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Foreign Private Capital-Led Growth: The Recent Rise and Fall of Turkey

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Abstract

This article maintains that after a decade as a poster-child for neoliberal growth, (1) Turkey has definitely fallen from its former impressive growth performance, (2) the cause is exactly the rupture of its foreign capital-led growth model, just as its fragility critics warned, and (3) given the state of both external and internal economic and political factors, there is very little chance of Turkey returning to its strong growth over the next several years.

JEL Classification: F43, F21, O11

Keywords

foreign capital-led growth, Turkey, development

1. Introduction

Turkey exited from its sharp and short 2001 financial and economic crisis into a decade of rapid growth. The average rate of growth of its gross domestic product (GDP) was 5.4 percent from 2002 to 2011, including its contraction of almost 5 percent in the world-recession year of 2009. This was stronger than three of the five BRICS (Brazil, Russia, India, China, and South Africa) countries, which international capitalism was then eulogizing as the pillars of the emerging new world capitalism being driven by Third World growth, with only China and India outpacing it.[1]

Throughout the whole period and continuing today, the international financial press has always put Turkey near the very top of its "most fragile" list. Moody's reported in October 2015 that "Turkey stands out as most vulnerable to external risks because of its high reliance on external capital and its large stock of external debt due annually." In 2002, Turkey's inclusion in that

[1]In addition to having strong growth, to play this future role, a country had to be large, engage in extensive trade, and especially be open to, and provide opportunities for, foreign investment. Turkey met all these conditions, but international capital chose not to anoint it to BRICS (Brazil, Russia, India, China, and South Africa) status. This paper hereafter refers to this period as Turkey's "BRICS decade."

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list was based on, in addition to broader political issues, three of the usual four concerns of the financial press: too big a budget deficit, inflation, and too big a current account deficit.[2] The government deficit was brought down to 1.3 percent of GDP by 2005, and other than 2009 and 2010, it has stayed at 2 percent or lower, so that is not a current concern. The rate of inflation was brought down sharply to 8.6 percent by 2004 and was held below 10 percent[3] up to the present.[4] The ratio of the current account deficit to the GDP became the biggest growth-fragility concern of the international financial press during the recovery from the 2009 growth contraction. In 2010, it reached its highest value ever in recent times, 6.2 percent. This then exploded to 9.7 percent in 2011, recovered to 6.2 percent in 2012, and slipped back up to 7.9 percent in 2013. Although the two-step reduction to 5.8 percent in 2014 and 4.4 percent in 2015[5] has, for now, reduced the level of concern of 2011 to 2013, Turkey is still considered to have "a big current account deficit" (*The Economist* 2015: 23). Too much credit, the fourth standard stability concern of capital, has grown steadily since 2004, going from 10 percent of GDP in that year to more than 50 percent in 2012 (Orhangazi 2014: Orhangazi's Figure 2).

As presented in this paper, the warnings by both academics and the financial press of Turkey's growth-fragility since 2001 throughout its BRICS decade had no effect on deterring large capital inflows, which in turn kept the economic growth strong. This paper presents evidence on how that has fundamentally changed over the last two to three years.

2. Foreign Private Capital-Led Growth: Two Roads to Breakdown

There have always been two fundamental problems with growth based on foreign private capital inflows,[6] exactly the two tersely stated in the quote above from Moody's on Turkey's fragility: "its high reliance on external capital and its large stock of external debt due annually." The heart of the first problem is that what the financial press calls "investor sentiments" can change at any time. In the worst case scenario, this could reverse the inflow into an outflow and could make such a reversal almost instantaneously. However, a breakdown does not require anything that draconian. To the extent that the country's growth rests on these capital inflows, simply a significant reduction in the inflows, without even stopping them, removes the economic driver, and hence, an economic downturn must then follow. The other problem is that in today's world, much of the private capital inflows are in the form of loans. Increases in world interest rates can turn economic profits and national growth into economic losses and a national slowdown, or even a contraction. Since Turkey's recovery from the 2009 world downturn, the international financial press has focused its continual warnings of Turkey's growth-fragility on the first of these two problems, under the appellation of an "excessive current account deficit." Just recently (for reasons to be indicated), the international financial press has begun to also focus on the second problem under the appellation of "excessive private corporate debt."

[2]See Tutan and Campbell (2015: Tutan and Campbell's Table 1), for data on all these variables from 2001 to 2013, including the following numbers presented.

[3]Except 10.4 percent in 2008.

[4]Although 2015 ended at 8.8 percent, very similar to as it has been since 2004, there is speculation that it could rise significantly in 2016 due to the effects of the recent sharp currency devaluation (and possible further ones to come).

