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Turkey's Economic Fragility, Foreign Capital Dependent Growth and Hot Money

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Despite a decade of strong growth, mainstream economists and financial markets have recently escalated their discussion of Turkey's economic 'fragility'. Contrary to their focus on 'excessive current account deficits', the key to understanding Turkey's condition is the foreign capital inflows that facilitate and promote these deficits, and the extent of hot money in the inflows. This paper documents this central fragility and its current explosion. It also contributes to the debate with a detailed economic and operational definition of hot money in Turkey, not present in the existing literature.

Introduction

Turkey's economic performance as measured by the standard indicator of the rate of growth of the gross domestic product (GDP) was strong on average over the decade after its 2001 crisis. It can be argued that Turkey over this decade from 2002 to 2011 was a 'missing BRICS' country.[1] It came back strongly from its only contraction during this decade during the 2009 global recession to post its second and third best performances in the period, with a growth of 9.2 and 8.8 per cent in 2010 and 2011, respectively. Its average growth of 5.4 per cent was stronger than that of South Africa at 3.6 per cent, Brazil at 3.8 per cent or Russia at 4.8 per cent, even if it did not match that of India at 7.7 per cent or China at 10.6 per cent.[2]

Despite this strong growth, however, by the middle of the last decade conservative commentators and international investment advisors began sounding the alarm bell concerning Turkey's growing 'fragility'.[3] This included above all (though not only—there were also broader issues such as politics etc.) the usual four major conservative concerns—inflation, too much credit, and oversized budget[4] and current account deficits. Over the following years, as will be indicated below, the issues of inflation and credit have maintained themselves as problems of qualitatively the same degree, while the current account deficit has significantly expanded.

This paper will address itself to this central aspect of Turkey's growth fragility, which comes from its foreign capital dependent growth model. It will consider the problematic current account deficits from the perspective of the degree and the

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nature of the capital inflows that allow these current account deficits. This perspective generates a deeper understanding of the nature and degree of the resulting fragility than comes from typical market evaluations of safe and unsafe levels of current account to GDP ratios.

The broad conceptual frame employed in this case study of Turkey's fragility is an updated form of Dependency Theory. While the early forms of this theory are generally discussed today in terms of their particular mechanism of transfer of wealth from the Third to the First World, unequal exchange (i.e. trade, backed by the prevention of Third World industrialization), the essential message was really much deeper and more robust. The conservative 'Modernization Theory' that was then dominant asserted underdeveloped countries were simply at an earlier stage in a uniform development process that capitalism would propel them through. Their futures were already visible in the existing developed countries. Dependency Theory, to the contrary, argued that underdeveloped countries were part of the world system of capitalism which was not developing them along the lines previously followed by the developed countries, but rather was 'developing' them according to whatever the growth and accumulation needs were of the developed countries. The result then was not authentic 'autonomous development', meaning that an economy's central dynamics depend on its own structure and not the structure and performance of other ('core') economies. Hence, the future of the underdeveloped countries was not even development in the distorted sense of the developed capitalist countries. Rather, these countries experienced 'the development of underdevelopment' or 'dependent accumulation', as in two titles of works by the Dependency School's best-known figure, Andre Gunder Frank.[5]

By the early 1980s, it was clear that industrialization and (specific types of) technological transfers were occurring to a number of countries in the Third World. Over time people ceased identifying themselves as members of the Dependency School, and by 1984 even Frank referred to himself as a World-System theorist. But as noted, this was exactly the robust core of Dependency Theory. The underdeveloped world remained assigned by the World System to dependent accumulation, or 'fragile growth' in the terms of the mainstream, notwithstanding that the mechanisms and procedures for its subordination to the core changed radically. 'In the era of globalization and great transformations in the international economy, the "new" dependency seems to be financial in nature.'[6] Foreign capital dependent growth[7] and its most fragile form, speculation-led growth and accumulation,[8] both of which this paper will explore for Turkey, are very much the currently appropriate mechanisms for effecting the central robust concepts of Dependency Theory.

Turkey's growth dropped sharply in 2012 to 2.2 per cent and only partially recovered to 4.0 per cent in 2013. As of when this paper was finished in mid-February 2015 the official growth rate was available only for the first nine months of 2014, back down to 2.9 per cent, with only a slight increase above that projected for the full year. However, we will see below that the fragility of the economy has not decreased despite this reduced growth. For 2012 and 2013 current account deficits as a fraction of GDP remain at their second and third highest ever, as do total capital inflows, while hot money inflows are the largest and third largest ever.

Following the May 2013 announcement by the US Fed that it would fairly soon begin the long anticipated process of 'tapering off' its massive quantitative easing monetary stimulus (later re-expressed to stress the intended gradual nature of the process), international investors' permanent concern with excessive current account deficits took on a greatly expanded importance. The basic logic is simple: large current account deficits are only possible through large capital inflows, and increased interest rates in the developed world will surely greatly reduce international capital inflows to emerging markets. Hence, any economy whose economic performance rests on such foreign capital inflows must be considered fragile and unsustainable. International investment capital today not only considers Turkey to be one of the 'fragile five' group of emerging markets,[9] it is the member of that group with the highest current account deficit to GDP ratio.

However, there is an important dimension of this fragility that is impossible to consider if one adopts the mainstream focus on the excessive current account deficits, rather than on the capital inflows that underlie and allow them. While all foreign capital dependence indeed results in fragility, dependence on 'hot money'[10] inflows is even more fragile than dependence on other capital inflows. The degree of fragility resulting from the extent of hot money supporting the current account deficits can only be seen if one directly considers the capital inflows, rather than only considering the current account deficits themselves.

