TURKEY’S UNHEARD VOICES

Economic Recovery and Institutional Reforms: A Comparative Analysis of Turkey's 2001 and 2022 Economic Crises

ECONOMICS

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Research Question

In what ways do the reforms implemented following the 2001 Turkish economic crisis differ from those introduced after the 2022 crisis, and how have these differences impacted the effectiveness and outcomes of the respective reform efforts?

Introduction

This research report will analyze the differences in the approaches implemented to stabilize the economy after the 2001 and 2022 economic crises in Turkey, and demonstrate why the reforms made in 2001 were more effective than those made in 2022. The primary objective of this paper is to evaluate the hypothesis that a nation's economic recovery following an economic crisis is fundamentally influenced by the strength and resilience of its political and economic institutions. This paper argues that while monetary and fiscal policy changes are critical, they must be complemented by substantive reforms in the political and economic institutions responsible for implementing those policies to drive sustainable and meaningful economic progress. By comparatively examining the data from the economic crisis of 2001 and 2022 of Turkey, this research report will reveal the indispensable role of institutions in shaping the efficacy of the reforms implemented after the economic crises.

Detailed Analysis

Up to date, Turkey has faced two major economic crises. The first economic crisis, the 2001 crisis, was caused by structural deficiencies including large budget deficits, public debt, and reliance on foreign investment. Amid the fragile state of the Turkish economy, the government implemented an exchange rate-based stabilization program (the details of this program are discussed below). While the policy was theoretically sound, the prevailing conditions in Turkey were not conducive to its success, ultimately aggravating the already vulnerable economic situation. The 2022 Economic Crisis was driven by the adoption of an unorthodox monetary policy, wherein the Central Bank repeatedly lowered interest rates despite high inflation. This approach directly contradicted conventional economic principles, resulting in a rapid acceleration of inflation and a concurrent depreciation of the Turkish Lira's value.

In response to both crises, the government implemented measures encompassing a wide array of strategies. However, the key distinction lies in their scope and focus: the 2001 reforms targeted structural deficiencies and emphasized the establishment of stable regulatory institutions, whereas the measures following the 2022 crisis were narrowly concentrated on short-term policy adjustments, with little consideration for long-term implications.

2001 Economic Crises

On February 19, 2001, the former president of Türkiye Ahmet Necdet Sezer, accused the prime minister, Bulent Ecevit, of wrongfully managing the country's banking system and threw a copy of the Turkish constitutional code book across the table at him. Soon after, the prime minister called a press conference and verbally attacked the president. As a result, overnight, the İstanbul stock exchange plummeted, interest rates rose by over %7,500 percent, and the Turkish lira began to rapidly depreciate. According to numerous experts, the economic impact of the 2001 crisis on Turkey amounted to approximately $20 billion, equivalent to 10% of the country's GDP at the time. The Borsa Istanbul stock exchange experienced a sharp decline, losing nearly 30% of its value within days, while interest rates surged to an unprecedented 7,500%.

The sudden collapse of Turkey's market in 2001 can be attributed to a combination of underlying socio-political and economic causes. During the preceding decade, the Turkish government had significant budget deficits and accumulated substantial public debt, creating a highly vulnerable economic environment within the country. The fragility of the market was exacerbated by the insufficiency of capital goods and an overdependence on foreign investment. Amid this state of the Turkish economy, in December 1999, the government launched an exchange rate-based stabilization program (ERBSP). The ERBSP aimed to stabilize the economy by adopting a fixed or semi-fixed exchange rate against major foreign currencies (the U.S. Dollar or Euro). Generally, monetary stabilization policies fall under two categories: exchange-rate-based stabilizations (ERBS) and money-based stabilizations (MBS) – or, in other words, floating exchange rates. ERBS's tends to trigger an initial consumption boom followed by an economic contraction, while MBS usually results in an initial consumption bust followed by a recovery. ERBS's are typically more effective in the short term, while floating exchange rates yield better results in the long term.