[5]With very low oil prices being central to this latter improvement.

[6]The authors of this paper reject a reduction of economic performance to the rate of growth. Even during its strong growth Turkey suffered from, among other economic problems, the deterioration in government services such as education, healthcare, and infrastructure, slow real wage growth (despite continued productivity growth), high unemployment, and low labor participation rates. The topic of this paper, however, is the increasingly discussed issue the fragility of Turkey's rate of growth.

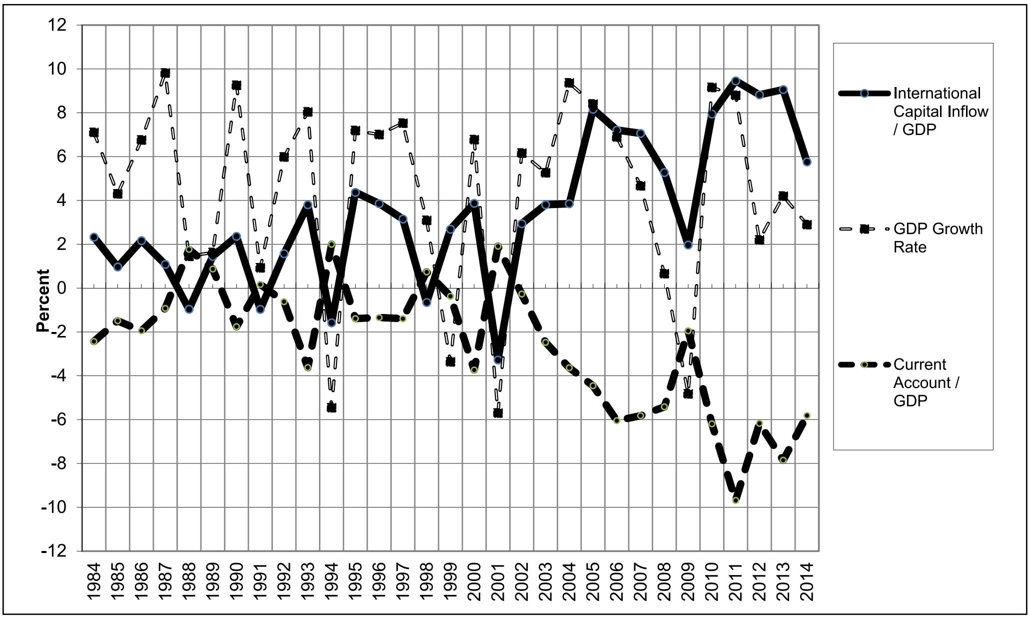

Figure 1. International Capital, Current Account, and GDP Growth.
Sources: Authors' calculations based on data from Republic of Turkey Ministry of Development (2016: Tables 1–8) and Türkiye Cumhuriyet Merkez Bankasi (2016).
Note: GDP = gross domestic product.

This section has two parts. The first presents Turkey's "old" growth-fragility problem, an "excessive current account deficit." The second presents Turkey's "new" growth-fragility problem, an "excessive private corporate debt." Section 3 then presents evidence that in the last few years, Turkey has exited from its decade-long high-growth performance, and that all indications are that it will at best settle into its current much slower growth rate, and at worst, slow significantly more.

2.1. Turkey's "old" (ongoing) growth-fragility problem

As commented in the introduction, since the beginning of Turkey's post-2001 strong growth economy, but especially since 2004 when its current account deficit reached the highest level it had ever been until then (Figure 1), an "excessive current account deficit" has been a central growth-fragility concern for international capital markets.

This growth-fragility concern of international capital markets can be recast it in a way that allows a deeper economic investigation and understanding of the nature of this problem. From the basic identity that the sum of the current account plus the international capital flows plus the changes in official reserves must equal zero, the current account deficit must equal international capital inflows up to the changes in official reserves, which are typically small compared with the other two terms. Hence, as one sees from Figure 1, the issue of the size of the Current Account deficit can be reconsidered as approximately the amount of the external capital inflows (Tutan and Campbell 2015).

This reformulation allows two important improvements to understanding this problem. Broadly, it shifts the focus from the size of the current account deficit to the issue of the amount and nature of capital inflows. "Excessive deficits" is a standard concern for conservative economists (including the powerful IMF among other similar defenders of the existing international capitalist order) who then typically prescribe deficit reduction through contractionary economic policies. Starting instead from the capital inflows allows alternative heterodox and progressive approaches.