Recognizing the central role that hot money played in a number of financial crises around the world at the end of the 1990s, a (small) number of authors[11] addressed the impact of hot money on the performance of the Turkish economy immediately before and after the 'avoided crisis' of 1999[12] and the 2000–2001 crisis. As Turkey's economic history actually unfolded in the subsequent decade, however, after 2002 there has in fact not been a single year of outflow of hot money. The crippling large and sudden outflows seen in a number of countries around the world at the end of the 1990s did not materialize in Turkey after 2002, notwithstanding that the description of the hot money fragility was completely correct. Beyond Turkey, with many of the most important developing countries first building up their international reserves and then beginning to introduce limited capital controls, large, sudden and internationally important outflows of hot money nearly disappeared. Other than periodic references to the remaining potential problems that such extremely liquid investment could cause, discussions of hot money in the Turkish economy naturally also nearly disappeared. As this paper will document, the surge of both total foreign capital inflows and the hot money component of these to historically unprecedented levels in Turkey in recent years has put the discussion of this fragility back on the agenda. One fundamental difference of the discussion that follows from the earlier work on this issue is that instead of their focus on hot money as the cause of the fragility, here general foreign capital inflow dependence is presented as its fundamental cause. Hot money continues to also be treated separately, however, because of its important greater contribution to this fragility than other foreign capital inflows.

This paper has three objectives. Given that exponents of Turkey's post-2001 economic performance rest their case above all on its rate of growth, the first objective

is to qualitatively indicate the principal and some secondary problems for the economy that come from the motor of that growth, foreign capital inflows. The second objective is then to quantitatively document the levels of, and growth in, both the fundamental source of Turkey's fragility, the total foreign capital inflows and, separately, the hot money inflows that are the most fragile part of these. The third objective is to present a detailed economic and operational definition of hot money for Turkey, until now absent from the literature.

Following this Introduction, the second section presents a brief overview of Turkey's BRICS decade, as background for understanding today's acute foreign capital inflow dependence and the problems this causes for the Turkish economy. The third section then addresses the first objective of this paper just indicated and the fourth section addresses the second objective. The third objective of presenting detailed economic and operational definitions of hot money for Turkey is addressed in the extended Appendices 1 and 2.

The need for a detailed discussion of hot money in Turkey and the reason for putting it into the extended Appendices 1 and 2 are as follows. The papers that mention or discuss hot money in Turkey have minimal discussions of what they mean by hot money, and what discussions they do have are only of a general and conceptual, as opposed to concrete and operational, character.[13] On the one hand, such a definition of hot money is of course necessary for future studies and for meaningful comparisons between studies, and that is the reason for its inclusion in this paper. On the other hand, the economic points that this paper makes in the third and fourth sections only require a reader to understand the qualitative nature of hot money. Reading the details of its economic nature and particularly of its operational calculation will presumably be of interest only to those who intend to do their own empirical work. Hence, this material has been separated out into the extended Appendices 1 and 2 to leave the rest of the paper readily accessible to readers interested in the Turkish economy (or in the general issue of problems with foreign capital dependent growth), who do not intend to do empirical work on it themselves.

Overview of Turkey's BRICS Decade

At the end of 1999, a year it finished with a negative rate of growth of −3.4 per cent, Turkey initiated an International Monetary Fund (IMF) designed exchange-rate-anchored stabilization programme to curb its problematic inflation and, related to that, its accelerating public debt accumulation. Until the last quarter of 2000 this programme appeared to be working well, and growth for that year as a whole rebounded to 6.8 per cent. However, such stabilization programmes with their currency peg have frequently exposed developing economies to the possibility of a speculative attack on their currencies.[14] Countries are particularly vulnerable to such attacks if the economy suffers from an accumulated deterioration of economic fundamentals, negative external economic shocks or any political events that could negatively impact international financial markets' attitude toward the country,[15] though speculative attacks can occur even in the absence of any such additional problems. The attack began in November 2000. Hot money fled (part of what makes

such an attack successful). The IMF stepped in with a large bailout, but the economic and related political crisis of November 2000 was only staunched until it re-erupted in February 2001, and the currency peg was abandoned.[16] The exchange rate sharply weakened from 670,326 Turkish lira (TL)/$ in January 2001 to 1,596,394 TL/$ in October 2001.[17] Capital fled Turkey throughout 2001 and growth collapsed to −5.7 per cent.[18]

Following the crisis of 2001, Turkey embarked on a new IMF programme.[19] Its two central components were: (i) fiscal austerity, with the target of a primary surplus of 6.5 per cent of GDP, and (ii) a switch to inflation targeting.[20] Its intention was that with the reduced rate of inflation nominal interest rates would fall, reducing the government payments on its debt which were a major cause of its continued unacceptably high deficits. With inflation and government deficits both reduced (these had been major concerns already in the 1999 IMF programme), confidence in the economy would grow, attracting foreign investment. This additional investment would both directly benefit economic growth and lead to lower real interest rates, where the latter would promote domestic investment and hence additionally promote economic growth.

The rate of inflation did in fact drop sharply, from 54.4 per cent in 2001 to 8.6 per cent in 2004, and with that the nominal interest rate dropped from 96.2 to 25.7 per cent (see Table 1). The real interest rate, however, while it did fall at the beginning of the growth recovery, then remained among the highest in the world until 2010.

This persistent high real interest rate over the growth recovery indicates that the actual dynamic at the centre of the economy's post-2001 performance was not the one projected by the IMF. The high real interest rate attracted a historically high inflow of foreign capital, and it is this inflow that was the motor of Turkey's growth performance over its BRICS decade. As this paper will argue, however, this huge capital inflow was simultaneously the source of Turkey's major economic problem today, the fragility of its performance.

Turkey's Economic Problems from its Foreign Capital Dependent Growth Model

The focus of this paper is the nature (this section) and extent (next section) of the foreign capital inflow dependence that is the cause of Turkey's economic fragility, which is ever more broadly discussed by conservative commentators and international financial markets. Before this section addresses that problem, however, we will spend a single paragraph stressing that this focus is not intended to suggest that this fragility is the only possible concern with Turkey's current economic model.