Given Turkey's persistently high inflation and unemployment rates during the 1990s, the decision to adopt an exchange rate-based policy seemed initially reasonable. Historical data suggests that countries incorporating fixed exchange rate regimes into their stabilization strategies were often successful in reducing inflation and fostering fiscal discipline. Additionally, countries pursuing exchange-rate-based stabilization programs generally experienced faster output recovery than those implementing money-based stabilization programs (in the short term).

However, the success of exchange-rate-based policies depends on several critical factors such as 1) the consistency of fiscal policy, 2) the strength of the banking systems 3) a pre-announced exit date and 4) the vulnerability of the economy to adverse shocks.

In Turkey's case, the fragile economy coupled with weak banking institutions and the absence of a clear exit plan prevented this approach from being successful. Overall, the

ERBSP proved to deteriorate the economic situation and Turkey's economy experienced a steady decline from December 1999, precipitating the economic crisis that unfolded in 2001.

Response to the 2001 Economic Crisis

The Turkish government implemented a series of reforms in response to the 2001 economic crisis. Prime Minister Bülent Ecevit appointed Kemal Derviş as the Minister of State Responsible for the Economy and Undersecretary of the Treasury.

Under the guidance of Kemal Derviş, the Central Bank introduced the "Strong Economy Program", a radical new policy that fundamentally restructured the economy. The program, supported by the IMF, focused on addressing structural weaknesses, restoring confidence in financial markets, and setting the foundation for sustainable economic growth.

The core components of the program included; 1) reforming the banking sector, 2) the introduction of novel legislation, 3) transitioning into a floating exchange rate regime and exiting the ERBSP, 4) adopting inflation targeting as a part of the monetary policy, 5) privatization of state-owned enterprises. This strong economic program was complemented by the creation of the Banking Regulation and Supervision Agency (BRSA).

The first component of the program, reforming the banking sector, required changes in both state-owned and private banks. For state-owned banks, the government addressed the issue of duty losses—unpaid debts resulting from subsidized loans—by issuing bonds to recapitalize these banks and settle these obligations. Additionally, the management of state-owned banks was professionalized, reducing political interference in lending decisions and enhancing operational efficiency. In the case of private banks, insolvent institutions were placed under the management of the Savings Deposit Insurance Fund (TMSF). Weak or underperforming banks were either liquidated, merged, or sold to stronger investors, resulting in the elimination of non-competitive banks and the development of a stronger, more resilient banking sector. As a result of these comprehensive reforms, Turkey currently has a relatively strong and stable banking system.

The second component of the program, legal and regulatory reforms, was carried out under the slogan "15 laws in 15 days," where a series of laws, including the Central Bank Law, Banking Law, Telecommunications Law, and Procurement Law, were passed by the parliament in 15 days. The Central Bank Law outlined the necessary provisions to strengthen the independence of the Central Bank, ensuring that political influences didn't get in the way of economic policymaking. As further discussed below, swift responses are crucial in preventing further losses during economic crises. The ability to rapidly implement these reforms, in contrast to the slower response of the government following the 2022 crisis, was a key factor in their effectiveness.

Another key element of the Strong Economy Program was the decision to exit the EBRSP. The exit from the fixed exchange rate regime enabled Turkey to regain greater flexibility in its monetary policy. By adopting a more floating exchange rate system, Turkey was able to utilize interest rates as a tool to manage inflation and respond more effectively to evolving economic conditions, without the limitations imposed by maintaining a currency peg.

Moreover, one of the most important aspects of overcoming a financial crisis is increasing investor confidence, so that more firms and individuals are likely to invest in the economy. With this objective, the government implemented full deposit insurance to prevent a bank run and restore depositor confidence.

