THE TURKISH POLITICAL ECONOMY AFTER THE 2000-2001 FINANCIAL CRISES:
AN UNUSUAL CHAPTER WRITTEN BY THE FIRST JUSTICE AND DEVELOPMENT PARTY GOVERNMENT

A Master's Thesis

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ABSTRACT

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This thesis analyzes the five-year period of the Turkish political economy following the 2000-2001 financial crises. This five-year period signifies an important point of departure from the classical Turkish political economy as stable and rapid growth was sustained for over twenty consecutive quarters. The strong commitment to the fiscal discipline and to the powerful external anchors such as the IMF and EU were key to this success. The central question is what motivated the JDP government to show this long-lasting commitment to the fiscal discipline and the external anchors particularly to the IMF-induced economic programs. Growing ties with the global economy, the new institutional framework, the new balance of power within the networks shaping the Turkish political economy and the successful implementation of the JDP's prudent political economy agenda are the four plausible explanations for the central question. Each of these explanations is elaborated in a separate chapter and the growing ties with the global economy prevail as the most competent explanation since it directly contributes to the emerging of the other three explanations.

Keywords: Turkish Political Economy, Justice and Development Party, Kemal Dervis, IMF, EU, 2000-2001 Financial Crises

ÖZET

2000-2001 EKONOMİK KRİZLERİNDEN SONRA TÜRK EKONOMİ POLİTİĞİ: İLK ADALET VE KALKINMA PARTİSİ HÜKÜMETİ TARAFINDAN YAZILAN SIRADIŞI BİR BÖLÜM

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Bu tez, 2000-2001 ekonomik krizlerini takip eden beş senelik dönemdeki Türk ekonomi politiğini analiz etmiştir. İstikrarlı ve hızlı büyümenin arka arkaya 20 çeyrekten daha uzun bir süre devam ettirilmesi, bu beş yıllık dönemin klasik Türk ekonomi politiğinden önemli bir farklılık arz ettiğini göstermiştir. Mali disipline ve IMF ve AB gibi güçlü dış çıpalara gösterilen sıkı bağlılık bu başarıda anahtar olmuştur. Temel soru, nelerin AKP hükümetini mali disipline ve başta IMF destekli ekonomik programlara olmak üzere dış çıpalara bu uzun sureli bağlılığa teşvik ettiğidir. Küresel ekonomiyle gelişen bağlar, yeni kurumsal çerçeve, Türk ekonomi politiğini şekillendiren bağlantılardaki yeni kuvvetler dengesi ve AKP'nin ileri görüşlü ekonomi politiği programının başarıyla uygulanması temel soru için dört makul açıklamadır. Bu açıklamaların her biri ayrı bir bolümde incelenmekte ve diğer üç açıklamanın ortaya çıkmasındaki doğrudan katkısından dolayı küresel ekonomiyle gelişen bağlar en kapsamlı açıklama olarak öne çıkmaktadır.

Anahtar Kelimeler: Türk Ekonomi Politiği, Adalet ve Kalkınma Partisi, Kemal Derviş, IMF, AB, 2000-2001 Ekonomik Krizleri

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CHAPTER 1

INTRODUCTION

This thesis aims to contribute to the better understanding of the recent Turkish political economy, which marked a point of departure from the traditional Turkish political economy, and the political party shaping this era, the Justice and Development Party (JDP). As a newborn political actor in the scene of roiled Turkish politics, the JDP gained a commanding electoral victory in the early general elections of November 2002. The Turkish voters gave a relatively unknown political movement the chance of being a single party government at a time when the country was at the crossroads of many important economic and political developments, as the European Union (EU) process entered a new phase after the 1999 Helsinki Summit, when Turkey earned the formal candidate status, and the economy was hit hard by the severest crisis of the Republic in 2001.

The Turkish economy especially after the capital account liberalization in 1989 witnessed a combination of long years of limited growth with major macroeconomic imbalances and a series of weak coalition governments unable to provide political stability. Consequently the average deposit interest rate between years 1991-2001 was 72.76

percent while the average rate of consumer price inflation was 74.67 percent. In the same ten-year period the average rate of GDP growth was only 2.67 percent and displayed a very inconsistent pattern, with the growth rates ranging from -7.5 percent up to 8 percent.[1]

This negative outlook inevitably called for tighter fiscal discipline and International Monetary Fund (IMF) support, two vital needs which could have been attained only for limited periods of time. The economic crises or stagnations forced the governments to take the bitter IMF pill, but when the macro economic balances were restored the commitment to fiscal discipline and IMF programs was quickly abandoned and populist and redistributive policies resumed.

However, when Turkey suffered the severest crisis of all time in February 2001, something out of the ordinary pattern followed the crisis. After the initial recovery from the catastrophic effects of the crisis, the fiscal discipline remained in place and IMF anchor stayed powerful. In 2005 a new IMF stand-by agreement was signed in the absence of any economic crisis or sign of stagnation. In fact, let alone avoiding any economic crisis or stagnation, as of 2005 the Turkish economy recorded many stellar achievements. While the inflation rate has come down to 8.2 percent, the GDP growth had been robust and consistent averaging 7.5 percent in 2002-2005 period.

While the previous coalition government (formed by the Democratic Left Party, Nationalist Movement Party and Motherland Party) provided the initial recovery within a

[1] The figures are taken from: (World Bank, 2006).

year after the 2001 crisis, the JDP government was in office in the following 5 years, which witnessed a rather unusual episode of Turkish political economy. The central question that this thesis will address is why the JDP did not return to populist and redistributive policies once the economy has bounced back from the 2001 crisis.

There are many indicators of the central question. For example, the role of IMF did not diminish despite the positive economic outlook. As Evrensel (2004: 17) observes: “Turkey enters the next IMF program in worse macroeconomic condition than the previous program”. However, this habit was drastically broken when in 2005 Turkey entered an IMF program with far better macroeconomic conditions than prior to the previous program. The fiscal discipline remained tight with every year the 6.5 percent primary surplus target was achieved despite the available and tempting state resources enabling the government to engage in populist spending and redistributive policies which in return would bring more electoral popularity for the JDP in the next election.

These indicators will be elaborated in Chapter 2, as it compares the characteristics of pre-JDP and JDP eras political economy of Turkey. It is important to grasp the fundamentals of Turkish political economy in the pre-JDP era so that it would be easier to see the changes and continuities under the JDP government. Since the very depth of the 2001 crisis has been instrumental in the post-2001 reshaping of the political and economic domains in Turkey, the 2001 crisis will be thoroughly analyzed. After establishing that there has been a fundamental departure from the “classical” Turkish political economy, the thesis will provide four different sets of plausible explanation for the central question and each one of these explanations will be assessed in separate chapters. A comparative method will be used to expose the differences between the pre and post 2001 crisis Turkish political economy and consequently to form the main argument.[2]

After providing the background information on Turkish political economy, Chapter 3 gives the growing dependence of Turkey on the global economy as the first explanation for the long lasting fiscal discipline and the commitment to reform process. While the globalization has established closer ties through multiple channels in social, cultural and political spheres, as the neo-liberal complex interdependence theory claims, the global economic ties has been the most visible and influential element for Turkey.[3] The intense flow of money and investment all around the world creates interdependence among the actors of the global economy and with its neo-liberalization efforts Turkey has become more and more involved with the global economy. After 1989 the Turkish economy has been prone to major current account deficits. The short-term foreign investments, a type of liquidity that is highly volatile by nature, finance this sizeable deficit. Thus in order to keep the money inflows coming, the Turkish policy makers especially after the February 2001 crisis have been forced to act in line with the expectations of the domestic and foreign finance actors who value fiscal discipline, IMF-induced reform process and the European Union (EU) accession dearly.

[2] For a detailed explanation of the comparative method see: (George, 1979), (Lijphart, 1971).

[3] For a detailed explanation of the neo-liberal complex interdependence theory see: (Keohane and Nye, 1977).

The fourth chapter of the thesis will cover the fundamental structural reform process that altered the institutional framework as another possible explanation for the unusual course of JDP's policy practice since 2002. As Onis points out, a new regulatory state has been in the making with powerful independent regulatory agencies taking the center stage, by-passing the political influence and backed up by the powerful external anchors of IMF and EU.[4] While the IMF provided a road map for the reforms with the 2001 economic program and later with the 2005 standby agreement, the EU guided a sizeable portion of the reforms with its *acquis communautaire*. Also the 2001 crisis was instrumental to ignite the reform process including elements of de-regulation and re-regulation and many of the key reforms were made before the JDP government took office by the former Minister of Economy Kemal Dervis, who was the leading figure for economic reforms under the previous coalition government. The autonomy of Central Bank of Turkey (CBT) was significantly increased. Bank Regulatory and Supervisory Authority (BRSA) was reinvigorated. Direct income support replaced the previous ineffective agricultural subsidy system.

Still there were many reforms to be implemented and the JDP administration continued to the constitution of the new institutional framework. The passage of new foreign direct investment (FDI) law, tax administration reform, monitoring the public employment and elimination of redundant positions, social security reform, revitalization of privatization program leading to major privatization sales such as Turkish Telecom (TT), continued reform on banking sector especially on supervisory and regulatory framework, administrative and parametric pension reform were all implemented by the JDP

[4] See (Onis, 2006a).

government through the IMF conditionality and harmonization with the *acquis communautaire*. As in the key sectors of economy such as banking, energy and telecommunication, either new independent regulatory agencies were established or the existing ones were empowered and with the swift privatization both additional revenues were made available and the clientist distribution of state resources had diminished in the post-2001 crisis trajectory. Thus the room for redistributive and populist practices was significantly decreased in the new institutional framework. This new setting is an influential factor that shapes the JDP's unorthodox course of policy implementation.

The fifth chapter will elaborate the shift in the networks shaping the Turkish political economy as a third explanation for the continued structural reform process and fiscal discipline in the JDP era of Turkish political economy. As Olson pointed out there are distributive coalitions forming political lobbies to influence politics in their favor.[5] The 2001 crisis was so severe and powerful that the existing system of networks tying this social distributive coalitions and political parties was largely abolished. Prior to the 2001 crisis each political party was associated with a certain segment of the society and would pursue a political agenda that directly provided incentives to that particular segment when they took office. While the core social coalition supporting the JDP was composed of the small and medium enterprises (SMEs), the JDP aimed to meet the expectations of not only the SMEs but a broader coalition including the big business and fixed income groups. As it would be unattainable to provide specific incentives to each separate part of this broad coalition the JDP had to focus on policies that brings an overall improvement for the whole economy especially on the macro level such as reduction of the inflation

[5] See (Olson, 1982).

rate or speeding up the privatization which requires fiscal discipline and commitment to reform process.

Connectedly the powerful effects of the 2001 crisis strengthened the hand of pro-reform coalition. The small distributive coalitions forming political lobbies in general are protectionist and anti-reformist in their agenda, as they benefit from the continuation of the existing structure in their area of interest. The most significant example showcasing this resistance to reform from a distributive coalition and shift of power is the banking sector. Prior to the 2001 crisis the powerful banking lobbies managed to block the reform proposals aiming to establishing a stronger BRSA with tight supervisory and regulatory tools. After the 2001 crisis, however, there have been achieved some fundamental structural reforms on the banking and finance sector as they have been widely accepted among the forerunning causes of the long-lasting macro economic problems in Turkey. One final major shift of power among key actors noticeably increased the influence of external actors. These external anchors contain not only the institutions such as the EU and IMF but also the private actors that intensely invested in Turkey after the 2001 crisis.

The sixth chapter will acknowledge the contribution of the JDP government in the overall improvement of Turkish political economy in the aftermath of the 2001 crisis. All the previous three alternate explanations in this thesis attribute the recent success of Turkey in maintaining fiscal discipline and continued reform process to structural factors. However, as a central agent the JDP deserves credit for successfully maneuvering within the new set of conditions in the post-2001 trajectory. To be more specific, the JDP realized that maintaining the high growth pattern which was initiated by the previous coalition government was going to bring absolute gains for each and every segment of the economy and society even though it required sticking the to IMF conditionality and tight fiscal discipline, two policies which are not favored by the SMEs that constitute the bulk of JDP's social coalition.

The thesis will end with a conclusion briefly recapping the central question and the alternate explanations of the puzzle. While recognizing the plausibility of each explanation and not ruling out any of them, the growing dependence on the global economy will be highlighted as the prime hypothesis answering the central question most competently since it is the facilitating factor for the other three explanations.