There are two general types of problem that an economy with strong growth can have. The first is that it may have economic problems other than growth. Sometimes these other-than-growth problems are even exacerbated by the way the growth is achieved. Other aspects of Turkey's economic performance over the last decade that portray a much less favourable picture than its GDP growth include high unemployment and low labour participation rates (like so many economies in today's world, a 'jobless recovery'), the related issue of a low rate of job creation, slow real wage growth (despite continued productivity growth), a high real interest rate,

Table 1 Turkey's Post-2001 Rate of Interest, Growth, Current Account and Budget Deficits (Per Cent)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2012	2013
Nominal Interest Rate	96.2	63.8	45.0	25.7	16.9	18.2	18.8	19.3	12.7	8.5	8.7	8.8	8.8	7.7
Rate of Change of CPI	54.4	45.0	25.3	8.6	8.2	9.6	8.8	10.4	6.3	8.6	6.5	8.9	8.9	7.5
Real Interest Rate	41.8	18.8	19.7	17.1	8.7	8.6	10.0	8.9	6.4	− 0.1	2.2	− 0.1	− 0.1	0.2
Rate of Change of GDP	− 5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.7	− 4.8	9.2	8.8	2.2	2.2	4.0
Current Account Deficit/GDP	1.9	− 0.3	− 2.5	− 3.6	− 4.5	− 6.0	− 5.8	− 5.4	− 2.0	− 6.2	− 9.7	− 6.2	− 6.2	− 7.9
Budget Deficit/GDP	− 11.9	− 11.5	− 8.8	− 5.4	− 1.3	− 0.6	− 1.6	− 1.8	− 5.5	− 3.6	− 1.4	− 2.1	− 2.1	− 1.1

Source: Authors' calculations based on the data from Republic of Turkey Ministry of Development, *Republic of Turkey Ministry of Development: Economic and Social Indicators, 1950–2010*, 2013, <http://www.mod.gov.tr/Pages/EconomicandSocialIndicators.aspx> (accessed 1 October 2014); and CBRT, *Balance of Payments Statistics*, July 2014, <http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+EN/TCMB + EN/Main + Menu/STATISTICS/Balance + of + Payments + and + Related + Statistics/Balance + of + Payments + Statisticss/Data> (accessed 1 October 2014).

an over-valued currency and a deterioration in government services such as education, health care and infrastructure.[21] Because of such a spectrum of additional concerns, Turkey's post-2001 recovery is called a 'growth recovery' throughout this paper.

The second general type of problem that an economy experiencing strong growth can face is that the growth could end and, in the most harmful scenario, suddenly: 'fragility' or 'unsustainability' in mainstream parlance. As mentioned above, the most volatile case of this is speculation-led growth.[22] We will argue below, however, that Turkey's economic fragility is rooted not just in capital manipulated by speculators. Rather, its fragility is rooted in its high dependence on all hot money (not just that which is actively manipulated), and most fundamentally beyond that, in its dependence on the broader category of all foreign capital inflows.

As noted in the Introduction, Turkey's problem of growth that relies on, and is driven by, inflows of foreign capital has been noted by both heterodox economists, who call for fundamental changes in the economy, and by conservative economists and international financial markets whose concern is to maintain and promote the basic relations of the existing economy. As *The Economist*,[23] one of the leading voices of this latter group, tersely noted in passing concerning this central problem for Turkey: 'Those with current-account deficits are vulnerable to a sudden outflow of capital if global investors become more risk averse.' While this is correct, it is what this statement leaves out that is the reason why the degree of Turkey's fragility is determined by the total amount of its foreign capital inflows and not only by hot money (with the latter remaining the most fragile part of that foreign capital). An important part of Turkey's current account deficit comes from importing capital goods and intermediate inputs that have been essential parts of Turkey's growth. While by definition foreign capital investments that are not hot money tend to be less likely to (quickly) disinvest at the first signs of either trouble in a given economy or simply better opportunities elsewhere, actual outflows are not necessary for this component of the total foreign capital inflow to dampen growth. Sharply reduced inflows have a similar effect as actual outflows, a reduction in capital available to the economy. In the empirical data that we will look at in the next section, one sees frequent sharp changes from year to year in the amount of inflow in this non-hot money category. Any sharp drop in the inflow in this category in itself reduces the amount of capital goods and intermediate inputs the Turkish economy can import, and thereby reduces growth. It is for this reason that Turkey's entire foreign capital inflows are the correct measure of the fragility of its economy and what this paper will carefully empirically study, notwithstanding that their hot money component indeed remains the part of it that is the most dangerous for the Turkish economy and so needs to be looked at separately as well.

Beyond this primary problem of fragility of the performance of the Turkish economy, the reliance on large foreign capital inflows contributes to the following four additional secondary problems.

First, the hyper-inflow of foreign capital supported and promoted the extension of domestic credit. As noted in the Introduction, by the middle of the past decade conservative commentators and international financial markets were pointing to excessive domestic credit creation as an element of the unsustainability of Turkey's

growth model. This has continued to be an important concern of theirs to the present. *The Economist*[24] found credit creation for the private non-financial sector in Turkey from 2008 to 2013 to be an outlier among major developing countries. It was even almost 40 per cent higher than that of any of the other four of the 'quantitative quintet'.[25]

Second, as is often the case though not a logical necessity, the existence of historically large amounts of credit promoted inflation. Inflation was another of the problems mentioned above by conservative commentators and international financial markets in the middle of the last decade. In fact, inflation was one of the central concerns of the IMF programme at the beginning of Turkey's BRICS decade. Table 1 shows both that Turkey was very successful in reducing its inflation rapidly at the beginning of the decade from 54.4 per cent in 2001 to 8.6 per cent in 2004, and that it has not been able to make any sustained further reductions since then. Many conservatives have adopted a figure of 2 per cent as an upper limit for acceptable inflation, and hence as indicated they find that Turkey continues to have excessive inflation.[26]

Third, the high inflation rates at the beginning of the decade meant that nominal interest rates were very high, and the resulting large interest payments on the government debt were a major contribution to the government budget deficits that Turkey was running then, which were also one of the central concerns of the IMF programme. Table 1 shows that government budget deficits were in fact brought down to quite low levels, partly from the fall in nominal interest rates and partly from the cuts in real spending on health, education and infrastructure that were mentioned above. The concern with government deficits re-emerged briefly in 2009 and 2010, but this is currently not a major concern of conservative commentators or international financial markets.

The final secondary problem from the dependence on large foreign capital inflows we note is, as also mentioned above, the sustained over-valuation of the Turkish lira.

The Degree and Growth of Foreign Capital Inflows and Hot Money Dependence

Figure 1 presents the yearly amount of the total international capital inflows and what part of these is hot money.

The following six points are important for understanding the recent history and current situation of the foreign capital inflows that were the motor of Turkey's BRICS decade and simultaneously the cause of its currently broadly discussed instability.