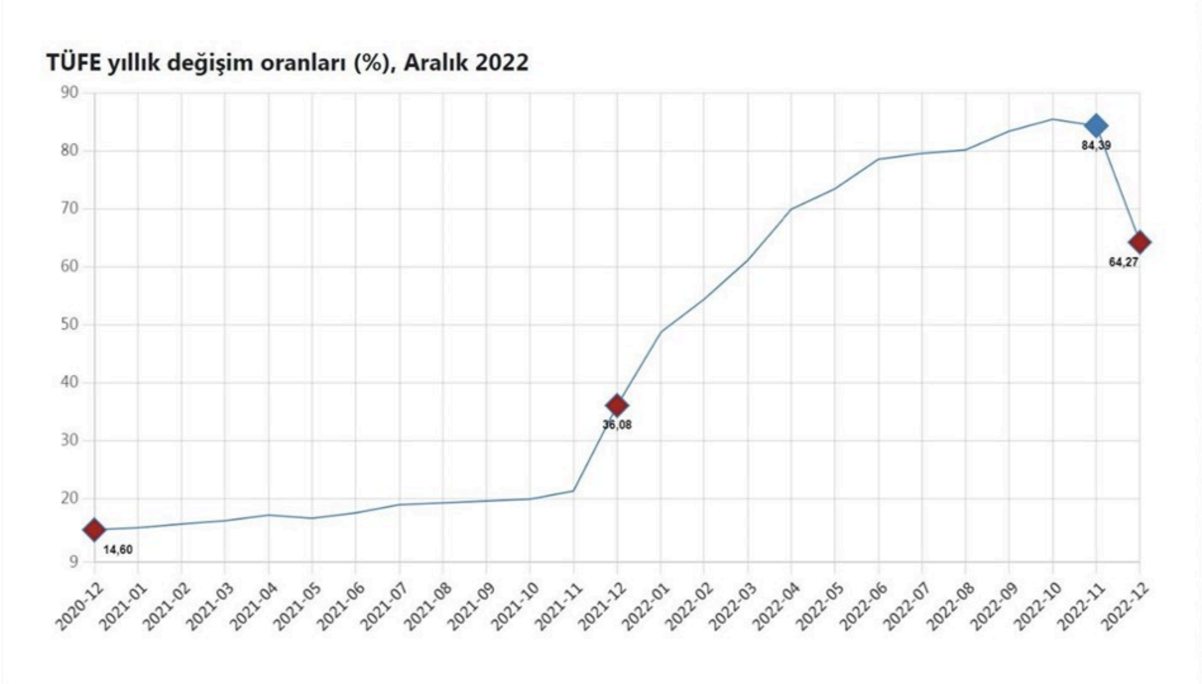
Next, in order to ensure that the new reforms were being implemented correctly, the government established and strengthened the authority of the Banking Regulation and Supervision Agency, BRSA. The agency's primary mandate included licensing, regulating, and supervising banks that operated in Turkey. It was tasked with ensuring that financial institutions adhered to prudential regulations, including capital adequacy requirements, risk management protocols, and governance standards.

These reforms were financed partly through the contribution of the IMF. The IMF approved a Stand-By Arrangement for Turkey with a total value of $14.3 billion provided in installments throughout the implementation of the Strong Economy Program. The release of these installments was contingent upon the implementation of structural reforms, which included banking sector reforms, fiscal consolidation measures, and improvements in economic governance. The IMF oversaw the implementation of the Stong Economy Program, conducting regular reviews to assess progress and provide technical assistance and expertise.

In a statement made in January 2002, it was announced that during the 2000-2002 period, $14.396 billion in loans were obtained from the IMF and $3.227 billion from the World Bank.

The 2022 Economic Crisis

The 2022 Economic Crisis was triggered by the decision of the Central bank to lower interest rates despite high inflation. This policy directly contradicts the standard economic approach which calls for raising interest rates in times of high inflation. Lowering interest rates immediately aggregated inflation, which then led to the depreciation in the value of the Turkish Lira. The Turkish Statistical Institute reported that inflation hit a 25-year high of 64.27% at the end of 2022, though independent researchers claim that the real rate is even higher. Independent analysts at ENAG estimated that the annual inflation was 137.55%



As illustrated in the table above, by November 2021, the average Consumer Price Index (CPI) for a product had increased from 20% to 80%. The Consumer Price Index (CPI) is a key economic indicator used to measure inflation by tracking the average change in prices paid by consumers for a basket of goods and services over time. The increase in the percentage of CPI on the graph above mirrors the rise in inflation.

