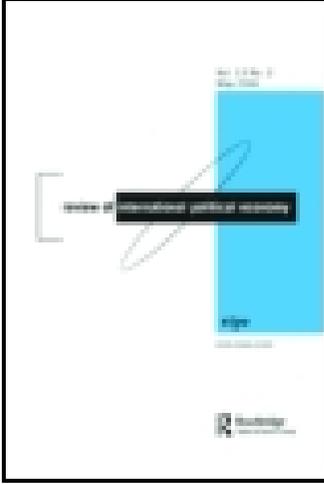


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# **Beyond the 2001 financial crisis: The political economy of the new phase of neo-liberal restructuring in Turkey**

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## **ABSTRACT**

Turkey has experienced consecutive financial crises in 2000 and 2001. The crisis of 2001 was particularly far-reaching in terms of its impact, resulting in a major collapse of output and employment. It was also quite distinct in terms of its income distributional consequences in the sense that not only the wage earners, but all sections of society at varying degrees encountered its negative consequences. The crisis also provided an avenue for a new wave of neo-liberal restructuring with a major emphasis on regulatory reforms. Turkey's political economy in the post-2001 era is investigated on the basis of four key inter-related elements: the impact of the IMF and the World Bank; the restructuring of the state's relationship with the domestic financial sector especially through regulatory reforms; the opening up of Turkey to foreign direct investment; and the adoption of a wide range of reforms modelled on the European Union, in line with the goal of entry into the EU. Indeed, the regional context associated with EU conditionality has provided the political focus of the process as a whole. A key hypothesis is that Turkey continues to be vulnerable in spite of the fact that the banking sector is much more tightly regulated in line with international norms during the post-crisis era.

## **KEYWORDS**

Globalization; state transformation; economic reforms; regulation; regional dynamics; International Monetary Fund.

## **INTRODUCTION**

Major macroeconomic crises have been an endemic feature of Turkey's political economy (Öniş and Rubin, 2003). The post-1980 neo-liberal era has also not been immune to crises. The apparent success of the first phase

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was more than compensated by three crises which have occurred over a time-span of less than a decade in 1994, 2000 and 2001 respectively (Alper and Öniş, 2003). Hence, we see a pattern which is rather reminiscent of Latin American experiences. Crises have been costly, having typically been accompanied by a collapse of output and employment as well as striking declines in real wages. Moreover, the wave of economic crises had costly political ramifications leading to breakdown of democratic regimes, notably in 1960 and 1980 (Benli Altunişik and Tür, 2005). At the same time, however, these periodic crises have created an *opportunity space* or a possible opening for a radical break with the previous model of accumulation. In 1980, Turkey was able to move from an inward-oriented model of industrialization to an export-led model following a major economic crisis, although clearly a better alternative would have been to accomplish this transformation earlier as part of a deliberate choice by domestic political actors. A similar observation can be made in the context of the deepest crisis that Turkey has recently experienced, namely the crisis of February 2001. The crisis was unusually severe in terms of its consequences. At the same time, by dramatically highlighting the inherent deficiencies of Turkish version of neo-liberalism during the 1990s, it created an important avenue for political change and economic transformation. Indeed, the post-2001 era – the third phase of Turkish neo-liberal experiment – marks a dramatic point of departure from the earlier phase. The new phase is associated with the emergence of a regulatory state with significant political and distributional consequences.

The primary objective of this paper is to underline the transformation that has taken place by illustrating the ways in which Turkey's political-economic landscape has been reshaped by the combination of domestic and external dynamics in the aftermath of the crisis. Employing a structure-agency framework, the paper seeks to highlight the socio-political processes at work that helped to shape the post-crisis restructuring process. The reaction to the 2000–01 crises was not simply due to external structural conditions. A *de facto*, socio-political quasi-consensus that drew in several key actors also played a critical role. The following actors were active participants in the process: (a) the poor and the losers as well as the rich; (b) domestic political actors in the form of the changing party political constellation; (c) transnational/institutional actors especially the EU–US–International Monetary Fund (IMF) 'triangle'; (d) key individuals in 'strategic transnational positions'; (e) the regulatory agencies (which, despite being institutions/structures, are made of crucial actors) capturing power from the old etatist bureaucracies; (f) different fractions of capital (including big business, transnational corporations and most small firms); and (g) foreign investors and other private external actors.

A central claim of the paper is that for late industrializing countries like Turkey in attempting to cope with the winds of financial globalization, the

broad regional context in which they find themselves matters a great deal and has an important bearing on the possible post-crisis trajectories. In the Turkish setting, it was the combination of a major financial crisis and the possibility of EU membership that helped to create a suitable environment for the restructuring of the neo-liberal model in such a way as to make it far more compatible with the objective of sustained economic growth. The EU element was also crucial in terms of producing an environment conducive to democratic deepening and extension of civil and human rights at a time when the crisis was naturally followed by tough IMF disciplines and clearly defined constraints on the redistributive capacities of the Turkish state.

### ECONOMIC REFORMS, SUCCESSIVE FINANCIAL CRISES AND THE QUESTION OF STATE CAPACITY

The relationship between neo-liberal globalization and the question of state capacity is a complex, bi-directional phenomenon (Hay, 2005; Phillips, 2005). The processes of liberalization and de-regulation tend to limit the range of instruments available to individual states to intervene in economic affairs. States are increasingly unable to utilize traditional instruments such as trade protectionism and capital controls. At the same time, the new era requires a new kind of state, a kind of *competition state* which possesses the institutional and political capacity needed to be able to provide the appropriate regulatory framework for an outward-oriented, market-based development (Cerny, 1998). A major problem, which many emerging market countries, including Turkey, faced, was that their transition from the import-substitution model to neo-liberal reforms was not accompanied by a parallel transition and institutional adaptation from an inward-oriented developmentalist state to an outward-oriented competition state. The logic of the 'Washington Consensus', which constituted the predominant line of thinking in the early wave of reforms implemented in the developing world, assumed that once markets were liberalized, the legal and institutional counterpart of the market would naturally follow.