CHAPTER 2

TURKISH POLITICAL ECONOMY IN RETROSPECT

2.1. The Liberalization Efforts

The roots of recent political economy of Turkey date back to the stabilization program of 1980. Until 1980 the economy had an inward orientation. Import substitution industrialization (ISI) model through state-directed plans constituted the base of this scheme. The primary goal was to avoid heavy reliance on foreign capital and keeping the economy manageable. As a result of this shortsighted policy, the record of Turkish economy had been timid and far from impressive.[6]

The perennial economic crises caused by the foreign exchange shortages and the conditionality of the IMF and World Bank urged the Turkish policy makers to reorganize the economic structure. The first step towards the liberalization of the economy came with the stabilization program of January 1980. With devaluation of Turkish Lira (TL) and specific measures addressing export promotion such as subsidies for exporters, simplification of bureaucratic procedures and tax cuts on intermediate goods of export-

[6] For detailed information on the ISI see: (Barkey, 1990).

oriented manufacturers, the state policy shifted from a closed economy guided by ISI model to a free market economy.

Although the competitive neo-liberalism replaced the protectionist etatism as the development strategy of the state, the mindset of politicians had hardly changed at all. The neo-liberal economy requires a competition state that assumes a minimal role within the market.[7] Solely providing a strong regulatory presence ought to be the fundamental function of the state. However, in the Turkish context protecting the invisible hand of the newly founded neo-liberal economy was not an appealing idea for the politicians who primarily sought to derive material benefits from the allocation of the state resources. As a result of this dichotomy, Turkey in theory shifted to neo-liberalism but in practice failed to provide the necessary political and economic foundations to fully materialize the neo-liberal economic model.

2.2. The Lost Decade of 1990

The closed economy prior to 1980 caused a great hunger among Turkish consumers for high quality, luxurious and advanced technology import goods. The only available consumption avenue for Turkish people had long been the low quality import substituting products and so inevitably Turkish people had a feeling of what Zurcher (2004: 308) describes as “not having lived”. Thus when the liberalization process started Turkish

[7] For more information on the competition state see: (Cerny, 1998).

people chose to spend rather than save. The already low level of domestic savings became inadequate to generate enough capital accumulation for investment and industrialization.[8] Therefore, the import of foreign capital to facilitate rapid economic growth seemed rather a prudent decision. Aside from the practical need also in theory, capital account liberalization is an integral part of any neo-liberal economy. Hence the establishment of the full convertibility of Turkish Lira (TL) in August 1989 was an expected policy implementation.[9] However, in Turkish case where the competition capacity of economy with powerful effects of financial globalization was inadequate, major macroeconomic imbalances and political instabilities were present and proper regulations on the finance sector were lacking, this move caused rather problematic consequences by fully exposing the economy to the risks of financial globalization. “The consequence of this decision, in the midst of high degree of domestic economic and political instability, was that the Turkish economy’s performance became heavily dependent on highly volatile short-term capital flows with costly ramifications.” (Onis and Bakir, 2007: 5) The following decade of the 1990s witnessed a struggling growth pattern with a dizzying mix of economic boom and crisis.

Table 1

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
GDP Growth (annual %)	9.3	0.9	6.0	8.0	-5.5	7.2	7.0	7.5	3.1	-4.7	7.4	-7.5

Source: *World Development Indicators* Database, World Bank

[8] For an extended analysis of the relation between domestic savings and investment in Turkey see: (Erden, 2005).

[9] For more information on the capital account liberalization see: (Ersel, 1996).

First and foremost the combination of available foreign capital, populist public spending and eager private consumption resulted in swift increase of public and private debt. Adding the chronic inflation and a series of weak coalition governments unable to provide fiscal discipline, the macro-economic problems started to grow.

In about five years the premature capital account liberalization produced its first major financial crisis. The rise in foreign capital inflows and rapidly appreciating TL worsened the foreign trade deficit. Moreover, the public sector borrowing requirement (PSBR) was swiftly increasing. These developments inevitably created, a budget deficit as of 1993 that doubled what had been originally targeted, and cumulative inflation rate of 60 percent within the first month of 1994. Additionally, to avoid the inflation tax, the dollarization became a common practice, which in return fueled the demand for foreign exchange. When the investors' sentiment towards to credibility of government policies was reversed with the official ten percent devaluation of TL in February 1994, a quick outflow of very much demanded short-term foreign capital crushed the economy. The Ciller government announced a stabilization program in April 1994 backed up by an IMF stabilization program. While a quick recovery was achieved within a year, the collapse of the coalition government in September 1995 led to the termination of the IMF agreement.[10] So this six year period starting with the capital account liberalization and ending with the termination of IMF agreement showcased all the traits of Turkish political economy prior to 2001 crisis such as the political instability, the strong effects of

[10] For a more detailed account of the 1994 financial crisis see: (Ozatay, 2000).

capital flows in and out the economy, weak commitment to fiscal discipline and IMF programs.

2.3. Populism, Political Instability and Vicious Cycles

While populism in economic policy can manifest itself in several different forms, Onis (2003: 3) describes populism as "Using state resources and manipulating economic outcomes in ways that disproportionately benefit select groups and classes, whose strength and support the elites relies on to maintain its rule". The motivation behind populism is to maintain and if possible broaden the electoral support, which can be taken as an unintended consequence and deficiency of democracy.[11]

In the multiparty era, growing distributional pressures became influential over the Turkish political parties. The shortsighted mindset that aims to save the day but ignores the long-term consequences became widespread among political parties. Choosing populist policies emerged as a common practice of Turkish politics. Populist policies, in general, bring short-term gains with long-term costs. But more importantly engaging in populism causes the neglect of the very much needed structural reforms and stabilization, which bring short-term costs and long-term benefits. For instance, the weak coalition governments relied on heavy borrowing to finance the massive public debt and postponed the long-term cost of this costly borrowing strategy to the following years.

[11] For more information on the historical account of the coexistence of the democracy and populism in Turkey see: (Keyder, 1987: 117-140).

So populism on the political front led to a distorted and unequal distribution of public resources. At the same time the liberalization process altered the ways that the government finances the public deficits. With the mushrooming private banks that emerged as prime lenders to the state, the domestic debt skyrocketed from almost zero percent of GDP in 1987 up to 30 percent in 2000. In other words, the already inadequate savings of the Turkish people, which ideally should have provided credit to real sector to invest and grow, was used to finance the public deficit, which was a direct result of mismanagement of the state finances.

Additionally, the lack of proper regulation of financial sector was also one of the leading reasons why the economy struggled in post-1989 era. Taking advantage of the existing system in which the state was in constant need of borrowing to finance the enormous public debt, Turkish banks not only dedicated most of their existing capitals but also additionally borrowed heavily from foreign sources to invest in the highly profitable government bonds and securities market. Thus two major problems hit back the Turkish economy.

First, the banking sector had emerged as the broker of the Turkish state's borrowing from abroad and failed to implement its vital task of lending money for domestic investors especially the desperately credit seeking SMEs. Table 2, below, illustrates the 7-year period when the Turkish economy suffered 3 large-scale financial crises. Whereas Turkey belongs to the middle-income group, the availability of the credit to private sector is only equal to those of low-income countries. This lack of credit availability emerged as one of the primary reasons for Turkey's instable and inadequate growth performance throughout the early years of its liberal experience.

Table 2

Domestic Credit to Private Sector (% of GDP)	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Low Income Countries	20.0	19.8	20.1	20.5	21.0	23.0	24.7	24.9
Middle Income Countries	51.0	48.9	50.6	53.7	53.0	55.7	54.4	54.4
High Income Countries	124.6	127.5	128.6	135.5	148.1	151.2	150.3	150.1
World Average	111.5	113.2	113.3	118.4	127.4	133.2	131.4	130.7
Turkey	17.1	19.5	24.0	27.5	24.2	23.5	24.6	21.7

Source: *World Development Indicators* Database, World Bank.

Second, Turkish banks had dangerously open positions in terms of foreign currencies. In other words, their profit was based on TL but they borrowed in foreign currencies and consequently any significant and quick depreciation of TL would have destructive effects on Turkish finance sector. This vulnerable system cost Turkey dearly when speculative attacks or political tensions triggered the outflow of short-term foreign capital most dramatically in November 2000 and February 2001.

Moreover, the liberalization process with its growing macroeconomic imbalances such as high rates of inflation and constant depreciation of TL created groups of losers including urban workers, farmers and SMEs. Each political party sought to appeal to a specific loser group of the liberalization process. While not differentiating in major political and ideological issues, leaders of political parties preferred to keep their dominant post hoping to gain access to incentive distributing capacity of state by gaining electoral success. This would enable them to provide extravagant material incentives to themselves and their constituencies ignoring the negative reflections upon the state budget.[12]

This fragmented structure fueled the political instabilities and populist economic policies that in return caused even more macroeconomic imbalances and eventually long-lasting vicious cycles of political problems and economic stagnations. In such a difficult domestic setting in order to attract the volatile foreign capital extremely high real interest rates had been offered. This in return caused more debt and therefore another vicious cycle had come to exist. Also one of the main objectives of liberalization process is to capture the benefits of financial globalization of which Turkey has only managed to attract highly volatile short-term capital. Ideally the liberalization of Turkish economy should have brought long-term foreign direct investment (FDI). But in the absence of political and economic stability this goal was never achieved.

By 1999 both domestic and foreign economic actors were aware of the growing macroeconomic imbalances that the Turkish economy has suffered all throughout the 1990s. The coalition government in charge recognized this common perception and for the first time in Turkish history an IMF agreement was signed without experiencing a financial crisis.[13] However, in the absence of any urgency to recover from a crisis the government acted rather reluctant to comply with demands of the IMF program. Even

[12] For further explanation on the patronage policy exercises in post-1980 period see: (Eder, 2003).

[13] For a historical account of Turkey's involvement with IMF see: (Evrensel, 2004).

countries suffering serious financial crisis in general act hesitant to take the bitter IMF pill as the Fund often seeks to switch or cut the expenditure policies in order to fix the short-term outlook of the macro economy. This type of policies hit hard the real economy and poorer segments of the society. So it is no mystery then why the national governments efficiently cooperate with the IMF only in times of crises and for a limited period of time.[14]

A similar line of criticism of the neo-liberal mindset of IMF and its stabilization programs is that the unquestioned primacy of the financial sector over the real sector. To be more precise, as Keyman and Koyuncu (2005: 107) articulates the neo-liberal assumption of IMF and the 2001 “Transition Program of Turkey into Powerful Economy”:

> Without a strong and stable financial sector, economic growth would not be possible, and that shifting the focus of the economic program on production should be deferred until the sound political development and the stable macroeconomic rationality are to be achieved in Turkey.

As the voice of real sector, for instance, MUSIAD had strongly opposed this economic program by claiming that its main goal is to save the banking sector and the capital of the big business in Turkey and would not bring any improvement to the real sector which was going through an extremely rough patch after the February 2001 crisis.[15]

Speaking of IMF in Turkish context, the Fund was also unable to impose its conditionality concerning the much-needed structural reforms mainly due to the short-

[14] For detailed explanation on the hardships of implementing IMF policies see: (Alper and Onis, 2002: 3-5).

[15] See: (MUSIAD, 2002).

lived commitment by the Turkish side. So in practice the only support that IMF provided was the cheap credit that brought the boost to the economy to overcome the immediate effects of the financial crisis. Thus the IMF could be criticized for bailing out the governments, which successively engaged in populist policies and abandoned the fiscal discipline. Still these governments should be held responsible for the long lasting economic problems before the IMF.

2.4. The Twin Crises

In any economy where long-lasting economic problems and political instabilities are present, the financial crises need only a couple of minor negative developments to be the final straw. Turkish case for that matter is no exception. Some domestic and external dynamics simultaneously worked to trigger the financial crisis.

