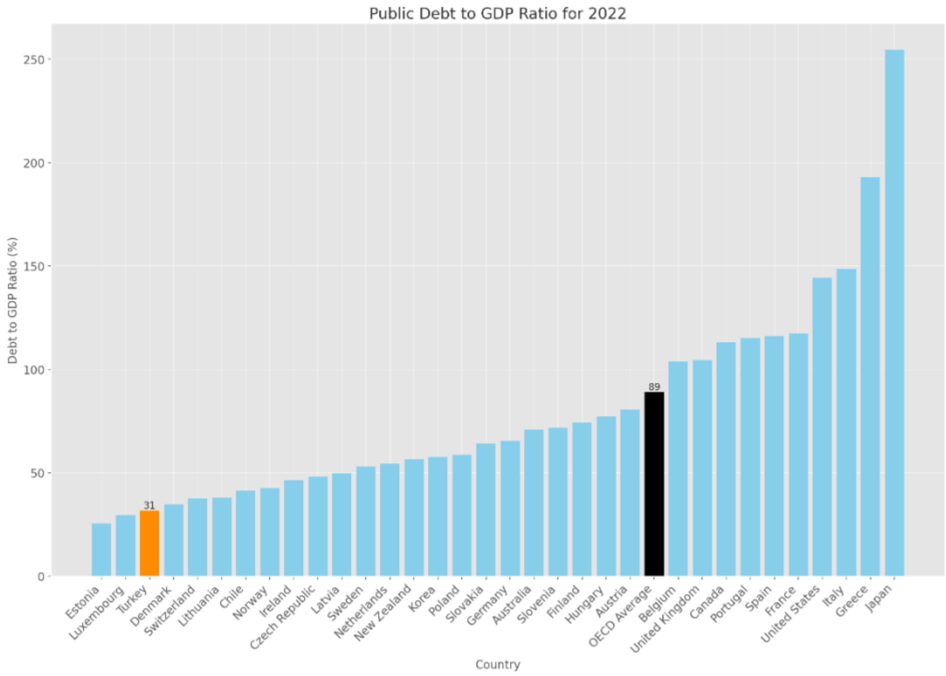


Figure 1

Despite the pandemic, the economy rebounded, with real GDP growing by 11.4% in 2021 and further rising by 6.2% in the first three quarters of 2022. Private consumption and exports were the primary drivers of this recovery. However, the economy now faces headwinds, with growth projected to moderate to around 3.6% in 2023. One of the significant challenges facing Turkey is high inflation, which reached a 20-year peak, with consumer price inflation at 85.5% in 2022.

In recent years, the interplay between politics and economics has become increasingly complex and pivotal, with President Recep Tayyip Erdoğan at its center. Erdoğan's leadership has been characterized by a hands-on approach to political governance and economic policy, impacting the nation's domestic and international standing. His strategies have sparked significant debate and analysis, particularly regarding their influence on Turkey's economic stability, inflation rates, and currency value. Moreover, Erdoğan's political maneuvers, which include consolidating power and pursuing assertive foreign policies, have further intertwined with the country's economic narrative, creating a dynamic where political decisions directly influence economic outcomes. The recent earthquakes in early 2023 added another layer of complexity to the economic landscape. The disasters caused extensive damage and displacement in the southern region, impacting industrial production and retail sales.

Turkey's economy has the potential for growth and recovery, but it faces significant challenges that require careful policy management and structural reforms to ensure sustainable growth and stability. The country's success in navigating these challenges will be crucial for its economic future and its role as a pivotal player in the regional and global economic landscape. Turkey's ability to leverage its strategic geographic position, address inflationary pressures, and implement structural reforms will determine its economic trajectory in the coming years.

MAIN ISSUES

In the midst of a persistent crisis, Turkey grapples with several challenges that transcend the realm of economic difficulties. The nation is currently navigating a complex landscape marked by natural disasters, social disparities, and intricate geopolitical dynamics. The earthquakes in February 2023 have intensified pre-existing vulnerabilities, prompting a call for a strategic and comprehensive approach to effectively address the array of issues at hand. As Turkey stands at a critical crossroads, the interconnected nature of these challenges underscores the imperative for careful consideration and innovative solutions. The nation finds itself in a delicate position, requiring a nuanced response to tackle not only economic downturns but also social inequalities and diplomatic challenges on the global stage.