Countries like Turkey, which have embraced the logic of the Washington Consensus rather uncritically, have been negatively affected in the process. In the Turkish case, the weakness of state capacity was evident in the failure to achieve macroeconomic stability. The premature transition to full capital account openness in 1989 without the necessary regulatory framework and fiscal and monetary discipline, in turn, has generated a fragile, lop-sided pattern of development, heavily dependent on inflows of speculative short-term capital. The failure to develop regulatory state capacity, in line with the needs of a more liberal financial and capital account environment, has been costly for Turkey, resulting in three consecutive crises.

The major financial crises experienced in 2000 and 2001 have, in turn, provided an appropriate context for a process of rebuilding state capacity and created a basis for the emergence of a kind of ‘competition state’ which was largely lacking during the previous two decades of the neo-liberal experiment. The international context was once again crucial in this delayed transition. The emerging ‘Post-Washington Consensus’ environment of the late 1990s meant that international organizations such as the IMF became more sensitive to issues relating to institutional reforms than has been the case in the past (Öniş and Şenses, 2005). This sensitivity has, in turn, been translated to a re-definition of the concept of conditionality with greater attention being paid to institutional and regulatory reforms moving beyond a simple-minded pre-occupation with trying to impose short-term macroeconomic discipline at all cost. However, the notion of the competition state promoted by institutions like the IMF is also necessarily limited insofar as it places a disproportionate emphasis on the *regulatory role of the state*, thereby minimizing the important role that states can play in the realms of *development and income distribution*.

Recent financial crises raise interesting questions in the context of the structure–agency debate in international political economy (Beeson and Bell, 2005; Pauly, 2005). In analyzing the process of post-crisis adjustment, the structural environments in which countries find themselves clearly matter. For example, in the case of Turkey, the geo-strategic and regional context that the country has found itself in 2001, involving close ties to the US and the EU, was important in terms of creating opportunities for re-building state capacity and emerging from a deep financial crisis in a relatively smooth manner. At the same time, the nature of such external ties combined with the country’s debt burden placed clear restrictions over the possibilities of using heterodox instruments such as the use of widespread capital controls or adopting a more radical option, such as negotiating directly with external creditors. Structural explanation alone, however, cannot account for the post-crisis trajectories that emerge in different national settings. One needs to take into account the role of agency and the role of political and policy actors and their specific responses to the opportunities presented and to the constraints imposed by the specific structural environments in which they operate in shaping the possible post-crisis outcomes.

### **IDENTIFYING POINTS OF RUPTURE IN TURKISH NEO-LIBERALISM: THE SIGNIFICANCE OF THE 2001 CRISIS**

The 1990s corresponded to the second phase of Turkey’s neo-liberal reforms. Altogether, it was an unhappy period marked by deep political instability and recurrent economic crises. Turkey was fully exposed to the

risks of financial globalization following the decision to establish full currency convertibility in August 1989. The fact that Turkey was exposed to financial globalization in the presence of severe macroeconomic instability and a weakly regulated financial system helped to create a fragile and lop-sided pattern of development, whereby growth became dependent on inflows of highly speculative and reversible flows of short-term capital. A series of unfavorable influences such as the virtual civil war conditions in the south-eastern part of the country until 1999 with the inevitable drain on public resources, a massive earthquake in the summer of 1999 as well as a volatile external environment characterized by successive financial crises in several emerging markets helped to aggravate the underlying disequilibria in the Turkish economy (Alper and Öniş, 2003; Cizre and Yeldan, 2005; Demir, 2004).

Certainly, there were attempts to reverse the bleak picture well before the onset of the 2001 financial crisis. The IMF was involved following the first crisis of the neo-liberal era in early 1994. The standard package of fiscal and monetary discipline coupled with a drastic depreciation of the Turkish lira helped to 're-equilibrate' the Turkish economy, at least in the short-run, by helping to boost exports, compressing imports and attracting a new wave of inflows of foreign capital into the economy. Yet, the 1994 crisis was not deep enough in terms of its impact, even though real wages declined considerably after the crisis, to generate deep-seated structural changes in the Turkish economy. Following the smooth recovery from the crisis, many of the key elements of the disequilibrium that characterized the early 1990s, such as huge budget deficits, chronic rates of inflation and heavy dependence on short-term capital inflows, remained intact. Weak coalition governments continued to finance large budget deficits via heavy borrowing. Major industrial corporations and banks adopted themselves to this perverse environment and increasingly made their profits by lending to the government at high rates of interest to finance the growing budget deficits. Indeed, the IMF itself contributed to instability by initiating blanket guarantees to the banking sector in 1994. The deposit insurance program with its 100% guarantee has been one of the reasons behind excessive risk-taking and moral hazard problems prior to the 2000–01 crises.

The Customs Union Agreement (CUA) with the EU, which became effective at the end of 1995, constituted an important turning point for the Turkish economy in terms of accelerating the momentum of the trade liberalization process, helping to expose domestic industry to greater external competition, as well as helping to initiate an important set of regulatory reforms (Hoekman and Togan, 2005). The setting up of the Competition Board was an example of a direct outcome of the conditionality associated with the signing of the CUA. The problem with the CUA, however, was that without the promise of full EU membership, it failed to provide a

sufficiently powerful external anchor to be able to accomplish a massive transformation of Turkey's economic and political system. The EU environment that Turkey was confronted with in the mid-1990s was much less favorable compared with its east-European counterparts such as Poland and Hungary. Turkey did not have any access to financial resources under the CUA because of the Greek veto and, given the absence of an explicit promise of full-membership, the policy-makers lacked the kinds of incentives necessary to press ahead with large-scale economic and political reforms.<sup>1</sup>