(1) Turkey's dependence on foreign capital inflows has continuously grown over its neo-liberal period.[27] Excepting the periodic outflows discussed in the next point, these oscillated around slightly below 2 per cent of GDP in the 1980s, were 3–4 per cent in the 1990s and have been 5–9 per cent since 2005 (except the recession year 2009). Hence Turkey's current dependence on foreign capital inflows is high in comparison to its own neo-liberal past, as well as being high by world standards.

(2) Up to 2001 Turkey's normal capital inflows suffered a single-year sharp outflow every three to five years. These outflows were always associated with sharply

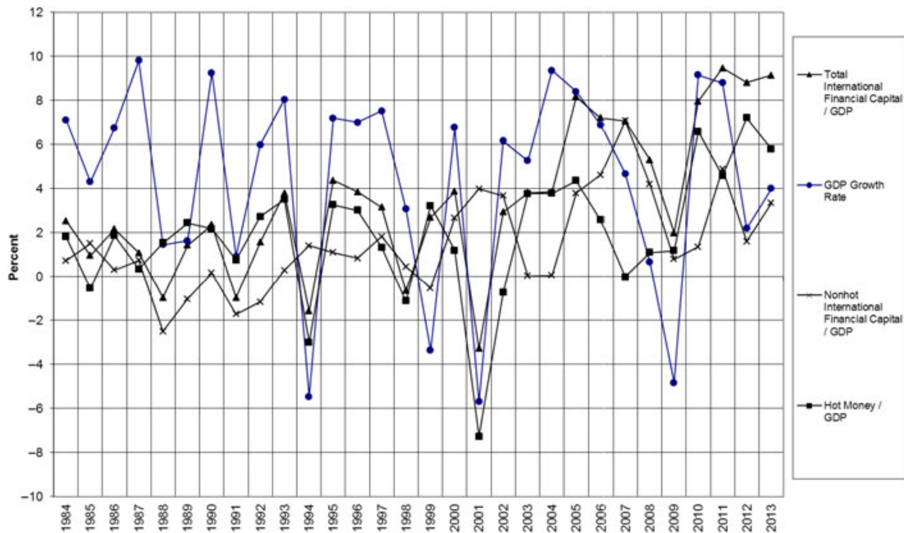

Figure 1 Capital Inflows and GDP Growth in Turkish Economy, 1984–2013. Source: Authors' calculations based on the data from Republic of Turkey Ministry of Development, *Republic of Turkey Ministry of Development: Economic and Social Indicators, 1950–2010*, 2013, <http://www.mod.gov.tr/Pages/EconomicandSocialIndicators.aspx> (accessed 1 October 2014); and CBRT, *Balance of Payments Statistics*, July 2014, <http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+EN/TCMB+EN/Main+Menu/STATISTICS/Balance+of+Payments+and+Related+Statistics/Balance+of+Payments+Statisticss/Data> (accessed 1 October 2014).

deteriorating and weak to bad economic performance as measured by GDP growth. Since the beginning of its BRICS decade in 2002, notwithstanding continued large volatility in capital inflows and associated rates of growth, Turkey has not had a single year of net foreign capital outflows.

(3) The majority of the capital inflows in the 1980s and 1990s were usually hot money. Only starting in 2000 did international capital markets begin to consider Turkey a desirable location for typically less volatile non-hot money capital inflows,[28] including the most sought after foreign capital inflows, FDI (foreign direct investment).[29]

(4) During Turkey's BRICS decade, when total foreign capital inflows almost never went below the highest levels they had reached before then, hot money dominated the total inflows in some years while non-hot money dominated them in other years. It is incorrect to characterize the strong growth of Turkey's BRICS decade as hot money driven, though it is also incorrect to understate the importance of hot money in the total capital inflows.

(5) There are only four years of data to date subsequent to the world's and Turkey's 2009 recession, but in these years both the total inflow of foreign capital and hot money's share of that are striking. Three of the four years have the highest total foreign capital inflows as a share of GDP ever, and the fourth year almost ties the previous record. Total hot money inflows are the highest four years ever, and in

two of those years they are more than 50 per cent above the highest previous hot money inflows. In two of these years hot money dominated non-hot money inflows, in one it was almost twice as much, and only in 2011 when there were also massive non-hot money inflows was it only about the same size.

(6) In the two years, 2012 and 2013, since the end of Turkey's BRICS decade, while its rate of growth has dropped sharply, its hot money and total capital inflows have remained at their record levels. With the slower rates of growth and high capital inflows, Turkey has entered a new less desirable trade-off: continuing fragility with its implication of potential implosion from its continuing foreign capital dependence, now being traded off against significantly less growth.

Conclusion

After its extended economic problems from 1999 to 2001, Turkey enjoyed a decade of strong growth. As can be observed in Figure 1, only in the two world-crisis years of 2008 and 2009 was it less than 4 per cent. It grew at over 8 per cent in four of the 10 years, and over 9 per cent in two. This growth rested on, however, dangerously large foreign capital inflows. For the first three years of its BRICS decade these were near the highest level ever experienced in Turkey's history. After that (except in the world-crisis year 2009) they became still larger, being roughly twice the previous maximum level in four of the 10 years. Looking at the same problem with the standard conservative and market indicator, Turkey's current account deficit rose rapidly over the first years of the decade to reach 6 per cent of GDP by 2006. It has stayed close to that level since then, excepting the expected reduction during the world-crisis year of 2009 and the spike to 9.7 per cent in 2011. The latest data for 2013 at 7.9 per cent suggests that it is possible that it is continuing to slowly move to still larger current account deficits, but it is too soon to tell if 2013 along with 2011 is something of an aberration, or if to the contrary these indeed are indicating a continued expansion of the current account deficits.

The dangers of foreign capital inflow dependent growth are exacerbated if the inflows are hot money. After the hot money component of the capital inflow in the second and third year of Turkey's BRICS decade was essentially 100 per cent, large non-hot money inflows were attracted for the next four years. Recently, however, Turkey has returned to massive hot money inflows, both in absolute terms and as a percentage of its total foreign capital inflows. Following Turkey's contraction of 4.8 per cent in the world-crisis year of 2009, it achieved an impressive growth recovery in 2010 and 2011 of 9.2 and 8.8 per cent. This growth rested, however, as throughout its BRICS decade, on foreign capital inflows, now at new record levels of 8.0 and 9.5 per cent of GDP, respectively.