Economic situation

The ongoing Turkish economic crisis is fueled by the substantial depreciation of the Turkish lira (TRY), soaring inflation rates, escalating borrowing costs, and a corresponding surge in loan defaults.

The crisis was caused by the Turkish economy's excessive current account deficit and large amounts of private foreign-currency denominated debt, in combination with President Recep Tayyip Erdoğan's increasing authoritarianism and his belief that low interest rates would somehow cap inflation. For a long time, Erdogan insisted that Turkish Central Bank interest rates be kept relatively low, to keep credit flowing, boost production, employment and exports. Additionally, he also criticized high interest rates as contrary to Islamic teachings and as exacerbating the gap between rich and poor. From September 2021 to March 2023, the interest rate moved down from 19% to 8.5% hence leading to higher inflation.

Last October, inflation hit a 24-year high of 85.5 percent on an annualized basis, meaning prices nearly doubled. This year, inflation has tempered from very high to somewhat high and is heading back toward being unsustainable. In June, inflation was close to 40 percent year-on-year. In July, it was nearly 50 percent, and in August, it was nearly 60 percent. Investment banks and the government agree that inflation will likely hit 65 percent by the end of the year.

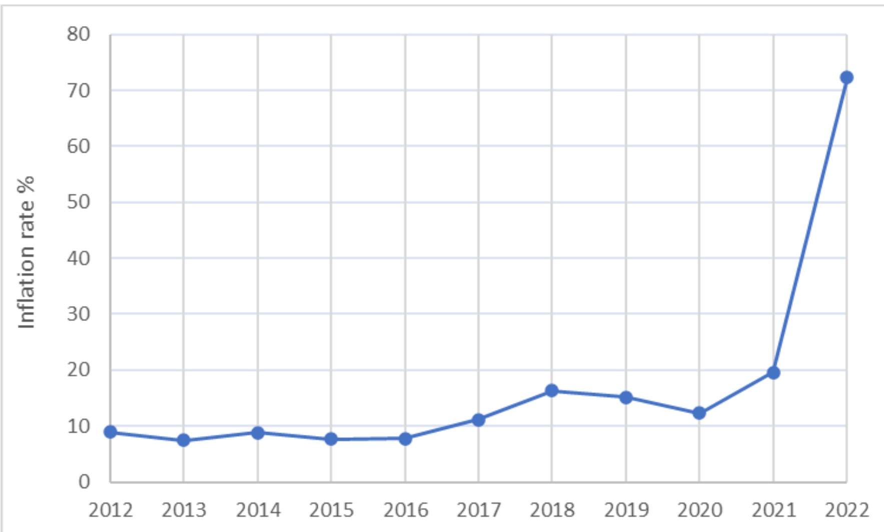


Figure 2

It shows the inflation rate value at the end of each year during last decade.

Additionally, a persistent feature of Turkey's economy is its low savings rate. Since Recep Tayyip Erdoğan took control of the government, the country has experienced substantial and growing current account deficits: $33.1 billion in 2016, $47.3 billion in 2017, and a peak of $7.1 billion in January 2018, contributing to a rolling 12-month deficit of $51.6 billion. This makes Turkey one of the countries with the largest current account deficits globally.

The economy has heavily relied on capital inflows to support excessive private-sector spending, with Turkish banks and large corporations borrowing heavily, often in foreign currencies. Managing this deficit and maturing debt requires finding approximately $200 billion annually, a challenge given the risk of inflows drying up, especially with the state's gross foreign currency reserves standing at just $85 billion.

Concerns about political instability, the decreasing value of the lira, and Erdoğan's authoritarianism suppressing factual reporting by financial analysts contributed to a decline in foreign portfolio investment. In 2017, foreign portfolio investors funded $13.2 billion of Turkey's $17.5 billion current account deficit between January and May, but by the same period in 2018, they provided only $763 million for a much larger $27.3 billion deficit.

By the end of 2017, Turkey's corporate foreign-currency debt had more than doubled since 2009, reaching $214 billion netted against foreign-exchange assets. The country's gross external debt, including public and private sectors, stood at $453.2 billion by the end of 2017. As of March 2018, $181.8 billion of external debt, both public and private, was due to mature within a year. Non-resident holdings of domestic shares, government bonds, and corporate debt saw a significant decrease from a high of $92 billion in August 2017 to $53 billion by July 13, 2018.