At the same time, there was a clear realization that the economy was on an unsustainable course and a crisis would break out sooner or later if the situation continued to remain unchecked. Consequently, a standby agreement was concluded with the IMF in December 1999 which was a novel phenomenon in the sense that Turkey, for the first time in its post-war history, was willing to accept IMF disciplines in the absence of an explicit crisis. The IMF program was also important in the sense that it was much more than a traditional program of fiscal stabilization. The program entailed important long-term structural and institutional reforms, such as the need to regulate the banking system through the setting up of an independent regulatory authority. Clearly, the IMF program of 1999 reflected the influence of the new thinking associated with the emerging 'Post-Washington Consensus' and the learning process that the IMF has been experiencing since the Asian Crisis in September 1997. Hence, it is important to emphasize that an important learning process had been taking place in Turkey prior to the massive breakdown of 2001. In retrospect, however, several factors have restricted the pace and magnitude of this transformation process. Firstly, the IMF was not in a politically powerful position to impose its institutional reforms given that the economy was not in an explicit crisis situation. Added to this, the amount of support provided to the program was quite limited, being in the region of \$4 billion (Öniş and Rubin, 2003). Secondly, the coalition government that came to office in 1999 was dominated by a mixture of right- and left-wing nationalist elements whose support base was mainly low income groups in urban and rural areas who were basically losers of the neo-liberal restructuring process. Clearly, this kind of government was lukewarm in its approach to key elements of the IMF package and failed to display the kind of commitment needed to implement the key elements of the program such as privatization of large state enterprises such as the Turk Telecom, reduction in agricultural subsidies as a key element of budgetary discipline and the regulation of the banking and financial system. Hence, a certain kind of stalemate emerged where the IMF was trying to impose certain institutional reforms but did not enjoy the kind of autonomy needed over national political actors to apply these reforms to the fullest extent possible.

At the same time, one needs to point out the inherent flaws in the design of the IMF program itself. Programs based on exchange rate stabilization have exercised a destabilizing influence in several cases by contributing to overvalued exchange rates and rising current account deficits in environments where the authorities have not been successful in reducing inflation at the expected pace (Calvo and Vegh, 1999; Lustig and Ros, 1999). Indeed, the rising current account deficit which constituted a key element of vulnerability leading up to the twin crises in Turkey was, in part, a reflection of the negative consequences of this kind of exchange rate-based stabilization.

Two other important points of rupture deserve emphasis before turning our attention to 2001 and beyond. The announcement of Turkey's candidacy at the Helsinki Summit of the European Council in December 1999 was an important landmark. Nevertheless, the real impact of the EU decision on the economy came at a later stage, notably after the crisis. The delay in the impact of the EU decision was, in part, due to the fact that the focus of the EU in the early stages was much more on the political front, and there was a certain tendency to delegate the implementation of the economic components of the Copenhagen criteria to the IMF as part of an implicit division of labor between the two key external actors. The second important point was that the first of the twin crises took place in November. While the November crisis clearly highlighted the weaknesses in the Turkish economy, particularly in the realm of private banks, the crisis was largely interpreted as a 'liquidity crisis' which could have been averted if the IMF could have been more flexible and had allowed the Central Bank to inject more liquidity into the system.

The February crisis of 2001 was far more dramatic in terms of its impact. The very depth of the crisis signaled the inherent structural deficiencies of the economy, notably in the realm of public banks, which could not be simply eliminated by pumping additional liquidity into the system. A novel element associated with the most recent crisis was that all sections of society, rich and poor, educated and uneducated, were negatively affected, though at varying degrees. This made a sharp contrast with the previous crises where the share of the burden had fallen almost exclusively on wage earners and other low income groups. Unemployment increased by a massive figure of one million and the collapse of output was accompanied by widespread bankruptcies, particularly in the realm of small firms. The banking sector felt the impact of the crisis in a drastic manner and had to respond by a severe cutback in skilled workforce. Even large conglomerates experienced a pronounced reduction in their profit margins.<sup>2</sup>

The political impact of the crisis was also quite profound in the sense that domestic political actors and notably the parties that constituted the incumbent coalition government emerged as the main targets for criticism.

Indeed, the two dominant members of the coalition government, the left-nationalist, the Democratic Left Party (the DSP), and the ultra-nationalist, the Nationalist Action Party (the MHP) of the far-right vintage, were effectively discredited and marginalized by the time of the early general elections of November 2002. A major political impact of the crisis was to wipe out all the established political parties of the left and the right of the political spectrum represented in the parliament. This paved the way for the emergence of a new political party, the Justice and the Development Party (the AKP), a party with Islamist roots, but more moderate in its outlook compared with its predecessors, to occupy the center stage in Turkish politics. The crisis seemed to bring into the forefront the inherent deficiencies and the corrupt practices of the existing mainstream political parties. It also effectively signaled the end of latest phase of coalition politics which had been associated with severe economic and political instability. What is striking about the Turkish experience is that the IMF did not become a centerpiece of criticism, although there were certainly criticisms stemming from intellectual circles pointing towards mistakes on the part of the IMF in the period leading up to the twin crises. There were also sporadic popular protests targeted against the IMF, but certainly not the kind of massive wave protests that occurred in Argentina, for example. Unlike Latin America, the crises in the Turkish context did not lead to the kind of discrediting of international institutions such as the IMF that we observe in the Argentina or indeed in many other national contexts both in Latin America and East Asia (Öniş, 2006; Vanden, 2004). This is all the more ironic in the sense that both crises in Turkey occurred at a time when the IMF program was actually being implemented. Indeed, the IMF emerged as a more powerful actor in the Turkish setting in the post-crisis context and the ability of the IMF to press ahead with its reform process, overcoming the resistance of national political actors and domestic interest groups, was considerably enhanced in the process.