On the domestic side the coalition government, despite the optimistic mood brought by the 1999 Helsinki Summit in which Turkey was given the formal candidate status and the 1999 stabilization program supported by the IMF standby agreement, failed to meet the expectations of the market.[16] As part of the IMF conditionality there should have been made some cuts in agricultural subsidies and some progress in the privatization sale of state assets in telecommunications. However, as what is perceived to be a sign of lack of cohesion within the coalition and the determination to implement the IMF program, the

[16] For detailed information on the stabilization program see: (Yeldan, 2001).

ultra-nationalist NMP blocked the implementation of these key issues. As a result the investor confidence towards Turkish economy and the government's commitment to the IMF stand-by agreement had diminished. The widening current account deficit also raised questions concerning the sustainability of the economic program and the optimistic mood. With quickly decreasing interest rates the domestic consumption boom had come to exist and in turn fuelled the current account deficit. Adding the high energy prices in 2000 the current account deficit emerged as the major concern over the Turkish economy. Moreover the 1999 Kocaeli earthquake hit hard the supply side of the economy as the city produced 17 percent of overall manufacturing in Turkey.[17]

The international context also helped the triggering of the speculative attacks. In the aftermath of the 1997 Asian crisis the investors' sentiment towards the emerging markets took a negative turn. Thus even minor problems in domestic front would be blown out of proportion by the international investors and the room for speculative attacks had grown significantly. The Russian crisis of 1998 also contributed to the negative perception of global financial actors towards emerging markets but more importantly hit hard the Russian economy where the 25 percent of total Turkish exports are destined. Thus the Turkish export numbers fell significantly.[18]

Nonetheless the November 2000 crisis was a simple liquidity crisis mainly affecting the private banks. Hence its magnitude was limited and the economy managed to overcome the crisis situation rather quickly. However, the February 2001 crisis was the severest

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[17] See: (Akyurek, 2006: 11)

[18] See: (Akyurek: 2006: 10)

crisis that the Turkish economy has ever experienced. It was triggered by the confrontation between the President Ahmet Necdet Sezer and the Prime Minister Bulent Ecevit during a National Security Council (NSC) meeting and escalating to a point where Sezer threw the booklet of constitution at Ecevit.

The results were catastrophic. In the day of the NSC meeting 5.1 billion dollars worth of foreign capital left the country.[19] Overnight interest rates skyrocketed to 7500 percent while the Treasury gave 144 percent interest rate for one-month bonds. Within three days the stock exchange index declined by 29.4 percent. The controlled (pre-announced) exchange rate policy was replaced by free floating of the exchange rate two days after the crisis broke out. In the first day of free-floating system TL depreciated 39.75 percent against the dollar.[20]

Overall in the year of 2001 the GNP declined by 9.4 percent, which is the worst single-year performance in the history of Turkish economy, while an estimated one million people including educated and skilled labor lost their jobs. Many SMEs declared bankruptcies. The inflation rate rose by 55.9 percent.[21] In sum, the 2001 crisis turned out to be the severest crisis of Turkish history. It directly affected the lives of almost every segment of the Turkish society. The very depth of the 2001 crisis was instrumental in the makings of the new institutional framework that will be elaborated in chapter 4 and the new balance of power within the Turkish political economy that will be elaborated in

[19] See: (Tekeoglu, 2001).

[20] See: (Yilmaz, 2001).

[21] The statistical data on the depth of the 2001 crisis is taken from (CBT, 2006).

chapter 5. Thus the aftermath of the crisis witnessed some profound and groundbreaking changes in Turkey.[22]

2.5. The Dervis Factor

Kemal Dervis, a distinguished economist with a bright career in the World Bank, was appointed eleven days after the crisis broke out as the Minister of State responsible for the Economy. He was given the role of a supra-technocrat who was above the daily politics. The presence of Dervis was deemed important to repair the torn confidence towards the Turkish economy especially among the international financial circles. The fact that he is being the leading figure and the architect of the Turkey's new economic program, "Transition to Strong Economy Program", also helped to provide the support of IMF for a new agreement. Dervis himself identified establishing a trustful environment as the most urgent element of immediate economic recovery.[23] In order to achieve the high-trust environment not only tight fiscal and monetary policies but also addressing the more deep structural problems was needed.

Dervis indeed successfully addressed the underlying structural reasons for the long-lasting economic problems. First, the public spending was not transparent with more than 70 independent funds spending a significant share of the budget without supervision. The

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[22] For more on the depth of the 2001 crisis and its implications see: (Ozel, 2003: 90), (Onis and Keyman, 2003: 97).

[23] See: (Dervis, Asker and Isik. 2006: 67-75).

agricultural subsidies based on base price support have long proved to be inefficient for most farmers. The tax base was inadequate while most of the revenue was earned from regressive taxation. The privatization of inefficient state economic enterprises (SEEs) was insufficient and problematic. The energy, telecommunication and banking sectors needed strong independent regulatory agencies. The deregulation of key markets such as tobacco, sugar, gas and electricity and improving the pension system were deemed necessary. Not only the autonomy of central bank was essential to reduce the inflationary pressures but also the reforming of public banks was important to cut the ways of populist policies leading to reckless public spending.[24]

Within a year the macro-economic figures proved the fact that the Turkish economy shook off the devastating effects of the 2001 crisis. In 2002 the growth was restored with 7.9 percent, inflation rate came down to 29.7 percent, and the reserves of Central Bank of Turkey (CBT) rose to 26.7 billion USD. But more importantly the ongoing reform process started with the IMF-supported economic program paved the way for a longer term and stable economic growth.

2.6. The JDP Era

While the single party government was broadly welcomed there were also non-negligible concerns concerning the JDP. First, the party had genetic ties with political Islam in

[24] For a detailed list of Dervis reforms see: (Dervis, Asker and Isik, 2006: 147-148).

Turkey which historically opposed the EU and IMF involvement, had experienced confrontations with the secularists segments of the country including the Army and TUSIAD and previously displayed a pair of poor performances when it took the office.[25] It was also established only one year prior to the elections, which brought question marks concerning the experience and competence of party in office. Finally the electoral support of party was based on a broad social coalition and the JDP could have very well been tempted to populist policies in order to keep this broad and diverse coalition satisfied.

The JDP government, however, proved these concerns wrong. Instead of engaging in a populist spending policy to satisfy its broad electoral coalition the full commitment to the ongoing reform process with the help of powerful external anchors of IMF and EU was maintained. Regarding the competence of the party, the bold initiative that was taken when the delicate issue of Cyprus had become a major stumbling block on Turkey's path to EU accession had proved the party to be capable of successfully tackling sensitive issues. The last major concern regarding the JDP government, which was the possible confrontation with the hyper-secular establishment within the state, did not materialized except for the Higher Education Bill, a policy initiative that was considered as a sizeable concession to the Islamists and consequently led to a serious political tension. However, JDP did not force this controversial issue and backed down on its demand to implement the Bill.[26] Leaving aside this single incident the Erdogan administration transferred the issue of extending religious rights and freedoms to the EU front. In other words, any

[25] For the past record of political parties associated with political Islam and the evolution of the political Islam in Turkey see: (Dagi, 2005), (Cavdar, 2006).

[26] For a detailed explanation of the incident see: (Heper, 2005).

reform paving the way for extending controversial religious issues was taken within the context of the EU reform agenda.

While the role of EU has significantly increased after the 1999 Helsinki Summit when Turkey was given the formal candidate status, in the post-2001 context the democratization reforms urged by the EU have come to be perceived as an integral part of the economic reform process.

> Market participants which were the principal actors promoting economic reform also became strong supporters of EU conditionality, primarily for its economic benefits. As a consequence, the coalition government in power was not able to resist the kind of far-reaching democratization reforms implemented during the summer of 2002. This was due to the fact that the failure to implement such reforms would mean a loss of trust on the part of the market participants in the government's ability to maintain the momentum of the economic recovery process. Markets, in a way, became an instrument of political reform. Political reforms, in turn, helped to generate greater confidence in Turkey's ability to create a favorable climate for domestic and foreign investment. (Onis and Bakir, 2007: 13)

By its nature the IMF is a short-term anchor. Its duties start with the worsening of macro economic indicators and end when the immediate financial difficulties are overcome. Hence it is instrumental to bring in short-term foreign investment to the country as long as it successfully complies with the IMF discipline. The only anchor that is capable of providing a longer-term investment, guidance and influence in Turkish case is the EU. Not only the accession process is a long one but it also requires some deep and permanent structural changes. Once the membership is obtained the investor confidence improves significantly as a sound functioning market economy with a democratic political structure emerges in an irreversible fashion. Statistically every state that started the negotiation process wound up earning the full member status. Thus there has been a significant boost in the amount of long-term foreign investment yielded towards Turkey after the negotiation process officially started in October 2005.

Another important element of EU's appeal for Turkey has been the material benefits that are offered in many different forms of direct fund transfers. Especially after most of the Turkish people suffered from the devastating economic losses of the 2001 crisis the public support towards the EU membership had notably increased with the motivation of deriving direct material benefits from the process.[27] "In Turkey we found solid optimism about the personal benefits of possible EU membership."(European Commission, 2001a: 59) So not only the business oriented market participants but also the ordinary people containing all different segments of economy and society united under the common goal of obtaining the EU membership.[28]

Turning back to the IMF, aside from the structural reforms, the IMF conditionality also forced the Turkish policy makers to maintain the fiscal discipline and the JDP administration responded well by keeping the fiscal discipline in place at any cost. One dramatic example for that matter is the confrontation with hazelnut producers. The JDP government stood firm and has not submitted to the high price demands of the vast hazelnut producing agricultural sector. This policy could reflect badly upon JDP's electoral fortune in northeast Turkey but it indicates that the JDP is, unlike the preceding governments, not inclined to apply populist policies but it rather prioritizes the higher goal which in this case being the keeping the public debt at minimum.

[27] See: (Onis, 2006a: 11),

[28] See: (European Commission, 2001a: 56-63).

Between the years 2002 and 2004 "56000 redundant positions in State Economic Enterprises (SEEs) have been eliminated."(IMF 2004: 20) This again is an unusual policy practice as the employment in SEEs has been long used for political purposes. Instead of providing jobs for its constituencies the JDP government acted in line with the demands of IMF and eliminated redundant positions. In other words, the JDP chose a bitter IMF conditionality over a populist inclination that would eventually bring electoral popularity.

Another striking example of JDP's commitment to the IMF induced reforms and fiscal discipline is the tight regulation on banking sector. SMEs which constitute the bulk of JDP's social coalition fiercely opposed the tight control on the banking sector as they continuously sought credit and in general had a hard time to access bank credits, as oppose to the big business conglomerates which either own their own banks or easily find credits due to their reputation.[29] On the other hand the inadequate regulation of banking sector especially after the current account liberalization is widely considered as the prime cause of Turkey's economic problems throughout the 1990s. Hence IMF persistently pushed for tighter regulation of banking sector. The JDP sided with IMF and continued the reform process of banking sector especially on supervisory and regulatory framework despite the opposition of SMEs.

All in all the JDP era witnessed some stellar achievements in terms of Turkey's long lasting economic problems. After 32 years of time the inflation rate has come down to single digits and consequently the interest rates decreased and confidence in TL has

[29] See: (Onis, 2006a: 23).

improved greatly. Commercial banks' engagement in productive lending has increased significantly. For the first time in the post-1980 structure the economy recorded GDP growth for more than twenty consecutive quarters and connectedly the ratio of public debt to the GNP came down to 44.8 percent in 2006 from the 90.4 percent in 2001.

Considering the weak record of Turkish policy-makers in maintaining fiscal discipline and commitment to IMF-induced structural reforms, it is all very intriguing as to what drove the JDP government to distinguish itself from the preceding ones. Why was the bitter IMF pill taken in the absence of any economic crisis or why the populist and patronage politics were not implemented. The coming chapters will introduce four alternative explanations to answer these questions.

CHAPTER 3

GLOBAL ECONOMIC INTERDEPENDENCE AND THE INCREASING ROLE OF EXTERNAL ACTORS IN POST-2001 CRISIS TURKEY

Turkey has established extensive ties with global financial actors especially after the capital account liberalization in 1989. However, in the presence of Turkey's long-lasting economic weaknesses and deficiencies, which were outlined in the previous chapter, this relation with the global finance actors has been a rather lopsided one. As a result of this asymmetry, Turkish economy has become more and more dependent on the inflow of short-term foreign funds mainly due to the current account deficit. As Onis (2006: 23) puts it "The manner in which the economy has been integrated into the global economy and the global financial markets severely constrains the options available to particular governments, to which the JDP government is no exception."

Especially in the aftermath of the 2001 crisis a unique structure has come to exist with the synchronized work of multiple factors and both the amount and the role of short-term foreign investment in Turkish economy reached its peak point. This increasing role of global finance actors and their investment in Turkish economy will be elaborated in this chapter as the first set of explanation for the unusual episode of Turkish political economy which has been taking place since the February 2001 economic crisis.

3.1. The Story of the Current Account Deficit in the Post-2001 Crisis Turkey

Turkey has a long history of current account deficit, but in the post-2001 crisis era, it emerged as the prime cause of concern for the Turkish economy. The backbone of this long-lasting problem has been the enormous foreign trade deficit. In the 2002-2006 period the foreign trade deficit exceeded the current account deficit by $8 billion on average per annum.