The reduction in interest rates fueled credit growth, leading to an increase in demand for loans and consequently driving inflation upwards. The announced interest rate was lower than the average inflation, meaning that interest rates fell below inflation, thereby creating negative real interest. Negative real interest rates meant that holding the Turkish lira would lead to a loss of value, as the returns on savings were outweighed by inflation. As a result, there was a growing demand for foreign currency, causing the Turkish lira to depreciate. As inflation rose and the value of the Turkish lira decreased, the purchasing power of citizens experienced a notable decline as well.

In addition to the monetary policy changes, structural challenges and global developments also contributed to the rapid rise in inflation. As of December 2024, Turkey's central government debt stood at approximately 9.25 trillion Turkish Lira, which is about 25.6% of the country's nominal GDP. Despite having a significant amount of public debt, the government continued to increase its expenditures. This continued rise in spending, without corresponding measures to manage debt levels, placed additional strain on the economy.

Furthermore, Turkey has an import-dependent economy, heavily reliant on external sources for essential goods and services. Turkey's projected import value for 2022 was $262B while its export value was $299B. As a result, Turkey's economy was put in a position more susceptible to global developments such as the COVID-19 pandemic and the Russia-Ukraine war.

Response to the 2022 Economic Crisis

The response to the 2022 economic crisis was primarily focused on monetary policy and government interventions, with little emphasis on structural reforms or strengthening economic institutions.

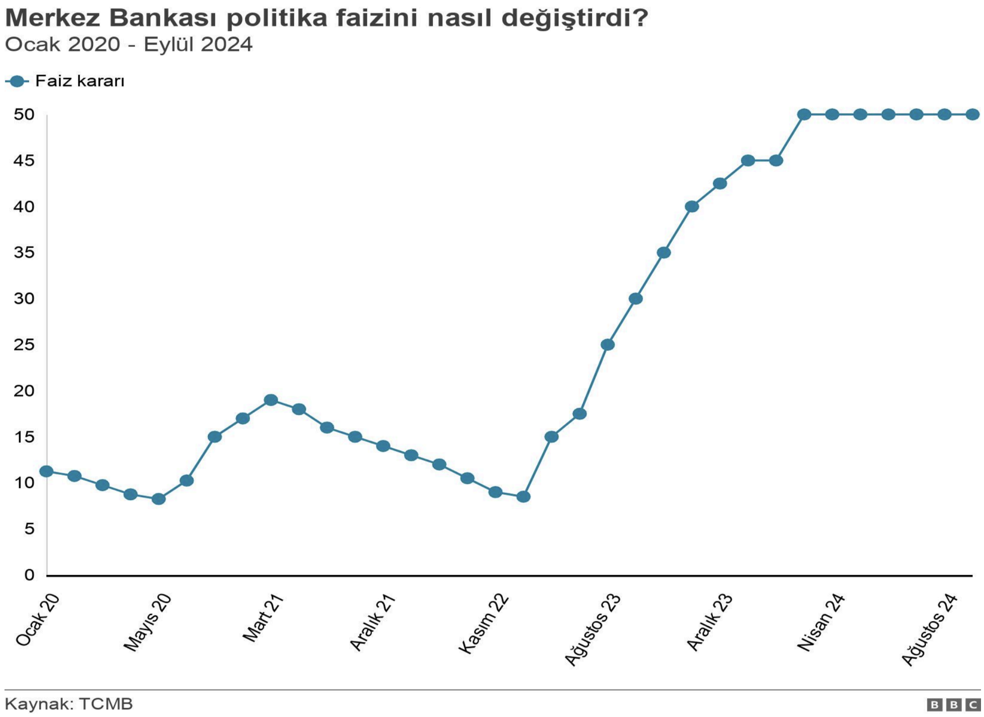
One of the notable characteristics of the response to the 2022 economic crisis was the government's focus on mitigating the political costs associated with the crisis, employing a discourse that avoided blame. The government initially refrained from taking responsibility and delayed its response to the crisis, waiting too long before implementing any measures.