### **FROM A LATIN AMERICAN TO EASTERN EUROPEAN STYLE ADJUSTMENT: THE TRANSFORMATIVE IMPACT OF THE EU**

In the Turkish context, the structural environment shaped the opportunity space available to domestic political actors in the post-crisis era and placed restrictions over the set of policy choices available. A key element of the structural environment in the post-crisis era was the concrete prospect of EU membership. This, in itself, was an important source of pressure for reform which even a nationalistically inclined coalition government with weak commitment to reform could ultimately not resist. Indeed, some of the major legislation in the direction of expanding the domain of civil and human rights was undertaken during the final months of the coalition

government by August 2002. There is no doubt that EU conditionality was a critical variable in influencing the path of post-crisis adjustment. It would have been extremely difficult for a country like Turkey to undertake dramatic reforms on the democratization front in the midst of a major economic crisis, if an explicit EU anchor was not available.

Another structural variable of key importance involved the approach of the international financial community. In this context, the role of the IMF should be examined in line with the foreign policy objectives of the US. Certainly, given its geo-strategic position, Turkey was considered to be a pivotal country from the point of view of US foreign policy. Turkey benefited from its geo-strategic location, involving its vicinity to the troubled region of the Middle East, whose importance became even more important in the post-September 11 global context. What is significant is that the IMF was able to devote resources on a much larger scale compared to the meager amounts allocated in the pre-crisis context.<sup>3</sup> The amount of financial assistance not only rendered the IMF far more powerful in the policy space, but also allowed Turkey to ride over the crisis much more smoothly than would otherwise have been the case.

It makes much more sense to think of the US-IMF-EU triangle in discussing the opportunity space available to Turkey during the post-crisis era. Certainly, US foreign policy objectives involved not only a commitment to ride Turkey out of the crisis through IMF assistance but also a long-term commitment to Turkey's eventual EU membership. The US interest in Turkey was also motivated by the desire to set an example of democracy in an Islamic context. The US has played an important role in promoting the case for Turkish membership of the EU. The underlying motive for this was that Turkey, as a pivotal state in an otherwise troubled region, could only become politically and economically stable if it was firmly anchored in Western institutions. In this context, the EU appeared to provide the kind of long-term institutional anchor that was needed in terms of promoting stability and breaking down long-standing resistance to reform in Turkey's domestic political arena.

The EU, progressively from 2001 onwards, became an important anchor for economic reform in the Turkish context. Policy-makers realized that the rising confidence of business actors, both domestic and international, increasingly rested on the ability to press ahead with both the economic and political components of the Copenhagen criteria. In a way, Turkey benefited from the presence of a double external actor. The EU and IMF conditionality became interlocked in the sense that the incentives provided by the EU in the direction of eventual membership rendered the task of implementing IMF disciplines easier. At the same time, the ability of the policy-makers to implement politically difficult democratization reforms, such as the elimination of the death penalty and the recognition of minority rights, was facilitated by the perception of key segments of

national and transnational capital that *political* reforms were important for the long-term stability of the *economy*. In other words, the political elements of the Copenhagen criteria, involving democratic deepening and the implementation of the rule of law, were increasingly seen as the key to a stable business environment which would provide a stronger degree of protection for their investments than has hitherto been the case.

The crisis of 2001 rendered the prospect of eventual membership all the more important given the material attractions of the EU for the ordinary citizens in the midst of severe economic hardships. This, in turn, created a rising momentum for reform, as vague promise of membership increasingly turned into a concrete promise of opening up accession negotiations in the critical EU Council meetings held in Copenhagen in December 2002 and in Brussels in December 2004. The latter was, indeed, critical in terms of confirming the EU's commitment to start off the process of accession negotiations, although there was every indication that the negotiation process for Turkey would be more open-ended than for other candidate countries in Southern and Eastern Europe. The fact that the EU anchor has become more visible and tighter in the course of the 1999–2004 period has clearly helped to boost the prospects for investment and helped to generate growing interest in the Turkish economy on the part of long-term foreign investors. The real breakthrough in the Turkish economy in terms of foreign direct investment (FDI) flows and large-scale privatization occurred in the course of 2005, once the opening up of accession negotiations emerged as a concrete possibility.

Structural explanations are important, but cannot provide the whole story without taking into account the response of key actors to the structural environments within which they operate. In the Turkish context, it is important to draw attention to the role of two key actors in shaping the post-crisis trajectory: the role played by Kemal Derviş, as the Minister responsible for the economy in the coalition government and the role performed by the AKP government following the elections of November. The case of Derviş clearly illustrates the importance of policy actors with significant linkages to the transnational financial community in terms of facilitating smooth adjustment in post-crisis environments. Derviş was brought into the government in the immediate aftermath of the crisis as an above politics technocrat to coordinate the adjustment process. His professional background as a highly successful top level economist at the World Bank over a span of three decades was particularly important in terms of generating confidence and credibility, for the kind of reform program that needed to be implemented, on the part of both domestic business and transnational financial community. Arguably, in the absence of a transnational policy entrepreneur such as Derviş, it would have been far more difficult to secure sustained assistance on a large scale from international financial institutions. Derviş also played an important role in helping to

*internalize* the reform package implemented under the auspices of the IMF (Derviş, 2005).

The role played by the AKP government deserves serious consideration. In spite of the fact that much of its traditional support base was in conservative, rural segments of the Turkish society and despite its Islamist leaning, the AKP government, to the surprise of many, has adopted a strong reformist orientation. In fact, it has displayed a far greater degree of commitment to fiscal discipline and EU-related political and economic reforms than any other Turkish political party to date. It would be misleading to give all the credit to the AKP in the sense that the reform processes both on the economic and the political fronts were well under way during the final stages of the coalition government. Nevertheless, if the elections had produced a different outcome, the momentum of the reform process would most probably have been lost under the jurisdiction of a different government. The AKP has benefited from being a single party in government. Its domain for action would have been considerably constrained, if it was forced to enter into a coalition with one of the major center-left or center-right parties.