Table 3

Yearly (million $)	**2002**	**2003**	**2004**	**2005**	**2006**
Current Account Balance	-1,521	-8,036	-15,601	-22,603	-31,654
Foreign Trade Balance	-7,283	-14,010	-23,878	-33,530	-40,176

Source: Turk Stat

There are two main elements of the long-lasting foreign trade deficit. First, Turkey is and has always been a net importer of energy, a main component of intermediate good imports. With the growing population and economy, the demand for energy displayed an upward curve and as of 2006 reached its zenith. According to IMF (2006: 12) “Each dollar increase in the price of oil translates into a 0.1 percent of GNP deterioration of the current account”. While Turkey’s demand for oil has been increasing rapidly, the price of oil has followed a similar trend in the meantime. The yearly basket price of Organization of the Petroleum Exporting Countries (OPEC) per barrel of oil was $24.36 in 2002 and in the following 5 years it went steadily up to $61.08 in 2006.

Table 4

Yearly ($)	**2002**	**2003**	**2004**	**2005**	**2006**
Yearly Basket Price of Oil	24.36	28.1	36.05	50.64	61.08

Source: OPEC

The energy that Turkey imports is not limited only to oil. Turkey has signed multiple agreements with Russia and Iran for the import of natural gas, which is one of the main import items in form of energy, above the market prices.

Second, the lack of technological capabilities in Turkish manufacturing sector creates a constant need of import of the investment (also known as capital good) and intermediate goods. Most of the medium and large industrial entrepreneurs need to import investment goods to start or enlarge their business. That is to say, in order to increase production and facilitate growth, Turkey needs import first. Once the industrial facility has been established, the production still requires import of intermediate goods. While the energy is one of the main sources of intermediate good imports, there are many other forms of intermediate goods. To give an example, Turkish company Vestel is the biggest television manufacturer in Europe. However, the display device, the main component of a television set, which turns the electrical signals into visible light and images, is produced by the Korean company Samsung. Hence the lack of technological and innovative capabilities of the Turkish manufacturers causes the Turkish production pattern to rely largely on the imports. Turkey's import numbers clearly indicates this heavy reliance on imports of investment and intermediate goods.

Table 5

Yearly (million $)	**2002**	**2003**	**2004**	**2005**	**2006**
Capital Goods	8,400	11,326	17,397	20,363	23,148
Intermediate Goods	37,656	49,735	67,549	81,868	98,623

Source: Turk Stat

In the 2002-2006 period the average rate of increase in import of intermediate goods was 26.8 percent. In nominal terms the annual total of intermediate goods has reached $98.6 billion in 2006 whereas this number was $37.6 in 2002. The same trend can be observed in investment goods too. The average rate of increase was 34.6 percent and the nominal number has come up to $23.1 billion in 2006 from $8.4 billion in 2002.

While Turkish economy is in heavy need of import, the foreign trade deficit has another aspect. The deficit is a mere result of imports outnumbering the exports. So if there is a growing deficit in foreign trade balance, one has to consider the lack of adequate export growth. In the post 2001 context the TL has sharply appreciated due to the intense inflow of liquidity to the economy. The growing appetite for risky investments on the side of global financial actors caused this inflow of liquidity in post 2001 crisis era. The emerging markets stood out as the prime source of major gains for the global investors with a substantial risk factor due to the common economic and political problems associated with these markets. Moreover the interest rates all over the world especially in developed countries were unusually low and at the same time the growth rate for the global economy has been strong which leads to a significant increase in the amount of liquidity used for investment. In such a favorable context the CBT offered high real interest rates, which have been a major attraction for the global financial actors to channel their portfolio investments to Turkey.

On March 1 2002, a date that Dervis describes as the beginning of the stabilization for the economy, the dollar was valued to 1.38 TL. Exactly 4 years later the value was down to 1.30 TL in spite of 68 percent cumulative inflation in the meantime. Even the prime minister himself criticized the value of TL and CBT for causing the appreciation of the currency by keeping the real interest rates high.[30] The CBT, on the other hand, stands firm as its ultimate goal is to achieve the inflation target and price stabilization. Decreasing the interest rates would jeopardize both of these goals. Moreover, in the presence of the growing current account deficit which is primarily financed by the inflow of short-term foreign investment (also known as hot money) decreasing the interest rate might lead to a sudden capital flight to the country and potentially leading to a large-scale economic turbulence.

Despite the constantly appreciating TL, the export numbers still managed to grow thanks to the increasing productivity and the stabilizing effect of disinflation on wages.

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[30] For the text of this speech see: (NTVMSNBC, 2007b).

Table 6

Yearly (million $)	**2002**	**2003**	**2004**	**2005**	**2006**
Export	36,059	47,253	63,167	73,476	85,502

Source: Turk Stat

Yet the export growth could not keep up with the pace of imports. Consequently the ratio of exports to the GNP increased by 1.5 percent while the ratio of imports to the GNP rose 6.1 percent in the 2002-2006 period. One of the reasons for this difference is the need for capital and intermediate goods import as a precondition for production growth. The other reason is the central role of the strong domestic demand in the rapid economic growth process. The decreasing interest rates after 2001 crisis accompanied by the improving tools of banking sector due to the significant penetration of the foreign banks in the Turkish banking sector resulted in a consumer credit boom. As it was stated previously, Turkish economy relies heavily on the imports of capital and intermediate goods. When the economy grew rapidly after the 2001 crisis, the import numbers skyrocketed to boost the supply. However, the domestic market mainly demanded this supply and thus it did not reflect equally well upon the export growth. So as a result, the recent rapid economic growth further contributed to the foreign trade and consequently current account deficits.

The other effect of overvalued TL can be traced in the imports. Combined with the Turkish consumer’s eager demand for technological and high quality consumption goods the increasing value of TL contributed to the rising numbers of consumption good imports. Speaking in numbers, the cumulative import of consumption goods in 2002 was $4.8 billion and this number has come up to $16 billion in 2006.

Table 7

Yearly (million $)	**2002**	**2003**	**2004**	**2005**	**2006**
Consumption Goods	4,898	7,813	12,100	13,975	16,019

Source: Turk Stat

Whilst the imports of investment and intermediate goods have a positive return as they generates production in long-term and their import is merely out of necessity, the consumption goods do not have any such positive return nor they are absolute needs but rather a choice that solely contributes to the widening foreign trade deficit.

Aside from the foreign trade deficit there are other factors contributing to the current account deficit. Since Turkish people prefer to spend their money rather than saving it, domestic savings have long been inadequate and when the TL started a constant appreciation phase after the 2001 crisis the private consumption peaked. The consumption boom narrowed the room for domestic savings and thus the need of the Turkish economy in general, but primarily the private sector, to import foreign capital to finance their investments grew rapidly, which clearly reflects upon the short-term debt. Back in 2002 the number for private sector's short-term debt stood around $15 billion whereas the same figure reached almost $40 billion in 2006.

Table 8

Yearly (billion $)	**2002**	**2003**	**2004**	**2005**	**2006**
Short-Term External Debt	16.4	23.0	31.9	37.1	42.0

Source: Turk Stat

3.2. The May-June Turbulence

Between the early May and late June of 2006 Turkish economy experienced a set of unpleasantly rapid shifts in major macroeconomic indicators due to a negative change in international investors' sentiment towards emerging markets. During the turbulence the overnight interest rate of CBT rose almost 30 percent, TL depreciated more than 30 percent. The stock market was also affected negatively and experienced a swift downturn. This economic turbulence was especially significant as it revealed the serious vulnerabilities in the Turkish economy despite its impressive run after the 2001 crisis and set a valuable example for how quickly the political and economic conditions can change to produce a financial turmoil.

As it was highlighted earlier, the current account deficit had been on the rise in the post 2001 crisis era and as of May 2006 it reached almost 9 percent of the GNP whereas according to the IMF (2006b: 9, 12) it should stand in the region of 4 percent. So the existing concerns on the sustainability of the deficit have reached to a new high point. This risk of financing the growing current account deficit was covered by the intense inflow of global liquidity. However, the global risk aversion increased abruptly and triggered a sell-off trend in emerging markets in mid spring. The Turkish economy was hit harder than any other emerging markets mainly due to the presence of domestic political and economic problems at that time.

First, the one-year rolling inflation rate came out much higher than the program targets for April and May respectively, reaching almost to the double digits with more than 9 percent mainly due to the slight loosening up of the fiscal discipline from late 2005 onwards. Since the chronic inflation has long been a major problem of Turkish economy, this upward trend in inflation rate had created second thoughts in the minds of investors regarding the sustainability of the recent economic success. Second, the reform process at the same time had also significantly slowed down with the program delays including the pension reform, tax reform, banking supervision and privatization of state banks.

The pension law, here, requires a more comprehensive look. The social security deficit was widely perceived as a major source of public debt and IMF conditionality urged a reform concerning the issue. “Without reform, the overall social security deficit was projected to more than double in the long run from its current level of 4.5 percent of GNP.”(IMF, 2005: 31) The JDP government did his part and passed the related reform from the parliament unlike the other delayed reforms. However, the President vetoed the eagerly anticipated reform on pension reform law and consequently it directly contributed to the making of the May-June turbulence.

The developments on the political front contributed to the snowballing of this negative mood in investors’ confidence. A series of events brought the secularist-Islamist divide to the headlines. First, the President, who has been extremely sensitive on the issue of secularism, twice vetoed the proposed candidates for the central bank governor and the appointment process overall took more than a month from mid March to late April causing an air of uncertainty in the markets. Although it was never explicitly indicated, the reason for the Presidential veto was believed to be the Islamist background of the candidates proposed by the government.

In mid May, the terrorist attack on the Presidency of Council of State leading to the killing of a judge escalated the political tension to dangerously high levels. The suspect indicated that the decision of the Council to confirm the ban on the headscarf was the reason behind his terrorist act. The incident led the President Ahment Necdet Sezer to publicly voicing his concerns on the danger of rising fundamentalist Islam to the secular establishment of the Turkish Republic. The secularist-Islamist divide, a major source of political tension, which was kept under the radar by the JDP government, inevitably re-surfaced. In the funeral ceremony of the deceased high court judge the members of JDP cabinet were protested in a rather unusually strong and intense manner while the President, generals, high court judges and members of Higher Education Board, who were all perceived as the symbols of the secularism, received massive support from the crowd. This mounting political tension generated a negative perception in the markets, as it is capable of triggering a financial crisis.

On the EU front, although the negotiation process had started, "The EU was critical of the limited progress Turkey had made on a range of political reforms, and laid down markers on Cyprus that many observers interpreted as foreshadowing difficulties in EU relations later in 2006."(IMF, 2006: 9)[31] Since the EU had emerged as a powerful anchor in the post 2001 crisis era guiding the reform process, this negative signal sent by the Union yielded a loss in the investor's confidence regarding the future status of Turkish politics and economy. Also the upcoming elections of President and general election in 2007 were seen as potential sources of political instabilities. On the economic side of the election environment, Turkish political parties historically have been prone to engaging in populist line of public spending to boost their electoral popularity as the general election nears. All in all, markets were getting increasingly aware that these developments might lead the distortion of fragile balances of the markets in medium-term.

Nevertheless, the TL and stock market quickly recovered their losses after the turbulence ended in late June but the interest rates remained relatively high. The inflation rate also got a boost from the fluctuation as the program target rate was doubled for the year 2006. While the quick and rather smooth recovery process and the ability to contain the magnitude of crisis at minimum demonstrates the resiliency of the economic achievements since the 2001 crisis, the fact that Turkey among all the major emerging markets faced the most dramatic effects of the global liquidity movements clearly unveils the existing vulnerabilities in the Turkish economy. This turbulence presented the fact that Turkish economy still operates on highly variable and fragile terms and thus the policy makers do not have any spare room to alter the path the country has been taking since the 2001 crisis. To be more specific, distancing from the anchors of EU and IMF,

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[31] For the negative remarks of the EU see: (European Commission, 2006: 6-10, 13, 15, 17, 23-24, 33, 35-37, 44, 51).

loosening up the tight fiscal control, slowing down the pace of structural reform process, and igniting a domestic political tension are needed to be avoided at any cost.