The initial wave of the crisis was experienced in November 2021, while the significant reforms began to be implemented only after 2022. In comparison to the swift response during the 2001 crisis, when the government acted decisively through initiatives like the "15 Laws in 15 Days" plan, the delayed action in 2022 only served to further exacerbate the situation. In fact, the Central Bank reduced the policy interest rate multiple times throughout 2022, instead of increasing it, which led to further depreciation of the Turkish lira and an escalation of inflation. Experts believe these actions were done under political pressure. By the end of 2022, inflation had soared to over 65%, with some independent estimates indicating even higher levels.

After the initial boom of inflation in November 2021, the Central Bank was instructed not to increase policy interest rates by government officials, therefore, economists had to look for alternative approaches to stabilize the currency. Consequently, in December 2021, the government introduced the Exchange Rate Protected Time Deposits scheme. This program aimed to make the Turkish lira more attractive by compensating depositors for any depreciation beyond the policy rate. While it temporarily halted the lira's decline, it did not address the underlying economic issues.

The response to the 2022 economic crisis in Turkey involved several critical adjustments to monetary policy. These measures included a significant increase in the Central Bank's interest rate after 2022, and the central bank selling its foreign exchange reserves to limit the depreciation in the Turkish Lira.

In 2023, after the presidential elections, Mehmet Şimşek was appointed as the Minister of Treasury and Finance. One of the first changes he made was increasing interest rates. Below is a graph that demonstrates the increase in interest rates in 2023.



This was a significant step in preventing further depreciation of the Turkish Lira, However, while it prevented additional damage, it was unable to reverse the losses already incurred. Inflation remained high during 20203 and 2024, standing at 44.38% by the end of 2024. This value is lower than the inflation experienced in 2022, however, the government projection at the beginning of 2024 was for the inflation rates to drop below 30%.

From 2019 to 2020, the Central Bank sold its foreign currency reserves amounting to an estimated $128B to bolster the weakening Turkish lira. As mentioned above, the president, an ardent opponent of high interest rates, prevented Central Bank officials from increasing interest policy rates. This left policymakers with limited options to curb inflation, and selling the banks foreign currency rates was one of them. According to the estimates made by Kerim Rota, a former banker and the vice-chairman of the Future Party, the Central Bank sold $33B in 2019 and $93.3B in 2020. Turkish economist Mahfi Eğilmez estimated that the central bank reserves were reduced to negative $39.6B after excluding the swaps. According to the former chairman of the central bank Durmuş Yılmaz, the reserves were at negative $55B. The estimates provided by Goldman Sachs put it at negative $60B.

These policies bear similarities to those implemented after the 2001 crisis, but three key differences distinguish them: 1) Timing – The government's response in 2022 was delayed; 2) Scope – While economic policies were adjusted, the government failed to address underlying structural issues; 3) Central Bank Independence – The Central Bank remained subject to political influence, unlike during the post-2001 period.

It is also important to note that the government implemented changes in fiscal policy to alleviate the burden on households. These measures included reducing taxes on essential goods and energy, providing subsidies to offset the costs of energy and fuel, and increasing the minimum wage. Such policies were vital in reducing the negative impact on civilian welfare since purchasing power had decreased significantly. By directly addressing the rising costs of living, the changes in fiscal policy aimed to buffer the economic strain on citizens, though their long-term effectiveness in promoting sustainable growth and addressing underlying structural issues remains uncertain.

Comparative Analysis

The 2001 economic crisis was primarily caused by structural vulnerabilities in the banking sector, excessive public debt, and political instability. In contrast, the 2022 crisis was triggered by the reduction of interest rates

During both economic crises, the government's priority should have been to purchase the Turkish Lira using state assets as quickly as possible to maintain demand and, consequently, ensure the Lira wouldn't lose its value. However, executing this strategy required sufficient liquid reserves. Due to the already fragile state of the economy, the government lacked the adequate amount of liquid reserves to properly execute this strategy.