Turkey's growth rate dropped sharply to 2.2 per cent in 2012, only recovered to 4.0 per cent in 2013 and will grow less than that in 2014. This was despite the foreign capital inflow remaining very near its record levels of 2011, 8.8 per cent in 2012 and 9.1 per cent in 2013.

Making this fragility even more fragile, hot money has returned since 2010 to playing a major role in total foreign capital inflows. While 2011 saw significant

non-hot money capital inflows, hot money still constituted 49 per cent of the total capital inflows in that year. In 2010, 2012 and 2013 it dominated the inflows, at 82, 81 and 63 per cent, respectively.

With GDP growth projected for well under 4 per cent for 2014 as of when this paper was being finished in mid-February 2015, three years of sharply reduced growth could lead to a significant reduction in both foreign capital inflows and their hot money component in 2015, which would lead to a further major reduction of Turkey's rate of growth. Working against this, however, is the near certain maintenance in the short term of historically low rates of interest in the developed world. Hence, while one expects some reduction in capital inflows in Turkey in the short term, the major reductions that would cause large reductions in Turkey's growth and with that increase other problems throughout its economy may be postponed as long as interest rates remain low in the EU and the USA. Notwithstanding this likely short-term continuation of capital inflows, however, Turkey's fragility continues to grow to new levels, both because of its increased foreign capital inflow as a percentage of its GDP, and because of the massive return of hot money in that inflow. Moreover, this increased fragility, this increased dependence on foreign capital inflows for its now reduced growth, implies that when these inflows do stop (or are even significantly reduced) Turkey will experience a major economic downturn. The obvious trigger for this would be a rise in the rate of interest in the developed world, which is likely to occur in the not-too-distant future. But that is not the only possible trigger for an implosion from the increased fragility. Anything that would cause reductions in foreign capital inflows, or in particular affect their most fickle part, hot money, such as, for example, political turmoil in Turkey or simply better profit opportunities elsewhere, would be disastrous for Turkey's now more-than-ever foreign capital dependent economy.

Disclosure Statement

No potential conflict of interest was reported by the authors.

Notes

[1] BRICS status, while not officially defined, is generally understood to require in addition to robust growth an economy of significant size, one with significant international trade and one with significant international investment opportunities, all of which Turkey also had.

[2] World Bank, 'GDP growth', 2013, <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/> (accessed 1 October 2014).

[3] Given the recent amount of discussion of the 'fragility' or unsustainability of Turkey's growth due to its mushrooming current account deficits by conservatives and international financial markets, there has been a surprising near absence of heterodox academic papers investigating this issue. 'The political economy of Turkey's economic miracle', *Journal of Balkan and Near Eastern Studies*, 16(2), 2014, pp. 137–160, by Turan Subasat, is an important exception to this lacuna that should be read as a compliment to this paper. The important difference here from his valuable work is the addressing of this issue through consideration of the foreign capital inflows and hot money that lie at the heart of this type of model of dependent accumulation.

[4] The budget deficit of 11.5 per cent of GDP in 2002 was down to only 1.3 per cent by 2005 and was 1.1 per cent in 2013. Since 2005 it has only gone above 3 per cent in the two years of

2009 and 2010. Commentators only discussed this concern during that time, and this paper will likewise not be concerned with the budget deficit as a central issue today in Turkey's fragility.

[5] Andre Gunder Frank, *The Development of Underdevelopment*, Monthly Review Press, New York, 1966 and *Dependent Accumulation and Underdevelopment*, Monthly Review Press, New York, 1978.

[6] M. Vernengo, 'Technology, finance and dependency: Latin American radical political economy in retrospect', *Review of Radical Political Economics*, 38(2), 2006, p. 556, the concluding line to a brief review of Dependency Theory.

[7] While speculation-led investment discussed in the next note is the most problematic foreign investment, the paper will stress that economic dependence on any type of foreign capital inflows, even their most secure form as FDI, is 'fragile'. Such capital does not need to start flowing out to cause problems, it only needs a sharp drop in its inflow to choke economic growth, as we will see in the data.

[8] Hot money or speculation-led investment is largely in financial assets, and in any case by the meaning of the term it is in assets that can be quickly liquidated and withdrawn. As such, these are the most potentially problematic foreign capital inflows. Ilene Grabel has been among the leading writers on this acute form of dependent growth over the last two decades. See, for example, Ilene Grabel, 'Marketing in the Third World: the contradictions of portfolio investment in the global economy', *World Development*, 24(11), 1996, pp. 1761–1776; and 'Speculation-led economic development: a post-Keynesian interpretation of financial liberalization programmes in the Third World', *International Review of Applied Economics*, 9 (2), 1995, pp. 127–149.

[9] N. Spiro and C. Weafer, 'Fragile emerging markets ride economic rollercoaster', *Financial Times*, 17 November 2013, <http://www.ft.com/cms/s/0/899a6d58-4afa-11e3-ac3d-00144feabdc0.html#ixzz2lVMUJzk4> (accessed 1 October 2014).

[10] Two other terms often used are 'short-term capital' or 'speculative capital', though as we will argue these terms are not actually fully synonymous.

[11] See E. Alper, 'The Turkish liquidity crisis of 2000: what went wrong?', *Russian and East European Finances and Trade*, 10(37), 2001, pp. 51–71; Y. Akyuz and K. Boratav, 'The making of the Turkish crisis', *World Development*, 31(9), 2003, pp. 1549–1566; K. Boratav and E. Yeldan, 'Turkey, 1980–2000: financial liberalization, macroeconomic (in)-stability, and patterns of distribution', in L. Taylor (ed.), *External Liberalization in Asia, Post Socialist Europe and Brazil*, Oxford University Press, Oxford, 2006, pp. 417–455; E. Yeldan, 'Patterns of adjustment under the age of finance: the case of Turkey as a peripheral agent of new-imperialism', the meetings of URPE at the ASSAs, Chicago, 5–7 January 2007.