Turkey has faced significantly higher inflation compared to other emerging markets. In October 2017, inflation reached 11.9%, the highest since July 2008. In 2018, the lira's exchange rate rapidly deteriorated, hitting 4.0 TRY per USD by late March, 4.5 TRY per USD by mid-May, and escalating to 6.0 to 7.0 TRY per USD by mid-August. Economists attribute this accelerating loss of value to President Recep Tayyip Erdoğan's interference with the Central Bank of the Republic of Turkey, preventing necessary interest rate adjustments.

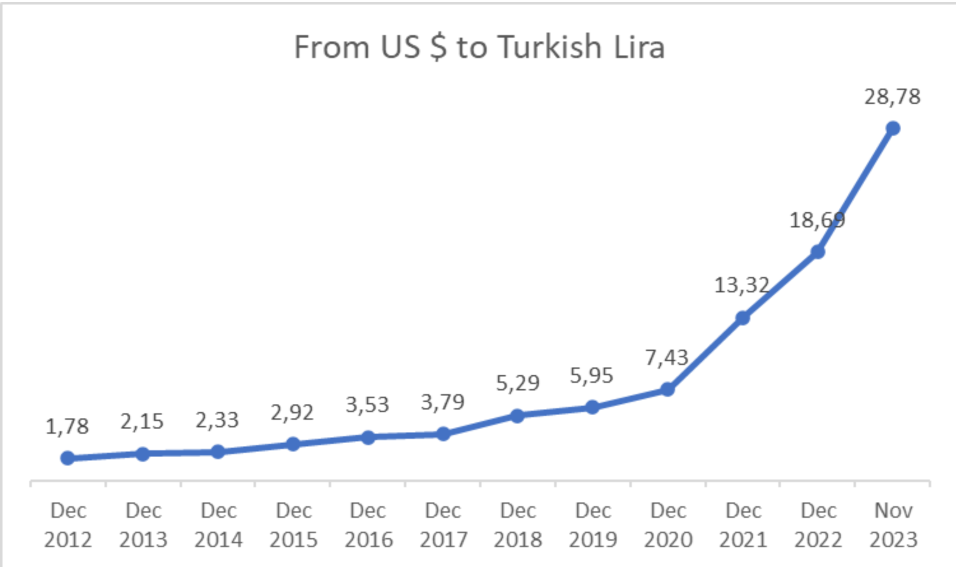


Figure 3

During the crisis's emergence, Turkish lenders faced restructuring demands from corporations unable to service USD or EUR-denominated debt due to the devaluation of earnings in Turkish lira. Financial institutions, once major contributors to the Istanbul stock exchange, saw their influence decline to less than one-third by mid-April. Lenders experienced a surge in demand for debt reorganization by late May, with public restructuring requests totalling $20 billion by early July. The asset quality and capital adequacy ratio of Turkish banks deteriorated, notably with Halk Bankası losing 63% of its US dollar value since the previous summer.

The crisis posed significant risks of financial contagion, especially for foreign lenders. According to the Bank for International Settlements, international banks held outstanding loans of $224 billion to Turkish borrowers. Major exposures included $83 billion from Spanish banks, $35 billion from French banks, $18 billion from Italian banks, $17 billion each from U.S. and U.K. banks, and $13 billion from German banks. This heightened the perception of risk for foreign lenders.

The crisis also raised concerns about the situation in other emerging economies with substantial debt denominated in USD or EUR. Turkey's mishandling of the crisis potentially increased international investors' retreat, amplifying the perceived risk in such countries. By May 31, 2018, the Institute of Financial Research reported the spread of the Turkish crisis to Lebanon, Colombia, and South Africa. The devaluation of the lira impacted inhabitants in northern Syria, who used it for everyday transactions, and severely affected the hazelnut industry, a critical economic sector in Turkey responsible for 70% of the world's hazelnuts.