3.3 The Implications of the Reliance on the Short-Term Foreign Capital upon the Political Economy of JDP

In the age of financial globalization, it is quite natural for liberalizing Turkey to be interdependent with the global finance actors. However, the nature of this relationship has been more of a one-sided reliance on the part of Turkey rather than a mutual dependence. The dangerously high level of current account deficit is a clear manifestation of Turkey's reliance on (mostly short-term) foreign capital. Not only does this reliance reflect the existing structural deficiencies of the economy, but it also poses a significant risk to the well being of the Turkish economy. Managing the growing current account deficit with highly volatile global liquidity is widely perceived as the leading problem of JDP era Turkey. This thesis, contrary to the common perception, argues that the need to finance the current account deficit via the short-term foreign portfolio investment has a bright side as it serves a strong anchor duty in forcing the JDP government to act in line with the expectations of the markets.

The May-June turbulence proved that the reversal of the positive sentiment of the global investors is capable of triggering a full-scale financial crisis. The global liquidity has a highly volatile nature. If the interest rates rise in developed markets or the world economy enters a recession phase, the channeling of global liquidity towards the risky emerging markets would drop significantly. So there is very good chance that factors purely external to Turkey's economy might distort the liquidity inflow to the country. In the presence of such a potential threat, the domestic conditions should be kept in best possible state. To be more specific, any domestic political tension or economic stagnation is capable of triggering a rapid outflow of the already volatile portfolio investment.

Despite all its recent achievements Turkey is still an emerging market with some major economic imbalances. If the money supply flooding from foreign investors were abruptly cut then financing the current account deficit would become extremely difficult. Like in the February 2001 crisis, the interest rates would have to be raised to dangerously high levels so that the foreign investors in the Turkish economy would not sell-off their TL assets and additional foreign portfolio investment could be appealed. In short term, the total debt would skyrocket because the depreciating TL translates into lesser volume of unit foreign currency. In other words, if hypothetically TL depreciates by 20 percent against the dollar, the overall debt stock of Turkey in terms of dollar instantly increases by 20 percent. In the long run, the payments of the high interest rate returns would further worsen the debt stock.

While the aforementioned effects of a possible financial crisis might be overcome in a rather quick fashion, the credibility of the Turkish economy would not be equally easy to restore. It took years for the Turkish economy after the 2001 crisis to convince both the domestic and foreign investors that the country has achieved decent stability in terms of economic and political structure, and promises a bright future with a full-on structural reform process underway.

The more economic crisis takes place in an economy, the more difficult it gets to achieve the high-trust environment. If a new financial crisis much like the one in 2001 recurs, it would be much more difficult to restore weakened investor confidence. Also this weak record increases the risk factor associated with the Turkish economy and consequently makes the already volatile short-term portfolio investment all the more volatile. So the JDP government needed to act more carefully to prevent any major financial crisis from breaking out than the all previous governments.

A potential financial crisis would not only have destructive effects on the Turkish economy but also the JDP itself would lose much of is electoral popularity. After the 2001 crisis the voters punished the members of the coalition government in office harshly by leaving all three of them under the 10 percent parliamentary threshold. In case of a similar financial crisis the JDP as the single party government in charge would very likely to face a same kind of reaction from the public. Thus the JDP had to avoid any bold move such as engaging in a populist line of public spending, quitting the IMF-stabilization program, abandoning the EU reform process or escalating political tension regarding the secularist-Islamist divide with forcing sensitive issues like headscarf and religious schools that might trigger a full-scale financial crisis. In other words, if the JDP wanted to maintain its dominant position in the parliament, it had to comply with the commonly shared expectations of the markets and the public in general. Therefore, it is safe to say that the macroeconomic problems, the current account deficit in particular, serves a safeguard role in the post-2001 crisis era.

The macroeconomic problems need classification. Unemployment, for example, is a major macroeconomic problem. However, by its nature, it is not capable of rapidly triggering a large-scale financial crisis. It may limit the economic growth and distort the income distribution, but these problems have mostly tolerable long-term ramifications. Problems such as current account deficit, on the other hand, operate on short-term scale. If the deficit grows or the financing for the deficit dries up, it exposes a major short-term macroeconomic problem. If the deficit cannot be sustained, it instantly triggers a financial turmoil. Thus the macroeconomic problems operating on short-term scale serve as invisible anchors over the governments, of which Turkey's and JDP government is no exception.

The urgency to manage the current account deficit narrows the opportunity space of the JDP government in a positive manner. For instance, the government would most likely prefer to aim for a much lesser primary surplus than the existing 6.5 percent standard. With a more relaxed budget the JDP could increase public spending which paves the way for more popular policy implementations such as offering high agricultural prices or tax relief. However, in the post 2001 context the markets performed an audit task and any inclination towards engaging in a populist line of economic policies or slowing down the structural reform process was largely prevented. If the JDP would have loosened up the fiscal discipline or slowed down the reform process, the markets as in the May-June turbulence would punish the economy by selling off Turkish assets and liquidity outflow would follow. In order to avoid such a financial turmoil, the JDP government was forced to provide a suitable economic and political environment for the external sources of finance to which maintaining the positive mood in the markets is the key.

Not only the short-term portfolio investment but also the attraction of the long-term Foreign Direct Investment (FDI) into Turkish economy emerged as a primary goal in the presence of the widening current account deficit. Much like the short-term portfolio investment, in order to attract FDI the Turkish economy and politics should first and foremost give a positive outlook to the investor. In the absence of political and economic stability, sufficient levels of FDI cannot be attained as it was proved in Turkey prior to the 2001 crisis. In the post 2001 era with the successful implementation of the structural reforms on both political and economic arenas, which also includes the improvement of the investment climate, and enhancing macroeconomic figures, the FDI numbers improved significantly.

Table 9

Million ($)	**1990-2001 average**	**2002**	**2003**	**2004**	**2005**	**2006**
FDI Inflow (annual)	1,002	1,137	1,752	2,883	9,813	19,797

Source: CBT

Since the FDI is a long-term commitment, the investors seek for permanent guarantees to secure their costly investments. The decision of the EU in December 2004 to open up the formal membership negotiations with Turkey was, therefore, the main reason behind the FDI boom that has been taking place after the 2004.

As the May-June turbulence showcased, in spite of its recent achievements, the Turkish economy rests on very fragile balances and the risk of experiencing a financial crisis is still present at large especially due to the widening current account balance and the heavy reliance on the highly volatile short-term foreign portfolio investment in financing the deficit. Being aware of this fact, the JDP has been following a careful political economy agenda, which has two main facets. First, the JDP government aims to avoid any major domestic political problem that may trigger a financial turmoil. Second, it intends to keep the investor's sentiment positive. In order to achieve this second goal, the fiscal discipline remained tight, the conditionality of the IMF stand-by agreement was successfully met and the reforms required for the EU accession were made. Therefore, it is safe to say that the widening current account deficit problem forced the JDP to follow a unique political economy, which clearly indicates a point of departure from the classical Turkish political economy as the fiscal discipline and reform process has been maintained for extensive periods of time.

CHAPTER 4

THE REPERCUSSIONS OF THE POST-2001 INSTITUTIONAL FRAMEWORK ON THE TURKISH POLITICAL ECONOMY

Turkey initiated its liberalization process almost three decades ago. While the early years of the transition was seen as a success story with the rapid industrialization and surge in the exports, the following years of the liberalization experience showed a dismal performance. In the absence of the proper neo-liberal state restructuring, the state remained largely involved with economics. The politicians who seek to address the interests of the specific social groups constituting their electoral base used the rent distributing capacity of the state. Consequently, populist policies aiming to respond the distributional pressures of the various social groups deeply distorted the macroeconomic balances. Adding the political instabilities after 1987, Turkish economy experienced three major financial crises within seven years.

The last and the most powerful crisis hit the country in 2001. Despite its harsh consequences, the 2001 crisis paved the way for many important developments in Turkish political economy. The shift towards a kind of competition state in line with the neo-liberal theory in the aftermath of the 2001 crisis was a front running factor shaping the political economy of the Turkey and inevitably the JDP government. This chapter focuses on this changing nature of the institutional framework.

4.1. The Making of the New Institutional Framework

The most influential factor contributing to the making of the new institutional framework was the IMF conditionality. The 2001 crisis was once again the key to initiate the process. Both foreign and domestic private investors completely lost their confidence in the Turkish economy in the immediate aftermath of the crisis. As outlined earlier in the second chapter, billions of dollars worth of portfolio investment left the country in matter of days. The economy promptly needed large amounts of foreign exchange in order to stabilize the major macroeconomic indicators such as the interest rates and exchange rates.

In the midst of such a large-scale financial crisis, IMF loans emerged as the primary source of finance. The Fund releases a portion of its credit assistance if the country meets the requirements of the IMF program. In order to review the performance of the debtor country periodic meetings are held by country and IMF officials. Hence the IMF earned an important bargaining position to impose its conditionality in the bilateral relations. With the influence of the IMF conditionality reaching an all time high, the neo-liberalization in its true essence has finally started to shape the institutional infrastructure in Turkey. As Cizre and Yeldan (2005: 403) articulate:

> What loan conditionality seeks to do is to set in motion the forces of the free-market by reducing the economic resources flowing through the public sector. As a result, the scope of political patronage available to the power wielders in the Turkish political system is curtailed.

Therefore, the roles of the politics and the state over the economics have noticeably shifted towards a more neo-liberal nature with the post-2001 crisis reform process.

There were three other factors further contributing to the making of the new framework. First, not only the influence of the IMF conditionality has increased but also the nature of the conditionality has evolved. After the 1997 Asian crisis, IMF started to embrace the emerging Post-Washington Consensus (PWC). The long lasting criticisms of the Washington Consensus led the emergence of the PWC. In essence, PWC transformed the pure neo-liberal goal of minimizing the role of state into granting a more central role to the state institutions.[32] Consequently the IMF adopted a fresh line of thinking and the scheme of its assistance programs had altered. As Onis and Senses (2005: 13) argue "the institution now tends to pay far more attention to regulatory reforms, notably in the context of the banking and financial system, and recognizes far more than in the past the importance of strong institutions and 'good governance'".

Second, the harmonization efforts with the *acquis communautaire* were influential in the making of the new institutional framework. The EU accession process not only requires passing of numerous new laws in line with the *acquis communautaire* but also successful implementation of these new laws. Annual progress reports, which are prepared by the European Commission to analyze Turkey's progress in harmonizing its institutional

[32] See: (Stiglitz, 1999).

framework with the *acquis communautaire*, serve strong monitoring function for the reform process. The public procurement law is a perfect example of the EU influence. In 2002 the new law was introduced and the annual progress report praised the new public procurement law for its success in aligning the Turkish laws with the *acquis communautaire*.[33] However, in the 2003 progress report the reversal of the previous success in aligning the public procurement law was immediately identified and Turkish authorities were notified.[34] In other words, the EU effectively contributes to the making of the reforms and monitoring of their successful implementation.

It is also worth noting that the IMF conditionality was still more effective than the harmonization with the *acquis communautaire* in the making of post-2001 institutional framework. As Eder (2003: 230-233) points out the EU changed its grand economic theory from Keynesianism to neo-liberalism and thus the Copenhagen economic criteria became very much in line with the classical IMF conditionality. Therefore, especially in the economic reforms the IMF conditionality emerged as the primary external anchor since the EU economic conditionality suffers from a time lag. While the EU offers long-term positive returns it asks for short-term policy implementations without providing any significant material incentive at the time of implementation. Yet, aside from the economic reforms in the political and social realms that IMF does not assume any role the EU was the single most influential anchor guiding the new institutional framework.

[33] See: (European Commission, 2002: 66).

[34] See: (European Commission, 2003: 64).

Third, the pro-reform coalition gained ground with the destructive effects of the 2001 crisis. Over the years bureaucrats prepared many blueprints for the restructuring of the institutional framework. However, prior to the 2001 crisis the political will was lacking to turn those blueprints into tangible structural reforms as Dervis, Asker and Cetin (2006: 71) point out. The strengthening hand of the pro-reform coalition urged the politicians to implement the much-needed structural reforms. With all these three factors at play, a new institutional setting has come to exist.

4.2. Main Components of the New Institutional Framework

The new institutional framework has reorganized the structure of the state mainly in order to achieve two goals. First goal was to improve the balance of the budget by making the public spending more efficient. Due to the shortsighted populist policies, the resources of state had long been recklessly spent. The public spending was not transparent, and accountability was largely lacking. Most visibly the State Economic Enterprises (SEEs) in general and the public banks in particular recorded large amounts of losses in consistent terms. Thus a set of structural reforms was made specifically to address these problems.