This brings us to the question of whether there was a real possibility of Turkey following a radically heterodox path at any stage as Argentina did, for example, from 2003 onwards (Öniş, 2006). Certainly, the structural environment in which Turkey found itself in the post-crisis period with its heavy debt burden accumulated over time, its geo-strategic position, its close relations with the US and its strong European orientation would have placed severe constraints on the ability of any Turkish government to follow a radically heterodox course which would not be in line with the demands of the transnational financial community. One should not forget, however, that the reform coalition in Turkey embodied a strong domestic component. Domestic business; not necessarily large conglomerates but also small and medium-sized businesses were broadly in favor of the kinds of economic and political reforms promoted by the IMF and the EU. For domestic business, the combination of political and economic reforms constituted the means for establishing a rule-based economy, thereby transcending the highly unstable and perverse patterns of development of the previous era where economic success largely depended on clientelistic political ties and easy access to state favors. Nonetheless, one should not automatically rule out the possibility of a different scenario with Turkey turning inwards and following a more heterodox path. The failure on the part of the EU to promise full-membership after 1999, weak commitment on the part of the IMF to support the recovery process after 2001, similarly policy reversals on the part of policy actors who lacked firm commitment to the reform process would no doubt have dramatically altered the post-crisis trajectory of Turkey's political economy.

The crisis in the Turkish setting in 2001 was not accompanied by Argentine-style violent societal protests which could have rendered the task of implementing an orthodox, IMF-style adjustment far more difficult. The reasons for the absence of widespread popular protests in the Turkey are quite complex. The following hypotheses may be relevant. Certainly, the strength of informal ties and family networks have rendered an East European style 'exit' strategy more viable compared with a Latin American style 'voice' strategy.<sup>4</sup> The fact that labor unions, in particular, and popular sector organizations, in general, have been weakened over the course of neo-liberal restructuring has also helped to counteract the emergence of a unified resistance towards transnational financial actors. The presence of the EU as an intervening variable was important in the sense that significant components of the Turkish public saw orthodox, IMF style reforms as an instrument for attaining EU membership and its associated material benefits. One should also take into account that the democratization component of EU reforms created significant benefits for large segments of the population in terms of expanding the domain of civil and human rights. Hence, Turkey in the post-1999 era found itself on an East European path where neo-liberal restructuring and democratization process have moved hand in hand with the EU playing a key role in this process, whereas its experience in the pre-1999 era was more reminiscent of Latin American patterns.

### ELEMENTS OF THE NEW PHASE OF NEO-LIBERAL RESTRUCTURING

The new phase of neo-liberal restructuring in the aftermath of the 2001 crisis involved a mixture of *re-regulation* and *de-regulation* (Table 1). In retrospect, the new phase represented a radical point of departure from the earlier phases in terms of improving the regulatory capacities of the Turkish state. This was particularly evident in the context of the state's ability to impose tight fiscal and monetary discipline which certainly constituted a novel development in the sense that even the best phase of Turkish liberalism, the Özal era of the early and the mid-1980s, was characterized by partial and incomplete stabilization. The huge public sector deficits and the associated chronic rates of inflation that characterized the Turkish economy in the late 1980s and throughout the 1990s have been costly not only in terms of their negative effects on domestic and foreign investment but also in terms of their income distributional consequences with weak and underprivileged segments of society emerging as clear losers in an environment of high inflation. Turkey has been able to meet the tight budgetary requirements of the IMF in the post-2001 period with the result that inflation has been reduced to single digit levels for the first time

**Table 1** Key elements of the post-crisis policy regime

Elements of re-regulation	<ul style="list-style-type: none"> <li>• Fiscal discipline through improving the transparency and accountability of the budgetary process; improvement of tax administration.</li> <li>• Strengthening the autonomy of the Central Bank through legal protection.</li> <li>• Enhancing the autonomy of the Bank Regulatory and Supervisory Agency (BRSA), much tighter regulation of the banking and financial system.</li> <li>• Strengthening the position of autonomous regulatory agencies in several areas of the economy including energy and telecommunications.</li> <li>• Greater transparency in the privatization process.</li> </ul>
Elements of de-regulation	<ul style="list-style-type: none"> <li>• Further liberalization in the economy such as the removal of state monopoly in electricity and tobacco production.</li> <li>• Reduction of the corporate tax rate.</li> <li>• Reducing administrative barriers to FDI.</li> <li>• Reduction of agricultural subsidies.</li> <li>• Revitalization of the privatization program.</li> </ul>

*Source:* Çanakçı (2005).

for over three decades. Rising confidence in the credibility of government commitment to stabilization and reform has been accompanied by falling real rates of interest, signaling a significant improvement in investor confidence. Indeed, a significant surge of private investment, both domestic and foreign, has been at the heart of the strong recovery process that the Turkish economy has experienced since 2001 which became even more pronounced during the tenure of the AKP government from early 2003 onwards (Table 2).

The improvement of regulatory capacities of the Turkish state was also backed up by key institutional reforms. For example, the legal changes introduced in 2001 enhanced the autonomy of the Central Bank, which was important in terms of the government's ability to adopt a strong anti-inflationary stance and resist popular pressures for populist expansionism which had been a striking element of the earlier phases of Turkish neo-liberalism (Bakir, 2007). In fact, the new phase could be described as an era where new regulatory institutions started to occupy the center stage in Turkey's political economy, clearly backed by an all-powerful IMF in the aftermath of a costly crisis. Powerful regulatory bodies made their presence felt in key sectors of the economy (Table 1). Perhaps the most striking and publicized of such regulatory institutions was the Bank Regulatory and Supervisory Authority (BRSA). Although the BRSA had been set up