Natural Issues

The earthquakes on February 6, 2023, in Turkey resulted in profound consequences, claiming at least 45,000 lives and leaving millions homeless across multiple cities. The immediate damage is estimated at $34 billion, roughly 4% of the country's annual economic output, according to the World Bank. The Turkish Enterprise and Business Confederation project the total cost of the earthquake at $84.1 billion, with housing constituting the majority at $70.8 billion. These catastrophic events have exacerbated the economic challenges faced by the nation, compounding the existing strain on the fragile macro-financial landscape. The reconstruction efforts, estimated to reach double the direct losses, will require a strategic and comprehensive approach to enhance recovery and fiscal stability, particularly as the nation had already experienced a decline in economic momentum due to external pressures and unconventional monetary policies.

Social Issues

Approximately one-third of Turkey's population faces the imminent risk of poverty or social exclusion, jeopardizing the considerable strides made in poverty alleviation since the early 2000s. Families, particularly those with young children, grapple with economic hardships, struggling to meet basic needs. Rising levels of mental illness, underscored by increased use of psychiatric drugs, raise significant health concerns. Children are disproportionately affected, with some attending school hungry or dropping out to contribute to household income. The crisis forces individuals into impossible choices, emphasizing the pressing need for humanitarian intervention. Sky-high inflation and economic mismanagement contribute substantially to social challenges. The collapse of the Turkish lira exacerbates these issues, eroding wages and adversely affecting local businesses.

Stakeholders advocate for a rights-based social policy, targeting the specific needs of vulnerable groups such as students, women, single mothers, the disabled, the elderly, and children. This approach aims to build a more inclusive and equitable society. The historical context highlights longstanding poverty issues in Turkey, with authorities perceived as failing to take effective action. As poverty deepens, the imperative for comprehensive rights-based solutions intensifies, emphasizing the need for a strategic, forward-looking policy approach.

Geopolitical frictions

Turkey's geopolitical landscape reflects a complex interplay of historical legacies and contemporary challenges, influencing its relationships with various countries. One key facet lies in Turkey's longstanding aspiration for EU membership, initiated officially in 1980. However, progress in accession talks has been sluggish, characterized by various obstacles. Presently, the strained Turkey-EU relations are marked by political differences, human rights concerns, and stalled talks, hindering the realization of closer ties.

Geographically situated at the crossroads of regional conflicts, Turkey faces ongoing challenges due to the Syrian Civil War and the resultant refugee crisis. This has not only strained Turkey's resources but has also prompted discussions with the EU regarding migration policies.

Turkey's historical affiliation with the United States, as a NATO member since 1952, has played a crucial role in shaping its geopolitical stance. Nevertheless, historical disputes, such as the Armenian Genocide recognition and the Cyprus issue, have been recurrent points of contention. Current tensions with the US revolve around differing approaches to regional issues, Turkey's procurement of Russian S-400 missile defence systems, and disagreements over Syria, straining the traditional alliance.

Lately were increased economic tensions with foreign countries, exemplified by the dispute with the United States over U.S. citizen Andrew Brunson, detained in Turkey. President Erdoğan characterizes it as a global economic war against Turkey. This conflict escalated with the imposition of U.S. tariffs, justified by national defence concerns, and targeted at Turkish steel and various products. In retaliation, Turkey announced tariffs on U.S. goods, including the iPhone, covering items such as American cars and coal. The dispute centres around the release of Brunson, highlighting the intricate interplay of geopolitics and economic pressures.

Historically, Turkey has maintained strategic partnerships with various countries, including other NATO allies, in addition to US. However, recent shifts in alliances, exemplified by Turkey's closer ties with Russia and involvement in regional conflicts, have raised concerns among traditional allies. The acquisition of Russian S-400 systems has strained relations with NATO.

Moreover, disputes over maritime boundaries and energy resources in the East Mediterranean, rooted in historical conflicts related to Cyprus, have further heightened geopolitical risks for Turkey. Ongoing tensions with Greece and Cyprus over energy exploration and maritime rights have resulted in increased military posturing and diplomatic disputes.

As a historically influential regional power, Turkey's assertive foreign policy, interventions in regional conflicts, and efforts to establish itself as a major player have shaped its current geopolitical dynamics. This has led to both cooperation and rivalry with neighbouring countries, impacting regional stability, and contributing to the intricate global geopolitics. Navigating these complexities demands a delicate balance between maintaining relationships with traditional allies and addressing emerging challenges.