With the world-wide spread of neoliberalism through the 1980s and 1990s, mainstream economics came to more and more champion the elimination of all protective legislation against external capital flows into Third World countries. As always, they based their ideologically motivated recipe on empirically unsupported claims of economic efficiency. Grabel (1995, 1996) published two early works debunking the threadbare theoretical support for this and included policies to partially protect countries against the harmful effects of such capital flows.

The narrower improvement to understanding the growth-fragility problem as coming from the dependency on external capital is that it allows one to distinguish between types of capital inflows, something not possible from the excessive current account approach. The topic of our earlier work was a careful empirical consideration for Turkey of the most dangerous capital flows, "hot money," financial investments that can move in and out of a country particularly quickly. However, if a country depends on external capital inflows for its growth, a reversal of inflows to outflows from hot money is not necessary to severely harm the economy. Any significant reduction in the amount of new inflows can cripple such an economy. A "change in market sentiments" (which we argue below has happened today to Turkey) affects not just hot money, but portfolio investment and even the most stable inflows, foreign direct investment (FDI). For a detailed but clear discussion of all the dangers involved in any of the various forms of capital inflows in foreign capital dependent growth, see Grabel (2003) and Chang and Grabel (2004: chapter 9).

Figure 1 makes clear that Turkey has made no significant progress on this problem over the last decade. Viewed in terms of the current account deficit, 2014 remains at the unprecedentedly high level it had reached by 2006. Viewed in terms of the external capital inflows, its dependency continually worsened until very recently. The greatest foreign capital inflows ever were between 2011 and 2013 (with 2010 almost tied for the fourth highest ever), and in addition, the success of those inflows in promoting growth dropped for 2012 and 2013. Then in 2014, the capital inflows experienced a sharp decline, to be discussed below.

2.2. Turkey's "new" growth-fragility problem

With world interest rates near zero after "the Great Recession," Turkey's growth-fragility problem of "a large stock of debt due annually" was largely a non-issue. It was not discussed by international financial markets, other than the occasional mention in passing that it would someday again be a problem when interest rates returned to normal. With the US Fed's May 2013 announcement that it would soon begin to "taper off" its "quantitative easing" program, and again with the talk in 2014 and 2015 that it would "soon" begin a long process of raising the Federal Funds rate back to normal levels (with the first mini-step taken in December 2015), this issue has newly returned to prominence. *The Economist* (2015) recently ran a briefing on the world economy indicating that it is still suffering from the same central problem that brought the Great Recession and the ongoing lethargic aftermath, a debt-driven world economy ("too much debt"). Now, however, the "rolling debt crisis" is moving into a third stage, this time centered on "emerging markets."

"In contrast to the credit booms in America and Europe, where households were the main borrowers, three-quarters of the private debt burden in emerging markets is shouldered by businesses" (*The Economist* 2015: 21). While the average for "emerging markets" has gone from less than 50 percent of GDP in 2008 to almost 75 percent by 2014, Turkey faces a significantly bigger problem. As indicated by Figure 2, its success in "overcoming" the 2009 world economic downturn involved a continuous increase of its corporate indebtedness from its already high position of 84 percent in 2008 to 108 percent in 2014.