[12] For a description of the IMF December 1999 intervention that merely postponed this crisis, see A. Ertugrul and E. Yeldan, 'On the structural weakness of the post-1999 Turkish dis-inflation program', *Turkish Studies Quarterly*, 4(2), 2003, pp. 53–66. For a different perspective, see E. Alper and Z. Onis, 'Emerging market crises and the IMF: rethinking the role of the IMF in the light of Turkey's 2000–2001 financial crises', *Canadian Journal of Development Studies*, 24(2), 2003, pp. 267–284.

[13] There are two partial exceptions to this that are more detailed in their conceptual definitions, but still don't indicate the detailed linkages to the Balance of Payments (BOP) data that we present in the extended Appendix 2. One is Boratav and Yeldan, op. cit. The Central Bank of the Republic of Turkey (CBRT) gave the most detailed conceptual definition we have seen in the literature, though in this presentation they graph Errors and Omissions separately from other hot money. See CBRT, *Monetary Policy Report 2005-I*, 2005, pp. 27–28, <http://www.tcmb.gov.tr/wps/wcm/connect/f44a915e-8b01-4a1c-a92d-e5c19dbdfd62/mpr2005I.pdf?MOD= AJPERES&attachment = true&CACHE = NONE&CONTENTCACHE = NONE > (accessed 1 October 2014). A graph in a slide presentation by Governor Durmus Yilmaz of the CBRT in 2007 that presumably is consistent with the CBRT's 2005 discussion gives the amount of hot money every 4 months (each point being a 12-month average) starting in

January 2002. Averaging the three data points in the graph for each year gives results very close to the figures we computed, present and more fully explain. See D. Yilmaz, 'Governor Yılmaz's presentation before the Planning and Budget Commission of the Grand National Assembly of Turkey', 27 December 2007, p. 87, <http://www.tcmb.gov.tr/wps/wcm/connect/9e693b47-06a6-4852-97b2-46fae52d7ced/07-01.pdf?MOD=AJPERES&CACHEID=9e693b47-06a6-4852-97b2-46fae52d7ced> (accessed 1 October 2014).

[14] This now well-known problem is described particularly clearly and illustrated with numerous recent examples in P. Krugman, *The Return of Depression Economics and the Crisis of 2008*, W. W. Norton, New York, 2009. In Turkey's case, the peg was both adjustable according to pre-announced changes (a 'crawling peg') and it was scheduled to change into a flexible rate by introducing a progressively widening band starting in July 2001. See Akyuz and Boratav, op. cit., p. 1553. These additional specifics of the Turkish peg, however, did not change the peg's exposure to attack at the time it occurred.

[15] 'The speculative attack on the Turkish Lira took place against the background of increased political uncertainty, policy slippages, and a weakening of economic fundamentals.' See IMF (International Monetary Fund), *Turkey: Sixth and Seventh Reviews under the Stand-by Arrangement; Staff Supplement; and Press Release on the Executive Board Discussion*, IMF Country Report No. 01/89, June 2001, p. 2. For some suggestions of a variety of background problems at the time that would have contributed to the climate supporting the attack, see C. Cottarelli, 'Turkey always had control of its economy', *Financial Times*, 5 June 2001; Alper, op. cit., p. 51; Akyuz and Boratav, op. cit., p. 1555; Ertugrul and Yeldan, op. cit., pp. 53–54; Alper and Onis, op. cit., p. 276; Boratav and Yeldan, op. cit., p. 427ff.; F. Ozatay and G. Sak, 'Banking sector fragility and Turkey's 2000–01 financial crisis', CBRT Research Department Discussion Paper, Ankara, 1 December 2003, p. 2ff.

[16] See IMF, op. cit., p. 1; Ertugrul and Yeldan, op. cit., p. 53.

[17] See Republic of Turkey Ministry of Development, *Republic of Turkey Ministry of Development: Economic and Social Indicators, 1950–2010*, 2013, <http://www.mod.gov.tr/Pages/EconomicandSocialIndicators.aspx> (accessed 1 October 2014).

[18] The postponed crisis of 1999 and the crisis of 2000–2001 have been written about extensively. Rich details on this background to the period considered in this section can be found in, among others, the seven references in Note [15] and E. Yeldan, 'Neoliberal global remedies: from speculative-led growth to IMF-led crisis in Turkey', *Review of Radical Political Economics*, 38(2), 2006, pp. 193–213.

[19] The structural changes effected were well received by international capital markets and generated their general positive perception of, and confidence in, the Turkish economy over the following decade, which was key to its strong growth performance. However, the $20.4 billion in net financial assistance from the IMF between 1999 and 2003 was also crucially important in overcoming the crisis.

[20] See CBRT, 'Press release no: 2006–04', 2006, <http://www.tcmb.gov.tr/wps/wcm/connect/7bc48975-bff4-499c-b036-05f52a31d35e/ANO2006-01.pdf?MOD=AJPERES&attachment=true&CACHE=NONE&CONTENTCACHE=NONE> (accessed 1 October 2014); and Yeldan, 'Neoliberal', op. cit., p. 4. The CBRT, however, did not officially announce it had adopted inflation targeting as its governing rule until January 2006.

[21] Note that to reverse these last problems, which have been allowed to accumulate to major proportions, will now require massive state spending, but minimizing non-interest-payment government spending remains a policy goal. See Yeldan, 'Patterns', op. cit. for a further discussion on these other problems.

[22] For an application specifically to Turkey, see Yeldan, 'Neoliberal', op. cit.

[23] *The Economist*, 'Emerging economies: dizzy in boomtown', 15 November 2007, <http://www.economist.com/finance/displaystory.cfm?story_id=10136509> (accessed 1 October 2014).

[24] *The Economist*, 'The quantitative quintet', 23 June 2014, <http://www.economist.com/blogs/buttonwood/2014/06/emerging-markets> (accessed 1 October 2014).

[25] These major developing countries with the highest domestic credit creation are the same as the 'fragile five', excepting they include China for its high domestic credit creation (but do not consider it fragile because the strength of its economy makes this appropriate), and exclude South Africa whose performance is fragile despite lower credit creation.