IMPLEMENTED STRATEGIES

Economic crisis: Monetary Policies

As already discussed, since 2018 Turkey suffers from severe inflation and devaluation of the lira. To relieve the soaring prices, the president of Turkey has insisted on keeping low interest rates for years. This policy is not reasonable economically because it leads to a decrease in the nominal exchange rate, causing the value of the Turkish lira to fall even more. Additionally, it stimulates both exports and investment, contributing to output growth, and, consequently, to even higher prices. Therefore, low interest rates make goods artificially cheaper in the short run but over time cause even more inflation and currency depreciation.

Throughout the years of the crisis, the central bank has not succeeded in stabilizing prices as it has often taken inappropriate actions. Since the beginning of 2018 the bank has changed the interest rate repeatedly. However, until the end of 2022 its actions have been highly inconsistent. Every contractionary monetary policy has been followed by an expansionary one as can be observed on the graph below by the continuous fluctuation of the interest rate between 8 and 24 percent during these years. In 2021, when prices were already increasing rapidly, Erdogan decided to cut the interest rate, causing even more severe inflation. Accordingly, the decisions until that point did not relieve the enormous levels of inflation but made the Central Bank of the Turkish Republic less credible.

However, this year the new economic team has taken consistent actions in raising the interest rate. In June, the central bank conducted a restrictive monetary policy, raising the rate by 650 basis points – from 8,5% to 15%, followed by even bigger increases in the following months. The rate grew gradually, reaching 35% at the end of October, the highest it has been throughout the entire last decade. The bank stated that the goal of this continuous change in interest rate is to achieve the target inflation rate of 5%. This policy gives optimism that Turkey is finally taking systematic and appropriate actions to stabilize its prices. The Turkish lira, however, keeps falling consistently despite the higher interest rate.

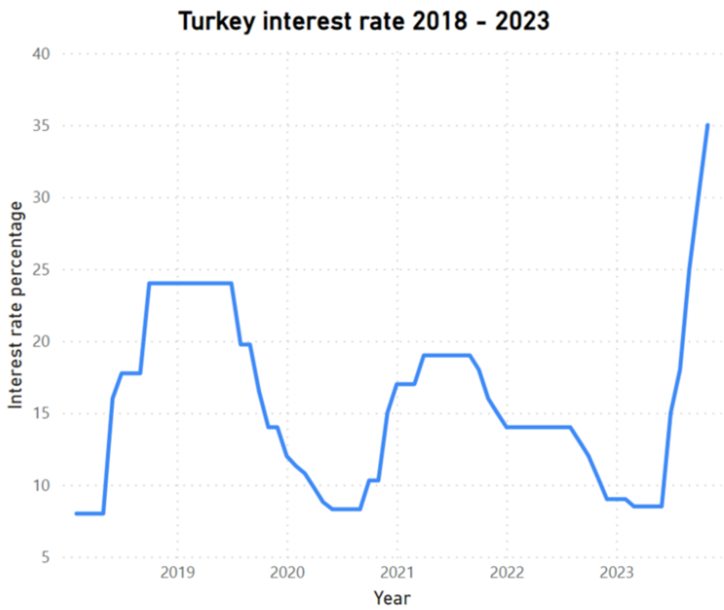


Figure 4

Economic crisis: Fiscal policies

Turkey has also tried to offset prices through government spending. To begin with, in 2021 energy bill subsidies were provided. Then, the following year, the VAT for basic food items went down from 8% to 1%. These policies failed in reducing inflation. However, in May 2023 the president implemented a new action - natural gas was provided completely free of charge for a month. In addition, Erdogan promised to continue providing a certain quantity of gas to households monthly at a 'zero price' until May 2024. As a result, in May 2023 the annual inflation went down to 39,6%, the lowest it has been since the end of 2021, and decreased even a bit further in June, reaching 38,2%.

This positive outcome was countered by other changes. Starting from July 2023 higher taxes have been imposed to reduce the public debt. In addition to a significant increase in corporate tax rate and taxes for gasoline and diesel, the general value-added tax was raised from 18% to 20%. That is a restrictive fiscal policy, which offsets the effect of free gas and subsidies. As a result, inflation started growing again in July and has continued to grow until now.