The other goal was to give the state a more complementary role within the economics. Prior to the 2001 crisis, the rent distributing capacity of the state was one of the primary sources of economic activity. The politics and economics were interrelated in such a manner that the politicians and businessmen derived joint rents. This twisted political economic structure needed a restructuring in accordance with the neo-liberal theory. Hence a competition state, which serves strict regulatory role, has emerged with the structural reforms of post 2001 era.

In order to achieve these two aforementioned goals many reforms were made which all are listed in the table below.

Table 10

Key Structural Reforms Constituting the New Institutional Framework	• Improving the transparency and accountability of the budgetary process • Strengthening the autonomy of the Central Bank through legal protection • Enhancing the autonomy of the BRSA, much tighter regulation of the banking and financial system with a special emphasis on the public banks • Strengthening the position of autonomous regulatory agencies in several areas of the economy including energy (oil and natural gas) and telecommunications • Increasing the transparency in the process involving the sale of public assets • Establishing a new independent regulatory board on the public procurements • Removing the state monopolies in electricity, sugar and tobacco production • Reducing the corporate tax rate • Reducing the administrative barriers to FDI • Reducing the agricultural subsidies via the new direct income support mechanism • Revitalizing the privatization program

Adopted from (Onis, 2006a).

4.3. Implications of the New Institutional Framework

There have been a number of developments brought by the new institutional framework which all contributed to the unorthodox political economy agenda of the JDP. First, the role of state within the economics had changed and ultimately reduced. With the powerful effects of the emerging PWC within the IMF, the Fund demanded strong institutions performing impartial regulatory function. Consequently many independent regulatory agencies were either established or reinvigorated. Thus a transfer of power from political institutions to the technocratic agencies occurred. The significance of this shift of power lies in the history of the Turkish political economy. The political parties have long used the political institutions in Turkey for distributing economic rents. Technocrats, on the other hand, do not act with political considerations because they do not have an ambition to be re-elected to their posts. Hence they are capable of achieving a stable course of policy that solely aims to bring the best possible outcomes both for the state and the economy. With the transfer of rent distributing capabilities of the state to the independent regulatory institutions, the populist patronage politics were curtailed. Consequently the JDP compared to the previous governments had lesser room to engage in populism and distribute rents to a selected businessmen or social groups.

The quick pick-up in the privatization sales is a perfect example to outline this new institutional framework and its reflections upon the political economy. Since the two main purposes of the making the new institutional framework were cutting off the sources of rent-distributing capabilities of the states and reducing the excessive and reckless public spending, privatization became a front-running priority addressing both of these goals. The politicians had long considered the SEEs as an infinite source of employment regardless of the negative financial consequences attached to this populist approach. Thus over the years most of the SEEs brought sizeable burdens to the budget.

Various reforms were made in order to set in motion the privatization process. First, the sale of the public assets was made more transparent. Some major privatization sales even broadcasted live on national television channels. This reform eased the skepticism of the public and the business circles over the lack fair competition in the privatization process.[35] Moreover, equal footing for the FDI was granted in order to attract the interest of foreign investors and encourage them to participate in the privatization sales. The reduction of the corporate tax rate from 30 percent to 20 percent has been a final incentive for the investors. The rapid growth, positive outlook of the Turkish economy in the post-2001 era and the beginning of the EU negotiations boosted the investor confidence and a privatization boom followed.

Table 11

Yearly (million $)	**1985-2002 average**	**2003**	**2004**	**2005**	**2006**
Privatization Revenues	444	187	1,283	8,222	8,096

Source: Privatization Agency

[35] For a comprehensive analysis of the barriers to the privatization in Turkey see: (Ercan and Onis, 2001).

The privatization sales provided significant amounts of resource to improve the revenue side of the budget. But more importantly the sales of constantly loss-recording SEEs cut back the inefficient public spending. A major avenue of populism was blocked. With the swift privatization sales, the budget relieved from a major source of deficit. The privatized enterprises turned into profit-making facilities in the hands of private sector contributing to the economy.

Also similar to the reforms making the privatization more transparent, the public procurement procedure was reorganized. The public procurements have long been speculated as a major source of patronage politics. Allegedly the political parties favored their political constituencies in the procurement procedures. Therefore, the required fair competition could not be attained. The state was forced to overpay for many public procurements. The foundation of the new independent Public Procurement Agency reduced the involvement of the politicians within the procurement process. Transferring the task of implementing the public procurements blocked another possible avenue for the politicians to engage in populist patronage policies.

The autonomy of CBT is also a crucial development. Prior to the 2001 crisis the CBT was heavily influenced by the political pressures and thus was not able to successfully execute its primary task of providing the price stability. The politicians had the room to overuse the sources of the state and then force the CBT to increase the money supply and the interest rates to cover up the budget deficit. This in turn heavily contributed to the chronic inflation that the Turkish economy suffered for decades. The new independent

CBT has the capability to block the political pressures, and to successfully maintain the price stability. Consequently politicians have lesser room to abuse the resources of the state.

One other structural reform contributing to the fiscal discipline is the reorganization of the budgetary process. Prior to the 2001 there were approximately 70 independent state funds each making non-accountable public spending. Most of these funds were shut down and consequently the public spending became more transparent and accountable. The transparent budget also helped the IMF to more accurately monitor the fiscal discipline. Given the increasing role of the IMF in the post-2001 recovery process, under these new circumstances the government had little maneuvering space, either to use the budgetary funds for populist purposes or to loosen up fiscal discipline.

Along with the reforms bringing the agricultural subsidy reduction and tighter supervision over the public banks, the new institutional framework managed to significantly decrease the inefficient public spending. With the declining public spending inevitably the populist use of state resources has diminished. But most important of all, independent regulatory agencies gained strength. The technocrats in these agencies provided a shield against abuse of the political interest. Consequently on the macro level the ways that the political parties may engage in patronage policies to harvest political gains are significantly reduced. With the help of superior monitoring abilities of the IMF the public spending has become much more efficient. Hence in the presence of the new institutional framework, JDP as the political party in office had lesser room to engage in classical populist policy practices and abundantly use the resources of the state to derive political gains.

CHAPTER 5

THE CHANGING NATURE OF THE NETWORKS SHAPING THE TURKISH POLITICAL ECONOMY

As it was outlined in the second chapter of the thesis, politics in pre-2001 crisis Turkish economy was the main source of the economic activity. Within the deeply divided political system, parties sought to provide material incentives to certain distributive coalitions and social groups. With the 2002 general election this era of Turkish political economy has come to a close. "All the political parties representing the old, statist, clientalist, corruption-producing and crisis-ridden Turkey have been penalized very strongly by the Turkish electorate." (Keyman and Koyuncu, 2005: 124)

The purge of the political parties and their mentalities brought about the onset of a new era in the Turkish politics. As a drastic change was taking place in the political realm, the old networks connecting the economics with the politics fundamentally changed. Consequently the balance of power within the system was reorganized in favor of the domestic pro-reform coalition and the external anchors. This new power structure is one of the main reasons behind the extraordinary chapter of the Turkish political economy under the JDP rule.

5.1. The Roots of the Change

One can trace the roots of the drastic post-2001 era political change in the economic realm. The dismal performance of the Turkish economy especially after the end of the first Ozal government in 1987 put the country into position of an underachiever. The economic growth simply could not live up to its potential. Inadequate governance of the politics and economics cost the Turkish people dearly with the recurring financial crises and chronic political instabilities. Thus, the disillusioned electorate elected none of the governments after 1987 for two consecutive terms. The 2001 crisis was the final straw with its destructive economic consequences. A total re-structuring of the political scene became inevitable.

Along with the political and economic problems, the 1990s also witnessed the rise of "economic" Islam. While political Islam is a much popular and commonly used phenomenon, the economic Islam lately started to attract some academic interest.[36] The economic Islam established its representative organization MUSIAD in 1990.

> The qualification of the MUSIAD as 'Islamic' is due to the fact that it has close ties with political Islam mainly represented in Turkey since the 1980s by the Welfare Party, then the Virtue Party and finally the Justice and Development Party. (Keyman and Koyuncu, 2005: 112)

[36] See: (Bugra, 1999: 9).

On the other hand, the parties associated with Islam have been on the political scene since the 1970s. The JDP has genetic ties with the political Islam even though the Party considers itself as a central right party with conservative tendencies.

The time lag between the institutionalizations of political and economic Islam can be attributed to the late blooming of the Islamic capital. Before the onset of economic liberalization in 1980, capital was divided between state and a limited number of domestic business conglomerates located in Istanbul. With the increasing economic activity of the relatively more liberal era, previously insignificant eastern and central Anatolian towns started to produce new businesses at various sizes.[37] In 1993, 188 enterprises, which were not located in Istanbul, entered to the top 500 industrial enterprises list. Among the top 100, only 24 enterprises located in Anatolia made it to the list. In following years these numbers gradually increased and in 2006 reached respectively to 267 and 34.[38] Within the more conservative texture of these regions these emerging economic actors relied upon Islam as a basis of trust to organize their economic lives.[39] The growing influence and power of the Islamic capital and MUSIAD, representing the SMEs that are mostly affiliated with Islamist inclinations, has been a key factor behind the rise of political Islam from 1991 general election onwards.

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[37] See: (Bugra, 1999: 14-15).

[38] These figures are obtained from (Istanbul Chamber of Industry, 2006).

[39]See: (Bugra, 1999: 13).

After the February 28 process the reformist wing of the rising political Islam favored a discourse much closer to the central political parties.[40] This new moderate version of political Islam appealed not only the growing Islamic capital but also it emerged as a clean and untested option for the disillusioned Turkish electorate especially after the 2001 crisis. All these factors pushed the JDP to the top of the political system, which left all the traditional political parties out of the parliament except for the Republican People's Party (RPP).[41] This new political picture and the expectations of the Turkish people desperately seeking the political party that is capable of providing stability in the political and economic realms urged the JDP to implement an unconventional political economy.

5.2. The New Political Economic Balance of Power

The domestic political authority was the centerpiece of the old Turkish political economy. Other actors both domestic and external had limited power within the system. The very depth of the 2001 crisis combined with the aforementioned factors such as the rise of political Islam and the balance of power of the political economic system had fundamentally altered. The domestic political authority transferred much of its power to other actors.

[40] See: (Mecham, 2004).

[41] For more on the 2001 elections see: (Ozel, 2003), (Onis and Keyman, 2003).

The first major recipient of the transferred power is the domestic pro-reform coalition. The mindset of the politicians and bureaucrats changed. Previously they were primarily seeking to maintain the old system. The powerful 2001 crisis proved the old ways to be unsustainable. Years of chronic economic and political problems could only be ended with drastic reforms. The growing public awareness of this very fact provided the ground for the reform process to take off. Against this broad consensus the domestic actors that sought to keep the old system running and quite possibly derive benefits from the maintenance of the *status quo* lost their power to resist the change.

As a direct result of the domestic pro-reform coalition's stronger status, independent regulatory agencies within the state run by the technocrats enjoyed greater degrees of power. Both IMF and Dervis placed utmost importance to the role of the independent agencies and JDP maintained the same tendency. These agencies are especially important as they strongly supported and contributed to the post-2001 crisis reform process especially on the sensitive issue arenas such as the privatization and banking sector.

Privatization sets a clear example for the increasing power of the domestic pro-reform coalition. Since Turkish liberalization initiative had begun, most of the central political parties declared privatization as an important element of their political program.[42] However, when these parties took office they did not implement privatization partly because they did not have the sufficient political power within the deeply divided parliamentary setting but more importantly because they would be losing a major source of political rent distributing capability. The intrastate bureaucracy was another major

[42] See: (Ercan and Onis, 2001: 121).

source of resistance in front of the privatization. Bureaucrats running the state enterprises enjoyed great degrees of power and influence due to their posts and thus do not favor the privatization of these enterprises. The labor unions also opposed the privatization as the private sector would look for laying off the abundant labor employed in the privatized SEEs.[43]

It was only after the 2001 crisis that these status-quo seeking actors were put in a position where they were unable to raise their voice against the privatization process mainly because the country was experiencing severe financial difficulties. Under these difficult conditions privatization offered a possible source of relief, which was already overly postponed. One other factor easing the JDP's way in privatization was the IMF conditionality and EU's eager anticipation. As it was pointed out earlier, the IMF was in a commanding position in the post-2001 era and its conditionality had the utmost enforcing capability over the JDP government. Also as a leading actor of post-2001 era the EU effectively pushed for successful privatization. All in all the pro-reform coalition was able to make the necessary reforms to revitalize the privatization program and ease the difficulties facing investors. With all these factors at play the Privatization Administration managed to execute its portfolio in a quick and effective fashion.