[26] The current prolonged world slump is causing some conservatives to revise this 2 per cent number upward somewhat, though they often argue the higher levels will be appropriate only as long as the world slump lasts and that then targets should be returned to 'normal'. Heterodox economists tend to find no evidence that inflation rates up to 10 or even 15 per cent are harmful to economic performance, whereas hyper low rates actually often are.

[27] The military took power in a *coup d'état* on 12 September 1980. A first series of neo-liberal reforms were introduced from 1980 to 1983, and a second phase deepening neo-liberalism was introduced in 1989. The government only publishes the consistent official data we use here back to 1984, but the years 1981–83 were not qualitatively different from the other years of the early phase of neo-liberalism.

[28] Note there is a stock-flow issue generally not indicated in the discussions on volatility concerning the difference between volatility in the sense of disinvestment once invested and volatility in the sense of changes in the levels of inflows. As indicated by their name, non-hot money capital inflows are more stable in that investments made cannot be as quickly liquidated. However, Turkey requires net capital inflows every year to balance its foreign accounts, and the amount of net new non-hot money coming in can change sharply from one year to the next, as one sees in Figure 1, despite its relatively less liquidity once invested. Hence, while hot money overall is certainly more volatile, there is significant volatility of non-hot money in regards to what is important for Turkey's economy, its yearly net inflow of foreign capital.

[29] For the concern of this paper with dependent accumulation, unsustainability and fragility, there is no need to distinguish between FDI and other forms of non-hot money capital inflows. Its behaviour, however, as indicated in Table 1 in V. Necla Geyikdagi and Filiz Karaman, 'Foreign direct investment and profit transfers: the Turkish case', *Journal of Balkan and Near East Studies*, 15(4), 2013, pp. 383–395, very closely resembles that of the larger category of non-hot money capital in Figure 1 of this paper, including its take-off in 2000 and further quantitative jump in 2005. Again going beyond the focus of this paper, that paper is also particularly worth reading for its careful treatment of other problems associated with the nearly mythical FDI in the case of Turkey.

[30] See K. Chang, S. Claessens and R. Cumby, 'Conceptual and methodological issues in the measurement of capital flight', *International Journal of Finance and Economics*, 2(2), 1997, p. 106; and CBRT, *Monetary*, op. cit., p. 27.

[31] For example, see the very rich study by Boratav and Yeldan, op. cit., p. 448ff., which allows for possible confusion on this point with its generally correct definition of hot money as 'arbitrage-seeking short-term private capital'. Hot money indeed has a short-term time horizon, but the instruments on which it speculates do not need to be classified as short-term capital, such as, for example, stocks, as will be seen in the operational definition we present below.

[32] CBRT, *Monetary*, op. cit., p. 27.

[33] CBRT, *Balance of Payments Statistics Definition, Principles and the Practice in Turkey*, 2013, p. 11, <http://www.tcmb.gov.tr/wps/wcm/connect/932be9ac-d4da-4d11-90f2-5866e091ef49/bopmet.pdf?MOD=AJPERES&attachment=true&CACHE=NONE&CONTENTCACHE=NONE> (accessed 1 October 2014).

[34] In the Turkish data the Capital Account is usually zero and never more than 1 per cent of the Financial Account in any case.

[35] The CBRT argues that a large part of this category is unreported flows of hot money. See CBRT, *Monetary*, op. cit., p. 27. Clearly, including this entire category introduces some error into the definition of hot money, since some of the content of the Errors and Omissions account comes from the data in the Current Account or the categories in the Financial

Account that we will not include in hot money. However, since Errors and Omissions is not broken down further the only alternatives are to include the entire category in hot money or exclude it. Like the Central Bank, we believe the former is the better alternative.

[36] It is planned that a fifth category will be included in the future, Financial Derivatives, but it does not yet exist in the current BOP tables.

[37] For its definition of Portfolio Investment, see CBRT, *Balance*, op. cit., p. 9.

[38] Ibid., p. 18 for its formal definition of assets. Note it defines three Turkish agents: General Government, Banks and Other Sectors.

[39] Ibid. for its formal definition of liabilities.

[40] Such long-term investments would anyway only appear in this data when the stocks are bought or sold (relatively infrequent for long-term holding).

[41] CBRT, *Balance*, op. cit., p. 10.

[42] CBRT, *Balance*, July 2014, <http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+EN/TCMB+EN/Main+Menu/STATISTICS/Balance+of+Payments+and+Related+Statistics/Balance+of+Payments+Statisticss/Data> (accessed 1 October 2014). Download the International Investment Position and then select the table Non-residents' Deposit Accounts in Turkey (1984–2014 July).

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Appendix 1. Economically Defining Hot Money for Turkey

While there exists a common general economic concept of what hot money is, there is no broadly accepted single detailed definition. Here we present such an operational definition for Turkey. We necessarily begin with the economic considerations that must underlie any operational definition.

There are two main misconceptions in the relatively limited literature which has any extended discussion of the economic concept of hot money. The first is that the owners of hot money buy and sell in financial markets in response to 'expected rates of return and risks'.[30] This claim needs to be addressed very carefully. The owners of the majority of what is generally considered to be hot money tend rather to be concerned with expected asset price changes. While expected rates of return and risks are related to prices, it is more accurate to refer to these owners of hot money as 'pursuing arbitrage gains'. To suggest that they are concerned with rates of return is to imply that they have a longer time horizon than they do, and it is exactly the continual buying and selling under their very short time horizon that makes these flows so potentially volatile. Money pursuing arbitrage gains is the real speculation-motivated hot money.

Given that the general concept of hot money is capital that can move out quickly at the first sign of economic problems, there is however an additional different type of hot money. This short-term capital is indeed loaned or deposited, motivated by high rates of (risk adjusted) expected returns. The owners of this capital are not constantly buying and selling in accord with asset price changes as is speculative capital—simple pursuit of an internationally high rate of return is not speculation. At the first sign of serious economic problems, however, this money can and often does flee. The difference in the nature of these two types of hot money is important. It is the former that can initiate crises by an attack on the economy, while the latter only tends to reinforce and deepen already unfolding problems. They are, however, both capital that can surge out suddenly, hot money. In our empirical definition below for Turkey we will distinguish these two types of hot money, and indicate the qualitative nature of their relative contribution to the total hot money.