Economic crisis: Liraization

With the drop in value of the national currency, firms and banks started exchanging the Turkish lira for either euros or dollars – an action which usually leads to depreciation. To stop the lira from plunging even further, Turkey used a strategy called "liraization" aimed at limiting dollarization and, consequently, achieving appreciation of the Turkish currency. In the last 2 years policies such as elevations of the required reserves ratio for FX-protected lira deposits in banks and obligating exporters to convert 40% of their foreign currency into lira have been implemented. Nevertheless, this approach has failed to raise the lira. Indeed, in 2022-2023 despite these actions, the lira fell even more drastically than in previous years.

Earthquakes

The earthquakes on 6 February 2023 have exacerbated the economic crisis in Turkey. To relieve the devastating consequences of the natural disasters, Turkey looked for financial help from other countries. For years Turkey has been using a "humanitarian diplomacy" strategy – it has provided notable humanitarian aid and development assistance for countries in need, such as Somalia, Afghanistan, and Syria. Now, when Turkey is the one needing support, other countries are willing to donate money to help it deal with the current crisis. Turkey received 7.5 billion dollars from the EU, 1.78 billion dollars from the World Bank, 185 million from the US, as well as many smaller aids.

Poverty and health

As the number of people living in poor conditions has been increasing drastically, the government has implemented the following policies to relieve poverty. On 1st July 2023, Turkey increased the minimum wage by 34% (from 10008 TRY/month to 13414 TRY/month) to help the population overcome the high price level in the country. Despite this change, the minimum amount of money a family of four needs for food is now higher than the minimum wage. In addition, wage raises may cause even more severe inflation over time, so this strategy might not be optimal in Turkey's situation.

Another action taken in response to social issues was increasing participation in the education system. A lack of education contributes to poverty due to the inability to work in higher-paying jobs. To reach its goal Turkey started circulating free textbooks and transportation. In addition, the FAITH project, which the Turkish government implemented, made education compulsory for all citizens for the initial 12 years.

Moreover, in 2014 various positive changes in the health sector were made, such as broadening of the vaccination program as well as the scope of newborn screening and support programs, creation of community-based mental healthcare services, and establishment of free cancer screening services. These reforms have allowed people in need to get the basic services without a fee, which has supported the population in poor conditions.

Social marginalization

The biggest social marginalized group in Turkey are the immigrants – around 4.1 million immigrants have moved to Turkey from countries like Iran, Iraq, Bosnia and Syria. This drastic rise in population has left more people confined to the poverty trap prevalent in the nation because all the immigrants are straining Turkey's resources. Since they play a huge part in the country's economy, to ease the situation, the Facility for Refugees in Turkey (FRiT) along with UNHCR, has pledged almost 24 million euros to allow access to protection and services for refugees and asylum seekers in Turkey. This policy shows an attempt to integrate the immigrants more in the society and facilitate their lives.

OUR SUGGESTIONS

There are several challenges that the country must face, and it is not always possible to find solutions that improve all aspects in a harmonious manner. We think that the Government should address some issues with more urgency than others, clearly defining its priorities. This is why we provide both benefits and disadvantages for each dynamic analyzed.

Value of Domestic Currency (Turkish Lira)

As discussed above, the Turkish Lira is plunging in value, raising concerns of even higher prices for people already struggling to afford basics like food amid high inflation. If the Government decided to tackle this issue, it would need to increase the Exchange Rate. Referring to the model of open economy studied in class, we know that, to achieve this objective, we can pursue 2 different strategies:

1. Increasing the interest rate (Contractionary MP): this would lead to an increase in the demand for the domestic currency and hence to an increase in the nominal exchange rate. Additionally, we should consider that an increase in E (exchange rate) would cause a drop in NX (net exports) as X(exports) would fall while IM (imports), becoming relatively cheaper, would go up. Consequently, Z (demand) decreases and so does the output. Overall C (consumption) would decrease because of a lower Y (output), I (investments) would decline both because of the fall in Y and the growth of i (interest rate) and the trade deficit would worsen.

