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# Speculation-led growth and fragility in Turkey: Does EU make a difference or “can it happen again”?

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## Abstract

The aim of this paper is to analyze the pattern of speculation-led growth in Turkey. It is dependent on international capital flows, whose continuity becomes more and more critical given the current account deficit, which is estimated to reach 6.1% as a ratio to GDP at the end of 2005. The paper assesses the sustainability of this speculation-led growth in the context of EU enlargement and compares the current state of fragility with former crises in Turkey as well as in East Asia and Latin America. Following a severe financial crisis in 2001, Turkey has entered a new phase of fragile growth led by boom-euphoric expectations. The paper aims at explaining this new phase and the evolution of the risk perceptions of both the creditors as well as the debtors in this “speculation game” based on the post-Keynesian/Minskyan concepts of endogenous expectations and financial fragility.

**Keywords:** Financial fragility, Post-Keynesian, current account deficit, EU enlargement

**JEL-Code:** E12, G15, G32, O52

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# **Speculation-led growth and fragility in Turkey: Does EU make a difference or “can it happen again”?**

## *1. Introduction*

The aim of this paper is to analyze the pattern of speculation-led growth in Turkey. It is dependent on international capital flows, whose continuity becomes more and more critical given the current account deficit, which is estimated to reach 6.1% as a ratio to GDP at the end of 2005. The paper assesses the sustainability of this speculation-led growth in the context of EU enlargement and compares the current state of fragility with former crises in Turkey as well as in East Asia and Latin America. Following a severe financial crisis in 2001, Turkey has entered a new phase of fragile growth led by boom-euphoric expectations. The paper aims at explaining this new phase and the evolution of the risk perceptions of both the creditors as well as the debtors in this “speculation game” based on the post-Keynesian/Minskyan concepts of endogenous expectations and financial fragility.

Recently the continual warnings by the radical political economists (e.g. Independent Social Scientists 2005, Voyvoda/Yeldan 2005) about the widening current account deficit are also shared by the headquarters of the mainstream policies and media, as voiced by e.g. the first deputy manager of the IMF, Anne Krueger, or the Financial Times (Boland 2005), though still not very loudly. Nevertheless, the policy makers pretend to believe that the “success” of Turkey in terms of macroeconomic stability, low inflation, and fiscal discipline has

increased the level of manageable current account deficit. The market players, who had perceived a current account deficit/GDP ratio of 4.9% in 2000 as critical for entering a crisis period, continued to invest in YTL denominated government bonds and stock market shares in 2005. Although everyone would agree that the current account deficit can not increase forever, international institutions like OECD and IMF as well as international investors are hoping that increased investment, which could increase productivity, on the one hand, and a normal slow down in growth in the coming years together with the floating exchange rate regime, on the other hand, will guarantee a smooth adjustment of the exchange rate and the deficit.

Despite its ups and downs, the progress in the relations between Turkey and the EU, and more recently the EU decision to start the membership negotiations, has been perceived as a positive signal in the international markets, contributing significantly to these optimistic expectations. This so-called EU-anchor and the Maastricht criteria, along with the continuing stand-by agreements with the IMF, are believed to be more effective than the former nominal exchange rate anchor, which had led the economy into the 2001 crisis in one year. An important part of this optimism is due to the positive expectations about foreign direct investment (FDI).

This paper questions this optimism from an alternative perspective: EU-wide integration is not a project that aims at overcoming the structural bottlenecks of the Turkish economy. The domination of neoliberal policies reduces the project of integration to the expansion of markets, and to securing the mobility of capital under stable conditions (Becker 2004, Bohle/Greskovits 2005). The management of industrial policy as well as convergence is delegated to the markets and private capital flows. Then a second question comes to mind: Can an economy, which is ruled by the rationale of profit seeking private capital flows, be stable, or is it the logic of those activities that will create a crisis sooner or later within the normal and even successful functioning of the system? Thus, can a crisis happen again in Turkey in spite of the EU-optimism, due to the high current account deficit and the structural problems that are related to it? The second part of the title of this paper is inspired by a similar question, which was asked by Minsky (1982) in the context of US, where he discusses the possibility of recurrence of depression. The Minskyan, and more generally the post-Keynesian theory suggest that

financial markets are prone to speculation and intrinsically unstable. Stable growth phases will cause more risky investment practices, shaky financial structures, and thus boom periods will be followed by a bust. In that respect EU also does not make a difference, and even the more advanced economies themselves are not immune to crisis. This paper attempts to show that the fact that Turkey did manage to live with its current account deficit until today, does not mean that it can do so in the future without facing a major crisis.