The second economic misconception to avoid is the common identification that because the time horizon for hot money is short term that it is equivalent to short-term capital.[31] On the one hand, not all short-term capital is hot money (for example, short-term trade credits). On the other hand, some things that are not classified as short-term capital are the instruments used for hot money (for example, portfolio investments into securities markets).[32] Hot money empirically measured in accord with its defining economic concept is significantly different from simply incorrectly taking it to be short-term capital.

Appendix 2. Operationally Defining Hot Money for Turkey

The Turkish Balance of Payments (BOP) statistics have three main categories: the Current Account, the Capital and Financial Account, and Errors and Omissions.[33] The well-known identity is that the sum of these three flows must be zero.

From our conceptual definition, it is clear that neither any of the sub-entries in the Current Account nor the Capital[34] part of the Capital and Financial Account will be hot money. Hot money will consist of the Errors and Omissions account,[35] and some of the subcategories of the Financial Account's four[36] subcategories: Direct Investment, Portfolio Investment, Other Investments and (changes in) Reserve Assets.

From the economic concepts implied by their names, it is immediately clear that the subcategories of Direct Investment and (changes in) Reserve Assets are not hot money. What needs to be determined is what subcategories of Portfolio Investment and Other Investments should be considered as hot money along with Errors and Omissions.

For reasons of space we cannot here argue why all items which will not be considered hot money are excluded. We will tersely motivate the items included.

Consider first Portfolio Investment.[37] Assets would be foreign equity and debt securities held by Turkish agents[38] and so none of them are components of hot money.

Our concern then is with which Portfolio Investment–Liabilities.[39] Liabilities are subdivided into two categories, Equities Securities and Debt Securities. Equities Securities are a net figure of purchases and sales of Turkish stocks by foreigners. While some foreigners do buy stocks as long-term investments,[40] the Turkish stock market, like all stock markets around the world, is very much what Keynes called a gambling casino. Therefore, the category Portfolio Investment–Liabilities–Equities Securities should be classified as hot money.

Next, consider Portfolio Investment–Liabilities–Debt Securities. This is divided into four subcategories: Monetary Authority, General Government, Banks and Other Sectors.

The subcategory Monetary Authority refers to the CBRT. Conceptually, this agent is not borrowing from foreign capital markets abroad (as we will see next the Treasury does), so its foreign exchange transactions should not be considered part of hot money. Note additionally that almost all entries in this category from 1984 to 2006 are zero anyway.

The subcategory General Government includes in particular the Treasury. The Treasury participates heavily in the hot money market, selling Eurobonds. Note that this subcategory is subdivided into two further subcategories, In Turkey and Abroad. The category In Turkey concerns Treasury Bills and Bonds denominated in Turkish lira that are sold to foreigners. The category Abroad concerns the Eurobond sales and retirements. Therefore, both of these and hence their sum Portfolio Investment–Liabilities–Debt Securities–General Government are part of hot money.

The subcategory Banks consists of paper that banks issue. We will see below an often discussed much bigger category of borrowing by banks, but Portfolio Investment–Liabilities–Debt Securities–Banks is included in hot money.

The final subcategory is Other Sectors. This category only began in 2010 and again is very small. It is like the Treasury and banks, but here the issuer is some other Turkish institution such as a private enterprise that has the size and credibility to issue bonds in international markets or to domestic markets and have them bought by non-residents. Portfolio Investment–Liabilities–Debt Securities–Other Sectors is included in hot money.

The final category one must look in for hot money under the Financial Account is Other Investments. CBRT defines this as: 'All the other financial transactions, not covered by direct investment, portfolio investment, financial derivatives and reserves are included in this category.'[41] Among the many subcategories of Other Investments–Liabilities, there are two under Loans that should be considered capital flows whose goal is arbitrage gain. A much discussed component of hot money in Turkey is the borrowing short term by banks on foreign capital markets at a lower interest rate, and then using that to buy Turkish Treasury bonds and bills at higher interest rates (often near the highest in the world), but thereby assuming exchange rate risk. The category Other Investment–Liabilities–Loans–Banks–Short Term is part of hot money.

A second category under Other Investments–Liabilities–Loans (but much smaller) is Other Sectors, for instance, private and state enterprises. The category Other Investment–Liabilities–Loans–Other Sectors–Short Term is part of hot money.

The final hot money subcategory of Other Investments–Liabilities is non-residents' deposits in Turkish banks. One can also find this number described more fully in the separate table of stock of deposits from the CBRT labelled 'Non-Residents' Deposit Accounts in Turkey'.[42] If one looks at this latter table under section A, Banks, one sees that the change from one year to the next is given by the sum of the actual net flows, the quantity we want, and the change in valuation of the deposits. However, if one looks back at the BOP table under Financial Account–Other Investments–Liabilities–Currency and Deposits–Banks one sees that one has exactly the same numbers as the net flows—that category in the BOP table is the flow of deposits into Turkish banks by non-residents. Other Investments–Liabilities–Currency and Deposits–Banks is hot money.

In line with the economic reasoning presented above, we can now operationally define hot money as the sum of eight categories from Turkey's BOP tables. Giving both the titles and numbers of the categories in the BOP tables, we have:

> Hot Money = Financial Account–Portfolio Investment–Liabilities–Equity Securities (II-B-2.2.1) + Financial Account–Portfolio Investment–Liabilities–Debt Securities–General Government (II-B-2.2.2.2) + Financial Account–Portfolio Investment–Liabilities–Debt Securities–Banks (II-B-2.2.2.3) + Financial Account–Portfolio Investment–Liabilities–Debt Securities–Other Sectors (II-B-2.2.2.4) + Financial Account–Other Investment–Liabilities–Loans–Banks–Short Term (II-B-3.2.2.3.2) + Financial Account–Other Investment–Liabilities–Loans–Other Sectors–Short Term (II-B-3.2.2.4.2) + Financial Account–Other Investment–

Liabilities−Currency and Deposits−Banks (II-B-3.2.3.2)+Errors and Omissions (III).

Referring to the economic discussion of hot money in Appendix 1, note that the first four categories and the last one are speculative hot money, while the fifth through the seventh are the different types of hot money consisting of short-term loans and deposits motivated by the pursuit of Turkey's internationally high rates of return.

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