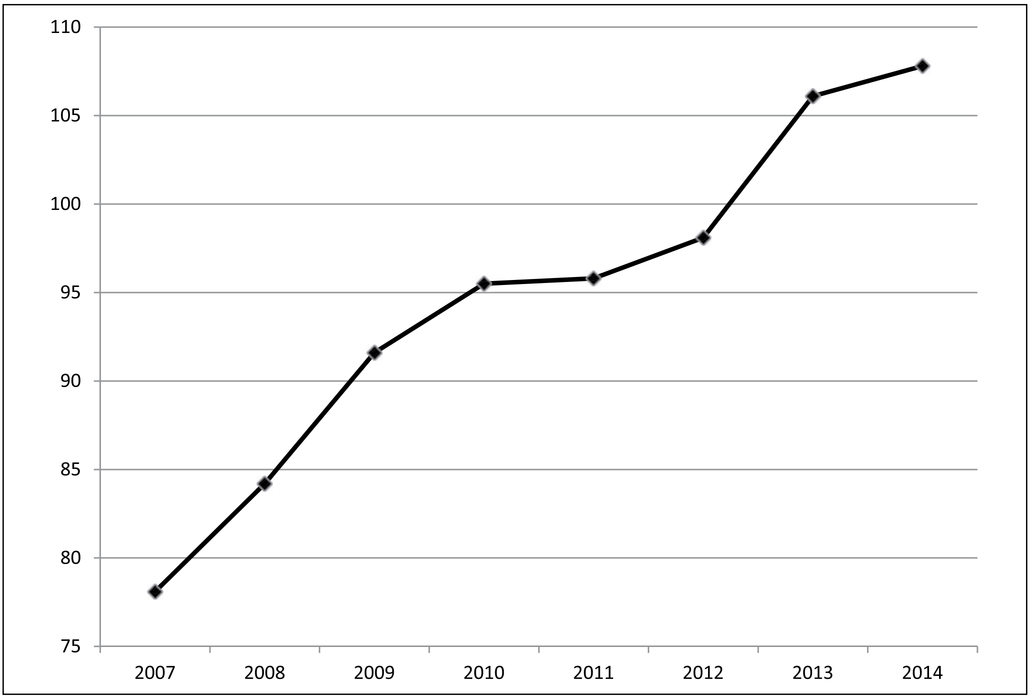

Figure 2. Total Debt of Non-Financial Corporate Sector as Percent of GDP.
Source: Authors' calculations based on Bank for International Settlements (2016).
Note: GDP = gross domestic product.

The upcoming increase[7] in world interest rates will deliver a proverbial "one-two punch" to Turkey. In the first place, the obvious effect will what could over time be a major increase in its required annual debt service payments, itself enough to threaten Turkey's overall macro performance. But beyond that as discussed in the last point, Turkey's foreign capital-led growth model requires a constant inflow of capital just to maintain its growth. As is now regularly discussed in the financial press, increased interest rates in the United States (presumably to be matched by Europe) are expected to strongly reorient international capital flows away from the Third World and back toward the First World, again by itself enough to implode Turkey's economic performance.

3. Turkey's Fall from High Growth Has Begun

As indicated above, both academics and international financial markets highlighted the fragility of Turkey's post-2001 high growth from its inception, but the correctly analyzed danger of significant growth reduction never materialized. We regard Turkey's ability during this decade to continually dodge its problems as a caution against claiming that the long-predicted slowdown has begun. We consider, however, that the following seven aspects of its current situation, when considered together, make the case that a marked slowdown in its economic growth has indeed begun, and further that there is a high probability that this will not be reversed to its BRICS decade performance in the near future.

[7]As of the writing of this article in spring 2016, the sentiment in the United States is for a significant delay before the next mini increase, for the moment, once again temporarily putting off this problem in its acute form for Turkey.

1. While the BRICS decade rate of growth was 5.4 percent,[8] that has dropped sharply by 37 percent to a rate of 3.4 percent for the nearly half decade from 2012 to 2015.
2. Figure 1 indicates that the foreign private capital-led growth model has broken down over the last years in two ways. First, after record capital inflows in 2010 and 2011 caused an impressive growth rebound from the 2009 contraction, continued record inflows in 2012 and 2013 experienced an unprecedented sharp drop in the growth effectiveness of the inflows. Then in 2014, the inflows themselves took a sharp drop from more than 9 percent to less than 6 percent. This continued in 2015, falling below 3 percent, Turkey's lowest level of capital inflows since the beginning of its BRICS decade in 2002.[9] As capital inflows are the engine of their growth model, growth must stay low as long as these remain low (and lower still if capital inflows are having diminishing growth effects). In what follows, we indicate some reasons why academics and the financial markets think Turkish growth will not rebound in the near future.
3. While we indicated above that international interest rates are not likely to increase greatly very soon, Turkey faces another problem from its large private debt. After remaining almost constant from 2002 to 2010, the value of the Turkish lira in US dollars has dropped 45 percent from 2010 to 2015, with the drop in 2015 being particularly sharp and financial markets discussing the likelihood of further declines. Much of the corporate debt discussed above is either directly contracted in dollars or euros from Turkish or foreign banks, or is in Turkish lira from Turkish banks who borrowed internationally in dollars or euros to make the domestic loans. Either way, the Turkish lira value of the US dollar and euro parts of the large corporate debt has almost doubled and is expected to increase further in coming years. The now much-discussed devaluation of Turkey's currency has made its corporate debt problematic even as international interest rates continue to slumber.
4. A much trumpeted success of the post-2001 economic program was that it brought the rate of inflation down from seriously problematic levels to the upper half of the single digits by 2004, where it has stayed since then (Tutan and Campbell 2015: Table 1). While inflation has not yet taken off, international financial markets have begun to raise the fear that a further depreciation of the lira will set it off again.
5. Although FDI is not the largest part of foreign capital inflows into Turkey, its nature as more difficult to withdraw makes it more indicative than other more mobile capital of "investor confidence" in the medium-term economic performance of a country. FDI climbed to average 3 percent of GDP from 2005 to 2008, as capital became confident that the BRICS performance was real. Following the 2009 contraction, capital never regained that outlook for Turkey's prospects, and FDI averaged just over half that from 2009 to 2014. In recent years, there have not only been no big greenfield projects, there have not even been any major acquisitions.
6. Numerous external factors have turned unfavorable to Turkey's growth. An important strategy in the early part of its BRICS decade was to establish itself as the dominant local economic power in the Middle East.[10] After some encouraging initial steps, this strategy largely imploded with the descent into chaos of much of the region with the rise of ISIS and the prolonged Syrian civil war. While it quickly consciously decided to reorient its