Having pointed out the role of IMF, the other major recipient of the power of the state is the external actors and their role within the new balance of power deserves elaboration. As it was highlighted in the previous chapters, the EU and IMF became two powerful

[43] See: (Ercan and Onis, 2001: 120).

anchors in the post 2001 context. These anchors provided valuable blueprints for the set of reforms that are needed to be implemented. Moreover they also encouraged the Turkish government to act within certain deadlines, which further contributed to the making and speeding up of the reform process. As Onis and Bakir (2007: 3) put it:

> External anchors, such as the IMF or EU can help domestic policy-makers to override strong resistance on the part of domestic interest groups. A good example would be the resistance of domestic banking lobbies against reform involving tighter regulation of the banking and the financial system.

Indeed the reform process reshaping the finance and banking sectors is a perfect example of how the domestic pro-reform coalition and external actors gained upper hand and thus reflected their influence over a prolonged economic problem. The voice of domestic pro-reform coalition, Dervis, and the IMF and EU as powerful external anchors identified the banking sector as a priority in the reform efforts. As it was outlined in the second chapter, the inadequate regulation of the finance sector was a major source of economic imbalance ever since the full convertibility of the TL was established. While making sizeable profits, Turkish banks took high levels of risks and ignored their primary duty of lending money to the real economy.

Although there was a growing consensus on the need for better regulation of the banking sector, the powerful banking lobby managed to postpone these reform efforts.[44] When the 2001 crisis reset the balance of power in the Turkish political economy and tarnished the old networks that provided the powerful position for the banking sector lobby against the political authority, the reforms providing tighter and more competent regulation of the banking sector started to take place in a rapid fashion.

[44] See: (Onis, 2006a: 7, 16, 27), (Akyurek, 2006: 26).

The banking sector reform also signifies the decreasing role of the specific distributive coalitions and social groups over the political authority. The small distributive coalitions such as the banking lobby lost their influence over the political establishment simply because the other side of the networks connecting these small distributive coalitions to the political authority was totally changed. The reforms on the banking sector after the 2001 crisis clearly indicates that first the coalition government under the guidance of Kemal Dervis and then the JDP government prioritized the interest of the whole economy before the interest of these small coalitions.

The reforms on the banking sector after the 2001 crisis also indicate the weakening status of the individual social groups. MUSIAD is the representative organization of the SMEs that constituted the foundation of the JDP's electoral base. However, this social group strongly opposed the tighter regulation of the finance sector. The risk factor associated with lending to a SME is quite high. Therefore the SMEs, in general, are not able to find credits as easily as the big business.[45] Without the sufficient levels of credit supply, the SMEs cannot enlarge their business or even they might struggle to keep their business running. Therefore, a tighter regulation and close supervision of the finance sector meant lesser credit availability for the SMEs. Yet, the government acted in accordance with the expectations of the broader consensus including the market, IMF and big business by implementing the reforms bringing tighter regulations over the banking sector.

[45] See: (Bugra, 1999: 31).

Turning back to the growing influence of the external actors, not only the international institutions such as the IMF and EU but also the private external actors earned a more central role. The penetration of these private actors to the Turkish economy via mergers and acquisitions has significantly increased in the post-2001 era. The banking sector reflects this increasing rate of foreign penetration quite clearly. In 2005 and 2006 alone, the foreign banks bought shares of 14 different Turkish banks. As of 2007, the total of foreign assets reached 42 percent of the entire Turkish banking sector.[46] Hence private external actors inevitably gained power and influence with their increasing volume of investments.

The same trend can be observed in the increasing influence of the private sector in general. With rapid privatization is underway, the presence of SEEs declined gradually and private sector occupied a more central role within the economics. In 1994, 71 SEEs entered the list of top 500 industrial enterprises while 18 SEEs made it to the top 100 list. Especially after the breakthrough of the privatization in 2000s, the number of SEEs entering the top industrial enterprises list declined sharply. In 2006, only 9 SEEs entered top 100 list while an overall 13 SEEs were ranked among the top 500 industrial enterprises. With private sector replacing the role of SEEs, the domestic competition climate affected positively but even more importantly the shrinking presence of state means lesser available avenues for populist policy practices.

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[46] See: (NTVMSNBC, 2007a).

5.3. The JDP within the New Political Economic Networks

The new balance of power in the Turkish political economy both pushed the JDP to implement the reforms and stick to the fiscal discipline and it also helped to achieve these goals. First, the declining role of social groups over the economics has been a great opportunity for the JDP in keeping the reform process and fiscal discipline on track. Prior to the 2001 crisis each social group from urban workers to farmers and SMEs supported a certain political party.[47] These parties were mostly able to pass the 10 percent electoral threshold but were unable to receive sufficient levels of votes to form a single party government. Thus many coalition governments were established with the participation of multiple political parties, which all prioritized the interest of a certain social group.

The 2002 elections witnessed a novel phenomenon. With the powerful effects of 2001 crisis creating discomfort for every social group, the interest of whole country was started to put in front of the interest of the individual social groups. The main concern of the electorate was to shake off the devastating effects of the crisis as quickly as possible. Thus the electorate did not vote the political parties that were historically associated with certain social groups. Instead the votes were accumulated in two parties, which were not associated with the crisis. With only two political parties earning seats in the parliament, each social group did not have a specific political party that primarily aims to protect the interest of the social group. Consequently, this new setting of the parliament notably decreased the influence of the individual social groups over the politics.

[47] For a detailed list of political parties associated with certain social groups see: (Eder, 2003: 225).

The SMEs could be identified as the bulk of JDP's electoral support. Also due to its genetic ties with political Islam, the core supporters of JDP may be termed as being expectant of the extension of the religious rights and freedoms. Yet, the JDP government was able to overlook the individual expectations of both SMEs and Islamists in the wake of the destructive 2001 crisis. Being aware of the fact that the front-running expectation of the people was to recover rapidly from the crisis, the JDP pursued a political agenda that aims to address the expectations of the general public rather than individual social groups. The reflection of this new order of priority can be found in the long-lasting reform process and fiscal discipline that the JDP managed to keep for an unusually long period of time.

Second, apart from the social groups the declining power of the small distributive coalitions and their lobbies also provided a major source of relief to the JDP government in keeping the fiscal discipline and reform process alive. If, for example, the banking lobby had re-asserted its power over the political authority, the JDP might not have been able to implement the reforms bringing tighter regulation and supervision of the finance sector. Or the pressures of the exporters to decrease the real interest rates in order to devaluate the TL could result in damaging the autonomy of the CBT, loosening up of the fiscal and monetary discipline and consequently price stabilization might not be maintained for four and a half years.

The increasing role of the external actors especially the strengthening position of IMF has been a major contributor to the reform process and the fiscal discipline. The JDP utilized the IMF conditionality and supervision to its fullest extent. One of the main arguments in overcoming the resistance of the anti-reform coalition was that the Fund conditionality requires the reforms and fiscal discipline. Failing to implement these conditions may very well lead to the breakdown of the IMF cooperation. After the 2001 crisis the cooperation and support of the IMF could not be jeopardized, as the newly established trust environment would be seriously damaged.

The political economy of the new era focuses on the big picture represented by the macroeconomic figures. Being aware of this fact the JDP aimed to achieve political and economic stability by meeting the expectations of the public, markets and external actors. While achieving the stability the decreasing influence of the social groups such as the SMEs, farmers and urban workers, small distributive coalitions and the increasing power of the domestic pro-reform-coalition and external anchors provided the opportunity space for JDP to execute the IMF conditionality and resume the structural reform process. This new balance of power in the Turkish political economy is one of the main contributors of the JDP's unorthodox political economy.

CHAPTER 6

THE ROLE OF JDP IN POST-2001 CRISIS RESTRUCTURING OF TURKISH POLITICAL ECONOMY

Up to this point the thesis provided three sets of explanations for the unusual course of Turkish political economy in the post-2001 crisis era. All of these explanations are based on developments that took place without JDP playing an active role. In other words, the JDP may seem to be acting with the flow and solely confirming to the parameters set by the new political environment after the 2001 crisis. However, in order to fully capture the making of the new chapter of Turkish political economy one has to acknowledge the direct contributions of the political party that was in office for four and a half years as a single party government. So it is impossible to deny the fact that the JDP government itself is part of the explanation for the long lasting fiscal discipline and reform process.

Without the determination and prudent political economic agenda of the JDP, the five-year period following the 2001 crisis would be a profoundly different one. No matter how the conditions positively constrained the JDP's political economic agenda and provided favorable environment, still "the JDP government has displayed a far greater degree of commitment to fiscal discipline and EU related political reforms than any other Turkish political party to date." (Onis, 2006a: 12) Also it is important to note that for the first time ever in Turkish history an IMF program was successfully implemented to the end, and then renewed in the absence of any major financial urgency. While realizing the central role of favorable conditions, one should not overlook the successful utilization of those favorable conditions by the JDP leadership.

6.1. Using the Advantages of Single Party Government

Being a single party government brought both enormous opportunity and responsibility to the government. To its credit, JDP followed a careful political agenda matching well to the responsibility weighing on its shoulders. "Even with the best efforts of the economic officials in Turkey and the Fund, political uncertainty could undermine policy efforts." (IMF, 2002: 15) The lack of cohesion is a vital threat to the credibility and sustainability of the economic program. The example of previous coalition government proves the point of IMF. Although under the guidance of Kemal Dervis the previous coalition government started the economic recovery and restructuring efforts, the members of cabinet had two public confrontations that had the potential to seriously jeopardize the success of the economic recovery process.

First, the minister responsible for privatization and MP deputy Yuksel Yalova, publicly opposed the proposed Tobacco law. Since Kemal Dervis considered this new law as a major fold of the structural reform process, the contradicting views of the ministers immediately reversed the market sentiment and TL depreciated while the stock market fell abruptly. In a similar incident, minister of transport and NMP deputy Enis Oksuz and Kemal Dervis did not agree on the appointment of a member of the Executive Board of the Turkish Telecom. Oksuz did not compromise on the appointment issue and then publicly criticized the privatization of the Turkish Telecom, which was a front-running priority in the economic program. In both incidents the ministers who challenged Dervis and the program were forced to resign. But more importantly the contradictions they created regarding the credibility of the program and the economy in general caused sizeable turbulences that had the potential to ruin the entire trust building efforts of the Turkish economy after the 2001 crisis.

The JDP, on the other hand, successfully used the advantage of being a single party government and showed the sufficient unity and harmony to avoid such encounters within the cabinet. Moreover, as pointed in previous chapters the government did not force controversial issues such as the Higher Education bill. This bill could have provided a great concession to the Islamists that are believed to be a founding stone of the JDP's electoral base but at the same time it could have created political tension within the Islamist-secularist axis. Such a political tension might very well lead to the break down of the IMF-induced economic program and seriously jeopardize the recovery process. As the single party government, JDP had the power to force the issue and re-send the bill to the President for the second time. However, JDP did not abuse its power of being a single party government and acted responsibly by sidelining the issue. JDP's conscious effort to avoid any political tension by considering the sensitivities of the other political actors proves the party's success in responsibly using the power of being a single party government.[48]

6.2. Using the Advantages of the Growing World Economy

The world economy as a whole experienced a rapid growth period when the Turkish economy recorded its impressive run after 2002. Thus one can argue that the positive world economic outlook rather than the policy implementations of the JDP government is largely responsible for this recent economic success.

Table 12

GDP Growth (annual)	**2002**	**2003**	**2004**	**2005**	**2006**
Middle Income Countries	3.7	5.2	7.4	6.5	7.2
World Average	1.8	2.8	4.1	3.5	4.0
Turkey	7.9	5.8	8.9	7.4	6.1

Source: *World Development Indicators* Database, World Bank.

Looking at the table 12 above, it is a fact that the world economy enjoyed a positive outlook in 2002-2006 period. However, Turkey still managed to outperform its middle-income peers each year except for 2006. The world economy surely experienced other rapid growth periods before but Turkey never utilized these periods so efficiently. Between years 1996 and 2000 the world economy averaged a higher growth rate with 3.35 percent than the 3.24 percent in 2002-2006 period. Yet the average growth rate of

[48] For another example of JDP's careful policy implementation to avoid tension on the politically sensitive issue of headscarf see: (Tepe, 2005: 78-79).

the Turkish economy in 1996-2000 period was 4.06 percent which is nearly half of the 2002-2006 average. So it is clear then that the JDP government effectively utilized the strong growth period in the world economy.