The case of the Central and Eastern European countries (CEECs) is an indicator that the process of EU membership has changed little with respect to the fragility of the economies. In a public lecture at the Central Bank of Austria in June 2005 Eichengreen has argued that in his list of countries, where a financial crisis is expected, Hungary and Turkey follow the US closely. Goldstein (2005), an ex-senior staff of the IMF, discusses the possible effects of a slow-down in the US and China on the emerging economies through the contraction in export-markets, the decrease in the risk appetite and increase in the risk perceptions of international investors, the increase in the interest rates, and the decline in the private capital flows towards relatively riskier emerging markets. He argues that emerging economies with high external financing needs, high ratios of short-term external debt, a large share of foreign denominated or foreign currency-indexed debt, weak domestic banking systems would have particular disadvantages, and shows that both Turkey and Hungary are among the most vulnerable countries because of interest rate, capital flows, exchange rate overvaluation, fiscal and monetary policy problems following a crisis induced by global imbalances.

The rest of the paper is organized as follows. Section two defines the generation of cycles of the boom and bust in a speculation-led growth regime from a post-Keynesian perspective. Section three discusses the regime of growth and the structural problems of Turkey, and places the current account problem in a long-term perspective. Section four compares the leading indicators of fragility in Turkey and the CEECs with the values of the same indicators in Asian and Latin American countries before their recent crisis years. The aim of this comparison is to understand the degree of risk as well as the endogenous evolution of expectations. Section five derives the policy conclusions.

## *2. Post-Keynesian perspective: Speculation-led growth*

The post-Keynesian perspective of speculation-led growth following domestic and international financial liberalization is based on the insights developed by Keynes (1936) and then later by Minsky (1982, 1986) on the systemic financial fragility and instability hypothesis. This is an analysis of the boom and bust cycles in the capitalist economies based on the linkages between financial and real variables. Systemic financial fragility develops endogenously out of the normal functioning of the economy. Minsky regards financial markets as intrinsically unstable, which is an outcome of the interaction of the market return (e.g. growth of asset prices) and fragility (e.g. level of indebtedness). If good performance persists, investors become more optimistic and are willing to hold more risky assets or accept higher levels of debt. They engage in speculative financing patterns based on short-term financing of investment projects with long time horizons. In order to be able to speculate, investors invent new forms of credit and ‘kinds of money’ (e.g. junk bonds, growth of derivatives, swaps ...). Thus it is hard to prevent speculation, because the means of financing speculation will change, and money is endogenously generated. This makes the firms vulnerable to credit availability and interest rate shocks, which leads to financial instability. A speculative growth pattern emerges in this process, where the payments of a firm may be larger than its expected income, and the difference can only be met by rolling over debt. In time, when there is a negative shock, and expectations evolve in a pessimistic direction, this fragility leads to a crisis through credit crunch, debt crisis, and bankruptcies. Skott (1995) develops a formal model of Minskyan cycle of boom and bust based on the endogenous development of “fragility and tranquillity.”

Endogenously evolving expectations play an important role in the formation of the financial fragility and the boom-bust cycles. Expectations are formed under fundamental uncertainty about the return/risk profiles of investment. Therefore, rational agents are influenced by conventional wisdom. Keynes himself argued that speculation on the stock markets is like betting on a beauty contest: You try to predict what the majority of people will think. Everyone is trying to guess what everyone else will guess. Thus it’s about investor sentiment, not fundamentals. Conventional wisdom is not only expectations induced

but also competition coerced (Crotty 1993). Competitive pressures among firms or fund managers push them to take similar risks, even when they would rather be more conservative.

Meanwhile speculative frenzy leads to evolving boom-euphoric expectations, increasing the risk appetite of the investors. Thus conventional wisdom is not static. Evaluations about what is reasonable change. Expectations are mutually validated by the actions of market participants, which lead to a self propelling adventurism and financial fragility during good times. As expectations of profits are realized over time, they become more optimistic and more self-confident in reducing safety margins.

It is important to note that the fragility of the system is an outcome of the “success” of the system. The source of the shock, which causes the crash, is not important. It is the built in vulnerability that leads to a significant effect of the shock. Financial fragility leads ultimately to a crisis, and lower rates of real sector growth. But the length and depth of both the boom and bust phases are variant, and not deterministic. It depends on not only the size of the vulnerability and the shock, but also on the evolution of expectations, which are not easy to forecast and quantify.

After crash and crisis, the investors will be cautious again for a while, but eventually after long enough a time has passed, competitive pressures and new search for profitable investment will start a new endogenous cycle of stability, to be followed by instability. The ultimate conclusion of the financial fragility hypothesis is that capitalist market economies cannot lead to stable full employment equilibrium.