**Table 2** Key indicators of macroeconomic performance: a comparison of pre- and post-crisis phases

Indicator	Pre-crisis	Post-crisis
Growth	Slow and fragile	High and more likely to be sustainable; yet, growth continues to be heavily dependent on favorable external dynamics representing a line of continuity with the previous era; domestic savings, gross fixed capital formation and domestic credit to private sector as a proportion of GDP have fallen below pre-crisis averages highlighting the least impressive dimension of post-crisis performance
Inflation	Chronically high and variable	Low; reduced to single digit levels
Budget deficit	Very large	Considerably reduced; large primary surplus; in line with the IMF targets of 6.5%; close to Maastricht requirements
Banking sector performance	Poor	Significantly improved
Debt-GNP	Unusually large	Large, but significantly reduced
Dependence on short-term capital	High	Still high, but risks of crisis considerably reduced due to an improved macroeconomic environment and tighter regulation of the banking system
Current account deficit	Large	Large in spite of a significant increase in exports
Inflows of foreign direct investment	Limited	Significant increase with a certain time-lag
Privatization	Limited	Significant increase again with a certain time-lag
Productivity improvement as a source of growth	Weak	Strong

Source: State Planning Organization, Main Economic Indicators.

in 1999 prior to the onset of the crisis, it was largely ineffective given the powerful resistance of bank lobbies against any kind of strong regulatory action. However, in the aftermath of the crisis, the power and autonomy of the BRSA expanded considerably. The positive effect of this development has been a significant improvement in the regulation of the banking system in line with international norms (Tükel *et al.*, 2006). By 2005 most commentators would argue that the banking system was far more robust

and much less vulnerable to a possible crisis than has been the decade during the previous phase (World Bank, 2006). On the negative side, the experience of the BRSA and other similar public bodies raised certain question marks against the accountability and their compatibility with a democratic and participatory political system. One could also detect improvements in other areas such as the government's ability to collect taxes and improvement in the provision of public services with the qualification that a large informal sector and considerable tax evasion continue to be dominant characteristics of the economy.

The radical improvement in the investment environment for foreign investors constituted one of the most striking elements of the new phase (Çanakçı, 2005). A major characteristic of Turkish neo-liberalism has been a perennial inability to attract foreign direct investment on a significant scale. The failure to attract FDI could, in part, be accounted for by a highly unstable macroeconomic and political environment, particularly in the context of the 1990s. Weak legal protection for foreign investors as well as administrative barriers resulting in lengthy delays in obtaining investment permits also had a negative influence over investment behavior (Foreign Investment Advisory Service, 2001a, 2001b). The resistance to large-scale privatization and to foreign direct investment has become parallel processes and the legal battles resulting in the reversals of some of the key privatization deals involving the sale of state assets to foreigners by the Constitutional Court, for example, had led to a certain lack of confidence on the part of foreign investors. The result was both limited FDI and limited privatization with a negative effect on the overall performance of the Turkish economy.

The vicious cycle of the 1990s, however, was turned into a virtuous cycle after 2001. Foreign investors benefited not only from an improvement in the overall macroeconomic and macropolitical environment, but also from the changes in the incentive structure involving an improvement in legal protection, reduction in administrative barriers to investment, and more recently in the context of 2005, from a significant reduction in the corporate tax rate. The outcome of this radical shift in incentives was not only a significant increase in the quantity of FDI flowing into the Turkish economy, but also a major increase in privatization revenues with the year amounting to \$8.5 billion in 2005, which is very close to revenues collected from privatization over the 1986–2004 period as a whole.

From a political economy perspective, the important changes outlined naturally implied significant shifts of power among the key actors involved. A major shift involved was clearly a significant increase in the power and influence of external actors. Not only had the powers of the IMF and the EU, but also the influence of private external actors, expanded considerably. This tendency, for example, became visible in the banking sector with a noticeable increase in the degree of foreign participation in the

sector in the post-crisis era. The second important shift of power occurred within the state apparatus itself with regulatory institutions experiencing a considerable expansion in their powers and autonomy at the expense of other state institutions. Thirdly, the larger domestic firms or conglomerates were able to overcome the crisis more easily than their smaller counterparts and appeared to have benefited disproportionately from the improvement in the macroeconomic and regulatory environment in the post-crisis era. It is also interesting that the crisis accelerated the process of transnationalization of major Turkish conglomerates, a process which had effectively gained momentum with the signing of the Customs Union in the mid-1990s. In the post-2001 era, an increasing number of Turkish conglomerates enjoyed expanding operations in neighboring countries such as Romania, Bulgaria and Russia. What is striking is that their individual fortunes seem to become progressively less dependent on their operations within their own national space. These are significant developments pointing towards a new stage in Turkey's globalization process with potentially serious economic and political ramifications.

#### **THE NEW PHASE AND PROSPECTS FOR SUSTAINABLE GROWTH: ECONOMIC AND POLITICAL CHALLENGES**

The recovery process of the Turkish economy in the post-2001 era is rather impressive and the fact that rapid growth has been taking place in the context of very low rates of inflation makes one even more optimistic regarding its sustainability over time. Yet, this optimism needs to be qualified in a number of important respects. First, it is too early to reach the conclusion that Turkey is on a sustainable growth path. It is typically the case that countries which experience a deep crisis tend to bounce back swiftly. A closer analysis suggests that there continue to be elements of vulnerability which may reverse the optimistic scenario outlined so far. In spite of the fact that the heavy burden has been reduced due to a combination of fiscal discipline and gross national product (GNP) growth, the debt-GNP ratio continues to be high and adverse developments regarding growth or ability to sustain fiscal discipline may aggravate the debt situation with potentially negative consequences.

Investment rates and domestic credit to the private sector have been disappointingly low. In this respect, 2001 does not represent a structural break. In particular, gross fixed capital formation, domestic credit to the private sector and domestic savings rates did actually fall since 2001. The share of credit to the private sector as a share of gross domestic product (GDP) fell from an average of 24% during 1996–2000 to 21% in 2004. Gross fixed capital formation declined from 24% during 1996–2000 to 18% in 2004 and 20% in 2005. These figures are below the 25% minimum that United Nations Conference on Trade and Development (UNCTAD) (2003) has

identified as the required threshold to generate high and sustained growth in middle-income developing countries. The main impetus for growth in the post-2001 era clearly originates from favorable external dynamics as opposed to adequate domestic savings and investment performance.