[8]The Great Recession was part of that time period, and so the following is not presented to claim "it was really higher" via data manipulation. But it is further indicative of the growth strength of the Turkish economy in that decade to note that without the largely exogenous effects of the two Great Recession years of 2008 and 2009, its average growth was 7.3 percent for the other eight years of the decade.

[9]Excepting the world-recession year of 2009, when it was 2.0 percent.

[10]The term used here excluding Israel.

trade toward Africa and Russia,[11] the trading relations with these countries never had the potential of the original plan to be an all-around local economic power in the Middle East. As such, they never had the attraction to foreign capital beyond their limited potential for simple trade-based economic improvement of the Turkish economy. More broadly, the lethargic world economy since 2010 has limited growth through trade opportunities with these regions and especially with Turkey's most important trading partner, Europe. But again, beyond blocking the potential for some simple trade-based economic improvement, the lethargic world economy has directly meant a reduced investor interest in exporting capital to the Third World, in general, and Turkey, in particular. Almost all international projections are for continued world economic lethargy for at least several more years.

7. Over the past several years, the internal political situation in Turkey has been constantly building toward increased social unrest and conflict. The current Turkish government has been continually narrowing the space, limiting the available channels, for any disagreement with any of his policies. From Gezi Park, to the formal and informal censoring of the press, to the purging of the police and judiciary, to the re-ignition of the war with the Kurds, to the elections in 2015 and to this year's broad attack on academic free speech, the conditions are being created for a large social explosion. The connection of social conflict to growth-collapse has long been academically documented.[12] This becomes particularly relevant for a country pursuing a foreign capital-led growth model. "Investor sentiments" are key to the whole approach, and international capital markets hate chaotic social conflict. The change in the attitude of international capital markets over the last several years toward Turkey in general, and toward the Turkish government and its social policies (and the growing reaction against them), in particular, is universally presented in the international financial press. *Foreign Policy* tersely indicated this major change in investor sentiments: "Once the darlings of investors, Brazil and Turkey have fallen into an economic rut of late" (Altman 2015).

4. Conclusion

Post-2001 Turkey has been an exemplar of foreign private capital-led growth. Notwithstanding the continuous warnings of "fragility" by both academics and financial markets, Turkey's growth outperformed three of the five BRICS countries from 2002 to 2011, the decade when international finance was extolling them as the new engines of world capitalism. Although this impressive growth performance in the face of continual warnings warrants caution with arguing that Turkey's high growth has ended, multiple different indications support that conclusion.

There is no reason that foreign capital-led growth should slow, provided both that the external capital inflows continue at the same levels, and that their growth effects do not drop. The fundamental fragility of the model, however, is that such foreign capital inflows constantly move to the markets where they believe that they will get the best returns. Favorable investor sentiments can reverse due to any of a myriad of "errors" a receiving country could commit, because another country has suddenly become more attractive even in the absence of any domestic errors, or simply because a change in the world economy reduces such capital inflows worldwide.

Turkey's growth rate has dropped to a new much lower level for the last four years, a level some economists are now calling its "new normal." Underlying this, Turkey's capital inflows that drove its strong growth performance for a decade first fell sharply in their growth effectiveness, and then over the last two years, dropped sharply in their volume. External considerations such

[11]The somewhat deteriorated economic relations between Russia and Europe that resulted from the political tensions (particularly around the Ukraine) benefitted this reorientation toward Russia. The very recent sharp political conflict of Turkey with Russia can be expected to significantly harm this relation.

[12]See as one example, Rodrik (1999).

as the expected continuation of the lethargic world economy for several more years argue against a near-term revival of the capital inflows. Internal economic and political considerations such as its weakening currency and excessive private debt burden, and even more so its rapidly sharpening social conflicts, support the same negative conclusion. Turkey has moved from being a "darling" of international capital markets and an exemplar of the possible success of a foreign capital-led growth model to being an exemplar of the inherently unsustainable nature of such a model.

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