Nevertheless, the government responded significantly more quickly to the 2001 crisis than it did to the 2022 crisis. The appointment of Kemal Derviş, followed by the rapid implementation of the "15 laws in 15 days," played a crucial role in stabilizing the economy and preventing the crisis from worsening to the extent seen after the 2022 crisis. These swift and decisive measures helped restore investor confidence, restructure the financial system, and lay the groundwork for economic recovery. In contrast, the response to the 2022 crisis was significantly slower and less coordinated. Researchers believe the slower response to the 2022 crisis stemmed from the government's efforts to minimize the political cost of the financial crisis and avoid taking responsibility and blame for its consequences. The political anatomy of an economic crisis is important to consider. Following the 2001 economic crisis, the Central Bank was granted institutional independence from the government, a critical reform aimed at limiting political interference, corruption, and malpractice. For the first 5 to 10 years, the Central Bank largely operated autonomously, however, government influence on the bank reappeared between 2010 and 2021. Since 2016, Turkey has had four different Central Bank governors, an unusually high turnover rate that has raised concerns about political intervention. The Central Bank Law explicitly states that the Bank governor may be dismissed only under two conditions: (1) violating specific prohibitions, such as engaging in commerce or holding shares in financial institutions, or (2) being indefinitely incapable of performing duties due to reasons like permanent illness or death. Outside these circumstances, the Law mandates that the governor serve their full term. However, President Erdoğan's dismissal of the two former governors does not align with this law, suggesting that the Central Bank's independence from political actors has been eroded. The erosion of the Bank's independence is illustrative of deeper and far more curious attributes of competitive authoritarian regimes and how they sustain themselves. It can be argued that political decisions were the primary catalyst for Turkey's 2022 economic crisis. President Erdoğan played a decisive role in pushing for interest rate cuts, despite soaring inflation and widespread criticism from economists. A comparative analysis of the role of politics in the two crises suggests that political influence was a key factor contributing to the significantly more severe impact of the 2022 crisis.

The conclusions drawn from this discussion will primarily emphasize how the 2001 crisis reforms were designed with a long-term perspective, focusing on the establishment of strong institutions that could sustain economic stability independently, without requiring continuous government intervention. In contrast, the reforms implemented following the 2022 crisis were largely superficial, lacking the structural depth necessary to address fundamental economic vulnerabilities. The establishment of strong, autonomous institutions capable of regulating and sustaining the economy without government intervention was crucial in building a self-sufficient economic system. By reducing reliance on government intervention and external financial injections, these institutions provided the structural foundation necessary for long-term stability and resilience. This aligns with the core argument presented in "Why Nations Fail" by Daron Acemoglu and James A. Robinson, which is that the key determinant of a nation's prosperity is the strength of its political and economic institutions. They contend that without strong, inclusive institutions to effectively implement policy decisions—no matter how theoretically sound these decisions may be—they will fail to generate sustained economic growth.

Following the 2001 crisis, the establishment of the Banking Regulation and Supervision Agency (BRSA) was essential in ensuring the effective implementation and enforcement of the new legal reforms introduced under the "15 Days, 15 Laws" program. Without a dedicated regulatory body to oversee and enforce these legislative decisions, the reforms wouldn't have been nearly as effective. This highlights a broader principle: regulatory institutions are fundamental in transforming policy reforms into lasting economic improvements.

Furthermore, the response plan to the 2001 crisis included transforming already existing institutions into more inclusive institutions that distribute power broadly instead of centering it in the hands of a selected few. Inclusive institutions are those that encourage widespread political and economic participation, enforce the rule of law, and provide equal opportunities for individuals and businesses to thrive. In contrast, extractive institutions concentrate power and resources in the hands of a select few, limiting economic opportunities and often leading to stagnation and inequality. These terms are most commonly used in discussions about governance structures, particularly in the context of authoritarian regimes or centralized power systems. After the 2001 economic crisis, Turkey underwent a significant transformation from extractive to more inclusive institutions. A clear example of this shift was the establishment of Central Bank independence under the Central Bank Law. This reform allowed the Central Bank to function with greater autonomy by severing direct political influence over monetary policy.