Third, the balance of the payments structure signals possible dangers. In spite of an impressive export performance during the recent era, a large current account deficit persists. The large current account deficit is a reflection of the economy's high propensity to import. A recovery of consumer spending in this kind of environment is immediately translated into a rise in demand for consumer goods imports. In addition, the export sector itself continues to display a high degree of dependence on imported intermediate and capital goods. Turning to the capital account, in spite of the strong surge in FDI in the post-crisis era, inflow of short-term capital continues to be an important element, and this item, in part, has contributed to the economic recovery process. Hence, the combination of a large current account deficit and continued dependence on short-term capital inflows suggests that one cannot automatically rule out the possibility of yet another speculative attack leading to another costly financial crisis, even though the economy, in general, and the banking and the financial system, in particular, appear to be far more resilient against such a possible crisis.<sup>5</sup>

This brings us naturally to the strength of external anchors. Provided that a financial crisis is avoided in the new era, the IMF will continue to be a temporary anchor up to the end of the current monitoring program, which is scheduled to end in 2008. Far more critical, therefore, is the permanent anchor provided by the EU. The fact that the relationship between Turkey and the EU has reached the stage of opening up formal negotiations for full membership, with the confirmation of this decision in October 2005, is a sign that the powerful EU anchor is likely to exercise a powerful stabilizing influence over the next decade. The virtuous scenario in this context is that the pro-reform coalition will be strengthened and Turkey will continue to attract high levels of FDI and continue on a high growth path which will enable it to contain the potentially serious distributional conflicts that are likely to manifest themselves during the course of the accession negotiations. Strong economic performance, in turn, will strengthen its claims for full membership with the implication that the EU anchor will become a progressively powerful signal for domestic and foreign investors, and so the cycle continues. The electoral success of the AKP in 2007 is an indication that this virtuous cycle is likely to continue, although the path to EU membership is likely to be a long and protracted process.

Turkey is unlikely to receive the magnitudes of adjustment assistance that the new Eastern European members of the EU have received on the path to full-membership (Derviş *et al.*, 2004). The main benefit of the EU anchor during the transition phase is likely to be its positive impact on long-term foreign capital. Indeed, Turkey has started to attract respectable

**Table 3** FDI flows to Turkey in comparative perspective (in million dollars)

Years	Turkey	Poland	Czech Rep.	Mexico
2004	2,7d65	7,860	4,463	15,435
2005	9,805	9,602	11,128	18,722
2006	20,120	13,922	5,957	19,037

Source: World Development Indicators, UNCTAD WIR 2007.

amounts of FDI (Table 3). Yet, much of the FDI has been in the form of mergers and acquisitions rather than green-field investment and question marks can be raised against sustainability once the opportunities for large-scale privatization are largely exhausted.

Even under the benign, virtuous cycle scenario, the management of serious distributional tensions emerges as a central economic and political challenge. Elements of such a tension can easily be recognized by examining the reactions of various groups in Turkish society to the impact of the new phase of neo-liberal restructuring in the post-crisis era. The reports of key interest organizations reveal the following pattern, as summarized in Table 4. Large domestic conglomerates and the transnational capital are broadly content with the process of re-structuring which has taken place since 2001. Small and medium-sized business is also broadly supportive of a more stable and predictable macroeconomic environment generated in the post-2001 phase as well as EU-sponsored reforms on the democratization front. Yet, key representatives of small and medium-sized business such as MÜSİAD, an organization with close and organic ties to the governing party, the AKP, tend to be highly critical of some of the regulatory reforms promoted by the IMF. This, in turn, illustrates the fact that regulatory reforms are not distribution-neutral processes. A tightly regulated banking sector may reduce the vulnerability of a country to future economic crises, but it may also distort the pattern of lending in favor of larger domestic and foreign firms with better reputations and lower risks of non-payment. Labor unions, a marginalized element in Turkish society throughout the neo-liberal era, are also critical of the distributional impact of the latest phase of neo-liberal restructuring drawing particular attention to the lop-sided nature of the recovery process benefiting largely high-income groups and better-off regions of the country. They also point to the fact that unemployment remains a serious social and economic problem and the recovery of growth has not been accompanied by an equally strong surge in employment creation.<sup>6</sup>

These intra- and interclass conflicts are likely to be deepened in the context of the new phase of accession negotiations with the EU. In a high growth environment, it will be possible to contain such distributional tensions and their negative ramifications in a reasonably smooth manner.

**Table 4** Assessments of post-crisis economic performance by key economic actors

Transnational capital	Broadly favorable assessment; happy with the course of fiscal discipline and structural reforms; increasing confidence in the sustainability of the recovery process. In spite of improvements, still concerned with bureaucratic and legal barriers to FDI; emphasizes the need for further structural reforms in the areas of tax policy and the social security system; high social security premiums and high labor costs in general create unfair competition.
Big business	Diagnosis of the economic situation is very much in line with the assessment provided by 'transnational capital', singles out improvement in price stability and growth as key achievements and largely confident that the growth process will be sustainable. However, there are elements of concern such as the persistence of large current account deficit and high social security premiums causing unfair competition in the presence of a large informal economy; strongly promotes further tax and social security reforms including reduction in tax rates and social security premiums.
Small and medium-sized business	Recognizes the positive aspects of the post-crisis recovery process; however, it is also more critical than 'transnational capital' and 'big business' concerning certain aspects of the recovery process. Highly concerned about the import dependence of export production and the persistence of the large current account deficit; SMEs would like to obtain a larger share of banking sector credits; rather critical of tight IMF disciplines on the banking sector; more sensitive to issues relating to unemployment and regional inequality.
Labor	Highly critical of the recovery process. Attention is drawn to the unequal and lop-sided character of growth. The key argument is that this kind of growth will not facilitate widespread employment creation and poverty reduction; identifies heavy unemployment as a major social and economic problem. Attention is also drawn to the regressive nature of the tax system.