But perhaps it is even more important to note that the Turkish economy managed to grow consistently at these high rates. No matter how much the world economy contributed to this process, a constant growth pattern that lasts for over twenty consecutive quarters is a record for the post-1980 Turkish economy. It is imperative to know that in Turkish context any domestic political crisis or failure to meet the expectations of the market in the economic front could have easily upset the long-lasting growth pattern. Hence the JDP government deserves credit for successfully utilizing an advantageous era and making good use of the opportunity by avoiding any political crises or letdown of the market expectations.

6.3. JDP as a New Type of Coalition

The JDP was given the chance of forming a single party government by the Turkish electorate after 15 years of coalition governments. As pointed out in the previous chapters prior to the 2002 elections each social group supported a specific political party and these parties were able to earn seats in the parliament but unable to form government single-handedly. Thus for 15 years many coalition governments were formed by political parties aiming to address the expectations of single social groups. In the 2002 elections these parties were left out of the parliament. The purge of the classic political parties such as MP or True Path Party (TPP) associated with different segments of the society and significant amount of votes that the JDP received indicated the fact that the electoral base of JDP was a combination of multiple social groups. In other words, this time the coalition was not made in the parliament but in the election.

"The party has been extremely successful in constituting a cross-class electoral alliance incorporating into its orbit both winners and losers from the neo-liberal globalization process."(Onis, 2006b: 1) This broad and diverse electoral support meant that the JDP needed to pursue the interest of the whole. The JDP could not single out a social group and favor its interest. The only way to satisfy the broad and diverse electoral base was to provide an overall improvement in terms of macroeconomic figures.

The JDP also realized the fact that rapid economic growth would enable the party to enlarge its electoral base. The big business and its representative organization TUSIAD, for example, historically distanced itself from political Islam and strongly advertised the importance of the secular, democratic and liberal structure of the state. "The main lesson that the JDP learned from the record of its predecessors involved the need to construct a broad based interclass alliance."(Onis, 2006b: 6) Hence adding the big business to its electoral base emerged as a policy priority of the JDP. In order to appeal the big business, JDP showed a stance closer to the TUSIAD rather than the core of its electoral base MUSIAD. The high level of commitment to the IMF cooperation and the genuine efforts to achieve the ultimate goal of EU membership are policy implementations which all signify a more of a TUSIAD-like approach.

The inclination of JDP's political economy towards TUSIAD deserves elaboration, as there are significant points of divergence between the MUSIAD and TUSIAD. MUSIAD questions the content of IMF programs and promotes the idea that the government should effectively bargain with the Fund before implementing these programs. Moreover, MUSIAD seeks to adopt an independent economic program as soon as possible and end the IMF cooperation. TUSIAD, on the other, hand believes in the guidance of the IMF and does not have any reservations about the nature of the programs, which it hopes to be kept renewed. The divergences are crystal clear especially on the issues of regulation of financial sector, tight budgetary discipline and formation of the autonomous regulatory institutions.

Table 13

	MUSIAD	TUSIAD
Budgetary Discipline	Accepts that the government has been successful in imposing fiscal discipline but also draws attention to some of the costs of excessive budgetary discipline, notably in the sphere of public investments.	Highly supportive of the Government's budgetary stance and commitment to fiscal discipline.
Financial Sector Regulation and the Real Economy	Financial sector regulation should be in line with the needs of the real economy. Single minded focus on tight banking sector regulation is costly in terms of growth and performance of the real economy.	Tight regulation of the financial sector is crucial. Weak regulations may create the basis of yet another financial crisis.

Regulatory Institutions in Action	Critical of such institutions. These institutions should be more accountable for them to be able to adopt a balanced approach to regulation.	In line with the IMF, firm belief that for tight and effective regulation, these institutions should be highly autonomous. Not much emphasis on accountability.

Source: Onis 2006b: 22.

JDP's stance, which is much closer to the TUSIAD than the MUSAID, could be attributed to a window of opportunity that the party had prudently identified.

6.4. The Window of Opportunity

Political parties in Turkey generally lose electoral popularity when they are part of the government as the country suffered long years of inadequate governance. The electorate was often disappointed with performance of the governments and sought for previously untested options in the next elections. However, the combination of various structural developments provided a window of opportunity for JDP to enlarge its electoral base while the party was in office. To its credit JDP successfully shaped its political economy in order to utilize this chance.

After the powerful 2001 crisis, the whole country was primarily seeking quick recovery and then stability. The previous coalition government had already achieved a decent recovery and provided the road map for the next government. Strictly following the IMF-induced economic program and making the necessary reforms for the EU membership could have turned the recovery process into a success story in the long run. JDP used this recipe even though the SMEs were unhappy with the tight fiscal policies and IMF engagement.

The wisdom here lies in the idea that a rapid economic growth environment would generate positive effects, which ultimately trickle down to every segment of the economy including the SMEs. Normally there is a trade off between meeting the demands of the SMEs and big business. For example, the SMEs seek for expansionary fiscal and monetary policies in order to enlarge their businesses. Big business, on the other, hand prioritizes stability to secure its costly investments. A stable and high level of economic growth would please both the SMEs and big business. Indeed the Turkish economy recorded growth for twenty consecutive quarters as of 2006. Although the JDP government chose the path that IMF and big business promotes, the end result pleased the entire economic segments including the SMEs. Thus JDP managed to keep the core of its electoral base happy while adding the big business to its electoral base.

The dismal performances of the previous governments provided yet another opportunity for the JDP. In relative terms, avoiding any major political or financial crisis would be a success. Decreasing the inflation rate and providing stable growth would be stellar achievements for the underachiever Turkey. The chronic inflation problem, for example, could simply be dealt with by fiscal discipline and determination, which supposedly all governments should provide, and yet never delivered for decades. Simply executing its occupational duties was enough for JDP to be successful.

All in all, JDP made a correct analysis of the conditions at hand and established its political economy accordingly. However, there is an important difference between theory and practice. Almost every political party in Turkey had excellent solutions to Turkey's problems, which were never successfully applied. What separates JDP from previous governments is its successful execution of the political economy agenda, which has been an important part of the Turkey's economic success in post-2001 crisis era.

CHAPTER 7

CONCLUSION

The 2001 financial crisis is a major turning point for Turkey. By all means the economy hit rock bottom and drastic changes in both economic and political realms became inevitable. This thesis aimed to shed light on this era by elaborating upon the making of this new, post-2001 episode of the Turkish political economy. The most striking element of post-2001 restructuring of Turkey has been the long-lasting fiscal discipline and structural reforms which both are uncommon considering the past record of the Turkish political economy. This thesis provides four different explanations for these novel phenomena.

First, the growing ties with the global economy have been instrumental in the making of the post-2001 crisis Turkish political economy. Turkey has been an active participant of the financial globalization after the capital account liberalization in 1989. Thus the global economic trends strongly affected the Turkish economy. In the post-2001 political economic restructuring this effect of global economy over Turkey reached new heights. The rapid and high level of growth brought widening current account and foreign trade deficits. Having been attracted by the high real interest rates that are offered in Turkey, global financial actors drastically increased their short-term portfolio investments in Turkey. These investments of global economic actors covered the foreign trade and current account deficits. In other words, the post-2001 growth was mainly financed by the global liquidity. In this new setting the efforts to secure the inflow of this global liquidity have been a primary anchor for Turkey under the JDP. Hence, the long-lasting fiscal discipline and the ongoing reform process can be attributed to the heavy need of Turkish economy to the foreign exchange supply.

Second, the new institutional framework made quite an impact on the JDP-era Turkish political economy. Previously the state had accumulated all the rent distributing capacity and actively participated in the real economy through the SEEs. This structure has changed with the new institutional framework that has come to exist after the 2001 crisis. The IMF conditionality and the harmonization efforts with the *acquis communautaire* were two influential factors in the making of the new institutional framework. They did not only inspire the Turkish policy makers for the nature of the reform agenda but also both IMF and EU performed strong monitoring functions in the timely and successful implementation of the reform agenda. The reform process in the end helped a new institutional framework to emerge.

Independent regulatory agencies were established or empowered and took over a sizeable portion of this rent-distributing capacity of the state while the structural reforms opened up the way for rapid privatization. Both the rent-distributing capacity of the state and SEEs had been long used by politicians and bureaucrats for political or personal interests.

However, the new institutional framework blocked both of these avenues of populism. Thus the JDP had lesser room to engage in populist redistributive policy practices and abandon the fiscal discipline even if it aimed to do so.

Third, the established networks that tie the economics and politics changed profoundly after the 2001 crisis. With a completely new parliamentary setting and powerful independent regulatory agencies, the way that the economy was regulated by the state has been altered. Powerful social groups and the lobbies of small distributive coalitions lost their influence over the state. They were used to pursue their narrow interests and often resist to reforms as they derived benefits from the *status quo*. However, the changing nature of political economic networks provided the opportunity for the JDP to override the pressures of these actors. The 2001 crisis also brought a more superior role and influence to the external anchors such as IMF and EU. The structural reforms, which are reinforced by these external anchors, were implemented swiftly as the *status-quo* seeking actors lost influence. The strengthening hand of IMF was particularly important for the long-lasting fiscal discipline as the Fund closely monitored the macroeconomic indicators. Within this new balance of power in the Turkish political economy, the JDP managed to maintain the fiscal discipline and the structural reform process.

Fourth, the prudent political economy agenda of the JDP and the successful implementation of this agenda also played a central role in the post-2001 crisis Turkey. The JDP identified a window of opportunity as a strong economic recovery was already underway and after the 2001 crisis the public primarily sought for economic relief. The previous coalition government collaborated with the IMF to produce a promising road map for the economic recovery and long-term stability. By successfully implementing this IMF-induced economic program, the JDP government could have put a stellar performance in comparison to many previous governments that were associated with major macroeconomic problems and political instabilities. But more importantly, by achieving stable and rapid economic growth the JDP had the opportunity to enlarge its electoral base without upsetting its existing electoral base. The core of this electoral base is the SMEs and there is normally a trade-off between meeting the expectations of big business and SMEs since these economic actors seek different policy implementations. However, after the destructive 2001 crisis these actors jointly prioritized economic recovery and then stable growth. JDP successfully saw this bigger picture and acted accordingly by keeping the fiscal discipline tight and continuing the reform process to successfully walk on the paths of EU membership and IMF program.

While all these four different explanations are important in order to understand the long-lasting fiscal discipline and structural reform process, the growing ties with global economy comes forward as it informs the other three explanations. The premature integration to the financial globalization without the adequate regulatory framework has been the number one source of the three major economic crises that the post 1989 Turkey suffered. On the other hand, the rapid recovery from the catastrophic 2001 crisis would not be possible if Turkey was not closely linked to the global economy. In other words, both the roots of the economic crisis and the cure of the major macroeconomic shortcomings lie within the global economy.

A basic summary of the main argument of this study could be given as follows.

Figure 1

Integration to the global economy X Severe financial crisis	→	The importance of IMF conditionality and EU accession efforts	→	Strengthening pro-reform coalition	↔	Institutional and economic reforms	→	Lesser room for political populism X Stable and harmonious political authority

→ Long lasting fiscal discipline and commitment to the economic program

In the highly competitive climate of financial globalization, Turkey needs to draw a stable and promising picture for global financial actors in order to attract a sizeable portion of the global investments. Especially short-term macroeconomic problems such as the widening current account deficit and inadequate domestic savings consolidate Turkey's dependence on the global economy. Global financial actors, which Turkey aims to attract, highly value the cooperation with the IMF and the EU accession process of Turkey, as these are important anchors of fiscal discipline and sustaining structural reform process. In the economic realm, the IMF conditionality is the key to set in motion the structural reforms and as a result of these structural reforms a new institutional framework has come to exist. This dependency on global economy also plays an important role in the making of the new balance of power in the Turkish political economy. Since the Turkish economy was in heavy need of foreign exchange supply, the influence of the global financial actors and IMF increased drastically while the traditionally strong domestic social groups and distributive coalitions lost power. Also the window of opportunity that the JDP successfully identified and utilized had come to exist with the favorable international context. If the global liquidity were not so abundant and the risk appetite of global investors towards the risky emerging markets were not so high, the intense inflow of foreign funds would not take place in the first place and thus the rapid growth in 2002-2006 period could not be financed.

The dependence on the global economy, therefore, is not a single explanation replacing others, for the long lasting fiscal discipline and structural reforms but it is the facilitating factor for the other three variables utilized in this study. Hence, it is safe to say that the growing ties with the global economy and the need for short-term foreign exchange supply are the most important elements shaping the post-2001 chapter of the Turkish political economy.

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