In contrast, the response plan to the 2022 crisis relied heavily on direct government interventions and injections into the economy, rather than the implementation of structural reforms to strengthen economic and political institutions. Even today, the Turkish economy remains deeply dependent on government intervention, particularly through its control of interest rates, currently set at 42.5%. Without this direct support, the economy would face significant instability, underscoring its persistent fragility in the absence of meaningful institutional reforms. The lack of independent economic governance and structural adjustments has left Turkey highly susceptible to external shocks and financial risks, raising serious concerns about the long-term sustainability of its economic model.

Economic systems are inherently complex and involve multiple key players, including the government, households, firms, and financial institutions, all of which interact in shaping economic outcomes. Therefore, an economy cannot achieve lasting recovery solely through top-down policy changes implemented by a single actor – the government. While government-led measures, such as changes in monetary policy and interest rate adjustments, play a crucial role, their effectiveness ultimately depends on how other economic actors respond. When a single economic actor introduces policy changes, it can trigger a domino effect, influencing the decisions of households and firms. In the aftermath of the 2022 crisis, for instance, the government's decision to raise interest rates was theoretically necessary and aligned with conventional economic principles. However, the broader economic context must also be considered. Despite the interest rate being set at 42.5%, inflation remained significantly higher at between 50 to 60% throughout the year. In such a scenario, real interest rates remain negative, meaning that holding money in Turkish Lira still results in a loss for individuals and businesses. To avoid a 20% erosion of their assets, firms, and households continued to store their wealth in foreign currencies rather than benefiting from the government's interest rate scheme. Additionally, foreign currencies offered a higher sense of security to the individual or firm. As a result, the policy failed to generate the intended outcomes. For instance, while the government projected inflation to reach 36% by the end of 2024, the actual reported inflation rate was significantly higher, standing at 44.48%. This discrepancy highlights the limitations of addressing economic crises through isolated policy changes without accounting for the broader institutional and behavioral dynamics at play.

Several economic theories align with and complement the hypothesis of this research paper which is that, as a response to an economic crisis, the government must accompany changes in monetary policy with reforms to institutions that empower society.

The Endogenous Growth Theory by Paul Romer and Robert Lucas suggests that economic growth is driven not just by external factors such as capital and labor but also by internal factors like innovation, human capital, and institutional frameworks. Endogenous growth models stress that investments in education, technology, and institutions are key drivers of long-term growth. Following the crisis in 2022, very few changes were made in the institutions in other sectors, and the government relied mostly on policy changes made by the central bank. In comparison, soon after the 2001 economic crisis, in 2003, Turkey transitioned into a universal healthcare system and implemented reforms in many other sectors, including technology. Reforms in the technology sector complemented the changes implemented in Turkey's banking sector, significantly enhancing its technological infrastructure. Turkish banks now boast one of the most advanced technological systems globally, which played a crucial role in their resilience during the 2022 economic crisis 20 years later.

The Macroeconomic Coordination and Credibility Theory by Barry Eichengreen, and Maurice Obstfeld emphasizes the importance of policy credibility and institutional coordination in maintaining economic stability. It argues that successful macroeconomic policy must be supported by strong, credible institutions that ensure consistency and commitment to long-term objectives. This theory also aligns with the main objective of this research paper, as illustrated above.

The Theory of Economic Shocks and Resilience by Robert Barro focuses on how economies respond to external shocks and the role of institutional resilience in mitigating the negative impacts of such shocks. Resilient institutions, including sound governance, social safety nets, and effective policy implementation mechanisms, are key to reducing the long-term effects of economic crises. he theory directly supports the argument that strengthening institutions is essential in the aftermath of a crisis, as resilient institutions help the economy recover and adapt to new challenges more effectively than relying on monetary policy alone.

Overall, it can be concluded that a successful approach for overcoming an economic crisis lies in 1) timely intervention, 2) minimizing political involvement, 3) the alignment of changes in monetary policy with reforms designed to strengthen the institutions responsible for implementing these measures.

Resources

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