*Sources:* See note 6.

Under a high growth scenario, all social groups are likely to benefit in absolute terms, although relative gains may differ considerably. Moreover, governments in such an environment will have more instruments at their disposal to make distributional transfers, at least through policies targeted at the most disadvantaged segments of society. If a high growth scenario cannot be sustained, however, distributional tensions are likely to become far more visible and politically destabilizing. In the Turkish context, such reactions are more likely to manifest themselves in the resurgence of nationalism both from the right and the left of the political spectrum.

**CONCLUDING OBSERVATIONS**

Economic crises tend to be costly. However, they can also open up avenues for significant structural change and institutional reform. The financial crisis that Turkey experienced in 2001 represented an important rupture in the country's neo-liberal restructuring process. The very depth of the crisis, affecting all segments of society at varying degrees of intensity, was important in terms of generating a broad consensus on the need to achieve macroeconomic stability and making a clean break with the clientelism and corruption which had characterized the previous era. The economic crisis entailed significant political ramifications, with the ensuing elections effectively penalizing all the established political parties represented in Parliament.

The geo-strategic and the regional context in which Turkey found itself in the midst of a severe financial crisis was also important in shaping the post-crisis environment and the choices available to the key political actors. External actors such as the US, the IMF and the EU were heavily involved in the post-crisis restructuring process. The direct involvement of the EU also meant that the new phase of Turkey's neo-liberal restructuring was accompanied by an important wave of democratization reforms. Certainly, if Turkey had found itself in a different regional environment the democratization impulse in the context of a severe macroeconomic crisis would probably have constituted a much weaker element. The powers of the external actors originated partly from the amount of financial resources made available (as in the case of IMF, broadly in line with the US foreign policy objectives) and partly from the incentives provided for reform through a promise of future membership of a powerful regional organization and the long-term material advantages that this is likely to entail (as in the case of the EU). One of the key implications of the heavy involvement of external actors was a shift of power away from national policy actors and a parallel reduction in the powers of interest groups within and outside the state apparatus providing resistance to the reform process. For example, politically difficult regulatory reforms, particularly in the realm of the banking and financial sector, would not have been possible without such a major shift in the balance of power.

Yet, structural environment provides part of the explanation. The responses of key actors are also important in conditioning the final outcomes. In the Turkish context, the role of Derviş as a key technocratic figure with strong links to the transnational financial community was particularly important in the initial sub-phase of the restructuring process corresponding to the tenure of the coalition governments which was, by and large, lukewarm to the reform process. Similarly, the AKP government's commitment to and willingness to go along with the IMF and the EU was also critical in terms of generating confidence among key elements of domestic and

external capital and was instrumental in generating a relatively smooth, and what is likely to prove sustainable, recovery process. The response of the AKP government was also striking in the sense that its electoral base involved a significant element of support from low-income strata.

The new phase of neo-liberalism in Turkey has been associated with a process of re-building state capacity in line with the requirements of a globalized market economy. What we observe, however, is the emergence of a 'regulatory state' or a 'competition state'. While this represents an improvement compared with the earlier phases of Turkish neo-liberalism, its ability to address the problem of income inequality remains severely restricted. The new phase of neo-liberalism promises to bring about superior macroeconomic performance without altering the fundamentally unequal and asymmetric nature of development which characterizes the neo-liberal model.

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### NOTES

- 1 The amount of financial assistance provided by the EU to Turkey for the years 2000 and 2001 is 423 million Euros. For more information see the website: [www.abgs.gov.tr](http://www.abgs.gov.tr).
- 2 For contrasting interpretations of the reasons underlying the 2000/2001 financial crises in Turkey, see Öniş and Rubin (2003), Akyüz and Boratav (2003), Cizre and Yeldan (2005) and Yeldan (2006). Öniş and Rubin's (2003) study takes into account the nature of domestic politics and the weak commitment on the part of the key political actors whilst the others tend to place the primary blame on the IMF for failing to prevent a crisis in the context of an on-going program. Concerning the position of large conglomerates the following qualification is called for. Such conglomerates, while losing revenues due to declining sales and a contracting economy, benefited asymmetrically from rising interest rates and depreciating domestic currency due to high levels of currency substitution and portfolio diversification on their part.
- 3 The number of loans provided by the IMF in the post-crisis period amounted to approximately 24 billion US dollars. The IMF provided 8 billion US dollars in the immediate aftermath of the crisis during the course of 2001 and 9 billion US dollars in 2002.
- 4 For a useful comparison of different styles of social and political response to crises in Latin America and post-communist Eastern Europe employing Albert Hirschman's concepts of 'exit' and 'voice', see Greskovitz (1998). On the importance of informal ties and family networks, see Buğra (2003).

- 5 A recent report by the IMF also draws attention to the persistence of a large current account deficit as a problem that needs to be addressed by the policy-makers. See IMF (2005).
- 6 The assessments of 'transnational capital' are based on the reports of institutions like the IMF, the World Bank and the OECD. See IMF (2005); the World Bank (2003, 2006); OECD (2004a). For the perspective of 'big business' the key source of information is the reports published by the key business association representing 'big business', 'The Turkish Industrialists and Businessmen's Association' (TÜSİAD). See TÜSİAD (2005). For 'small and medium-sized business', the assessment was based on the reports of two key business associations, 'The Confederation of Chamber and Stock Exchanges in Turkey' (TOBB), a semi-official organization for every business unit has to be registered and 'The Independent Industrialists and Businessmen's Association' (MÜSİAD). See TOBB (2005) and MÜSİAD (2005). In this context, see also OECD (2004b). For labor, the publications of TÜRK-İŞ, a major umbrella organization of labor unions in Turkey, constitute the main source of information. See Bağdadioglu (2004). The annual assessment of the organization 'Independent Social Scientists' provides a similar critical perspective. See Bağimsiz Sosyal Bilimciler (2005).

### NOTES ON CONTRIBUTOR

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