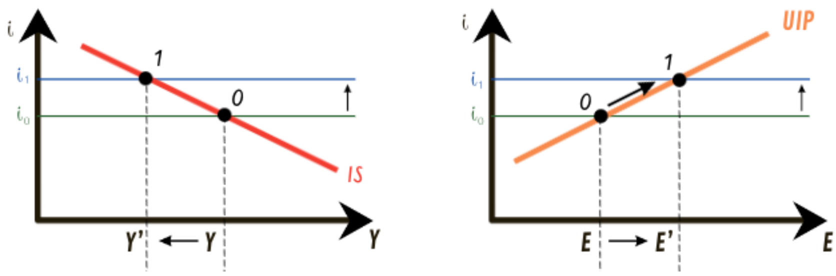


Figure 5

2. Higher Expected Exchange Rate: this would have the same effects as the policy previously described except for the fact that investments are not negatively affected by a greater interest rate, which in this case is unchanged. However, this would work only if the central bank is considered credible, a condition that cannot be satisfied at the moment.

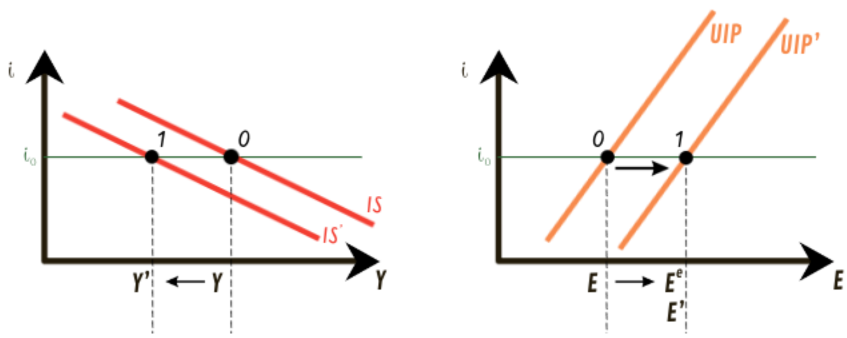


Figure 6

In both cases an expansionary FP could be considered to mitigate the effects on both Y and NX as it would result in a rise in Y that would consequently lead to an increase in IM, reducing net exports.

Trade deficit

The net exports negatively contribute to the Turkish current account deficit and to improve its value, according to the model of Open Economy studied in class, there are 2 possibilities:

1. Decreasing the real exchange rate to boost the exports.
2. Lowering imports through a restrictive fiscal policy.

Pursuing the first option we would obtain an increase in Y because of the growth of Z caused by the rise of NX (X go up as domestic goods are relatively cheaper than the foreign ones and for the same reason IM decrease). Still, it should be considered that implementing such policy to improve the Trade deficit would further depreciate the domestic currency, which is already weak. Instead, the second option would be able to reduce IM as a restrictive FP would trigger a decrease in D and Z, leading to a drop in the level of output. As IM depend positively on Y, a drop in the latter would cause a decline in IM, resulting consequently in an improvement in net exports.

However, to conserve the same level of output, a combination of these strategies could be contemplated due to the opposite effect that they have on Y. For instance, considering the first case explained above, implementing an adequate restrictive FP would offset the effect on Y caused by the depreciation of the local currency and further improve the NX.

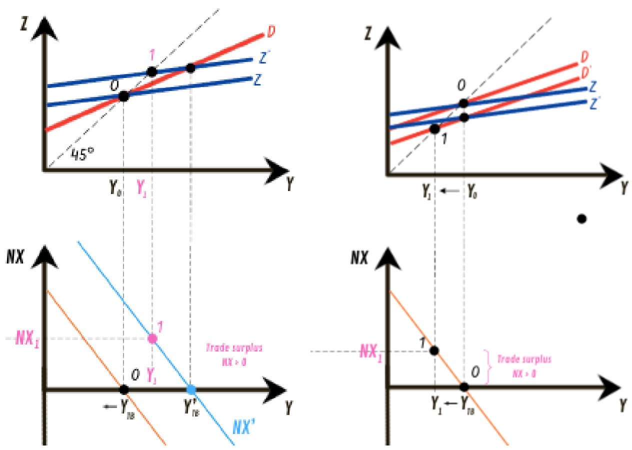


Figure 7

Central Bank credibility

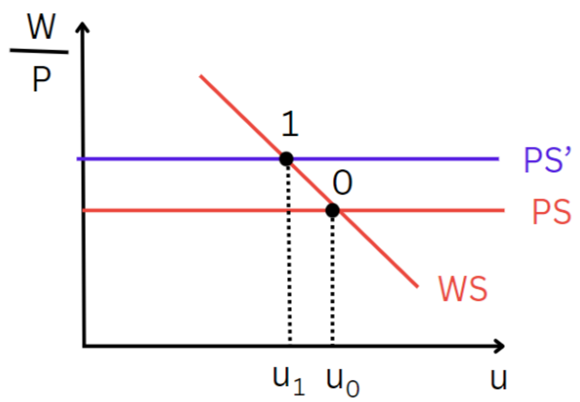
The Turkish CB has lost its believability, and this has negatively impacted the national financial situation, this is why we think it is important for the CB to restore its credibility. Enhancing the credibility of a central bank is a multifaceted endeavor. Achieving credibility involves clear and transparent communication, especially through forward guidance and the regular publication of economic data and policy decisions. Independence from political influence is crucial, allowing the central bank to maintain consistency in its monetary policy decisions over time. Accountability mechanisms, such as regular reports and engagements with legislative bodies, reinforce transparency. Establishing credible policy targets, such as inflation targets, and consistently working toward them underscores the central bank's commitment to its objectives. Moreover, actively promoting financial stability within its mandate and engaging in international cooperation further solidifies a central bank's credibility. Ultimately, adaptability and flexibility in responding to evolving economic conditions showcase the central bank's capability to address emerging challenges, fostering confidence in its policies and decisions.

Inflation

To fight the issue of growing prices, Turkey can increase the level of natural output, so that the positive output gap closes and inflation stops rising. This can be done through the following policies:

1. Increase in market competition (m) in the country, leading to firms setting a lower marginal cost mark-up.
2. An increase in productivity of labor (A), which creates lower marginal costs for the firms.

In both cases firms set lower prices, the general price level goes down and for the same nominal wage, the real wage increases. As a result of the higher real wage, workers start looking for a job more actively, so the natural unemployment rate decreases. In the WS-PS model, this is represented by the upward shift of the PS curve, which now crosses the WS curve in a point of lower unemployment. The decline in the unemployment rate leads to an increase in the natural output level. In the IS-LM-PC model, the PC curve shifts to the right (from point 0 to point 1) so the positive output gap becomes smaller and the rise in inflation is also now lower($\pi 1<\pi 2$).



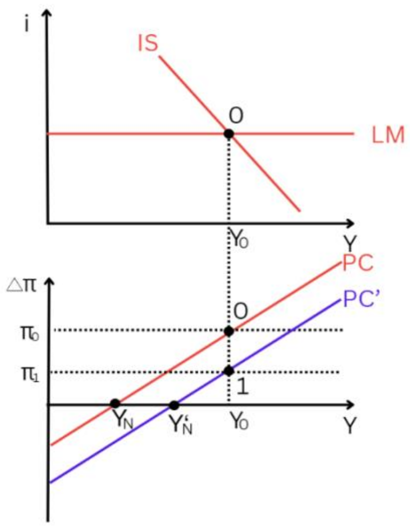


Figure 8

Currently, strict regulations shield incumbents from competition and limit the entry of new firms. Particularly, complex and burdensome administrative procedures to obtain permits, licenses or concessions hamper the creation of formal businesses. In order to promote more open competition in product markets, Turkey should consider creating a one-stop shop issuing all licenses and authorizations. There is also room to ease barriers to international trade and investment, particularly restrictions on foreign ownership, which are stricter than in other countries.

To stimulate labor productivity, Turkey should provide more support for innovation by redesigning its R&D support programs that have proven to be inefficient. Particularly, it should improve schemes related to education and training of workers. It is worth mentioning that consistent investment in increasing productivity will generate more technological progress so the potential output will grow not only in the medium run, but it will keep rising also in the long run. This will allow the economy to keep growing in the future without causing other economic instabilities such as high inflation.

Conclusion

Despite its relatively high GDP, Turkey is in an economic crisis, characterized by high prices and falling in value Turkish lira. To mitigate these problems, the country has implemented a series of monetary and fiscal policies as well as a significant increase in minimum wages. These attempts have been mostly inefficient, often giving positive results only for a short period of time and eventually exacerbating the economic issues. For this reason, we would recommend that Turkey implements two of our suggestions - restoring the credibility of the

Central Bank through the policies described above and boosting technological innovation by investing in R&D. These policies will give long-term solutions to the high inflation and plummeting national currency without causing economic shocks.

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