Grabel (1995) argues that financial liberalization induces speculation-led growth, risky investment practices, shaky financial structures, and ultimately lower rates of real sector growth than would prevail in the absence of liberalization. In the case of domestic financial liberalization, the first stimulus for the formation of fragility is the increase in the real deposit and loan interest rates, and the deregulation of financial institutions and dismantling government influence. On the supply side, this leads to boom euphoric expectations, increasingly competitive climate, and reduced credit rationing by the banks. On the demand side, higher interest rates and financial returns lead to a shift to financial investments at the expense of physical investments. The quality of the remaining physical investments also deteriorates. Credits with high

interest rates are accepted only by the investors engaged in riskier projects with a higher expected return. It also leads to short-termism in investment decisions under competitive pressures. Even when speculation and increasing financial fragility go along with increased aggregate demand and investment, a speculation-led regime leads to a misallocation of credit to the detriment of long term economic growth. Thus it is “growth distorting” and “resource wasting”, and creates economic interests that are not likely to disappear very easily (Grabel 1995).

Capital account opening adds exchange rate risks to the financial fragility generated by domestic financial liberalization. Based on the analysis of the currency crises since the 1997 Asian crisis, Arestis/Glickman (2002), Schroeder (2002), Foley (2003), Dymski (1999), Kregel (1998), and Isik (2004) have presented a Minskyan analysis of the financial crises in the developing countries. International financial liberalization and capital inflows generate a fragile, foreign debt-dependent, speculative growth pattern. In addition to cash flow and maturity imbalances of the closed economy, another factor that makes this growth pattern speculative and fragile is exchange rate mismatches in terms of cash inflows and outflows of the indebted countries. As capital inflows invite the speculative growth in a country, boom euphoric expectations, conventional wisdom, and competitive international pressures lead to further capital inflows, which in turn cause the appreciation of the local currency and foreign trade deficit. As currency appreciation increases beyond a certain point in order to avoid capital outflow, the interest rate starts increasing to justify higher risk perceptions regarding expected depreciations. This intensifies the debt problem. Finally, the conventional wisdom towards pessimism starts to evolve endogenously; a shock in the neighbour country, in the world economy or in the domestic political or economic system sparks this shift and leads to the reversal of capital flows. In the end an expected depreciation becomes a self-fulfilling prophecy. The resulting debt problem becomes magnified by economic recession and depreciation.



### *3. The regime of growth and structural problems in Turkey*

Turkey has shifted from an import-substituting industrialization strategy to an export-oriented growth regime based on a neoliberal structural adjustment program in 1980. While the first decade of the program was marked by the liberalization of foreign trade along with the deregulation of domestic goods, labour and financial markets, in 1989 started the second stage via the liberalization of the capital account. The attempted integration of Turkey into the EU has also been part of the neoliberal project.

Pro-capital change in income distribution has been the major axis of the post-liberalization structural change. Table 1 summarizes the regime of growth, and the developments in investment, distribution, international trade, and unemployment in the pre and post-liberalization periods<sup>1</sup>. The wage share in value added (which is announced only for the manufacturing industry as a time series) has eroded dramatically and continually during this period. However, this shift has not generated together an improvement in the growth performance of the economy. Growth on average has been not only lower but also more volatile in the post-liberalization era. High growth rates have been followed by stagnation or even major crises, particularly after the liberalization of the capital account. The decline in the wage share, which was shortly reversed during 1989-91, as well as in average growth also have continued after the first decade of structural adjustment programs, mainly but not only due to the major crises in 1994 and 2001. The fall in the wage share has been much deeper than in output during both crises, and has been persistent, continuing for 2-3 years after the crises. Thus both crises have left a “distributional scar” (Diwan 2001), which has been a regularity of the many crisis-hit developing economies (Onaran 2006).

<sup>1</sup> The data for real sector variables are not yet available for the whole 2005, but only for the first three quarters. Therefore we report the figures until the end of 2004.

*Table 1: Growth, investment, unemployment, distribution in Turkey:  
Pre- and post-liberalization*

	<b>1970-1979</b>	<b>1980-2004</b>
<b>Growth of GNP (%)</b>	4.8	4.0
<b>Volatility of growth</b>	0.7	1.3
<b>Investment / GNP (%)</b>	22.9	22.1
<b>Real interest rate of lending</b>	-15.52	13.35
<b>Interest payments/budget expenditures (%)</b>	2.79	19.83
<b>Unemployment rate (%)</b>	7.9	8.0
<b>Manufacturing industry data</b>		
<b>Wage share in manufacturing value added (%)</b>	30.71	20.11
<b>Manufacturing Investment / value added (%)</b>	56.0	25.5
<b>Export / value added in manufacturing industry (%)</b>	7.70	47.43
<b>Import / value added in manufacturing industry</b>	45.11	70.49

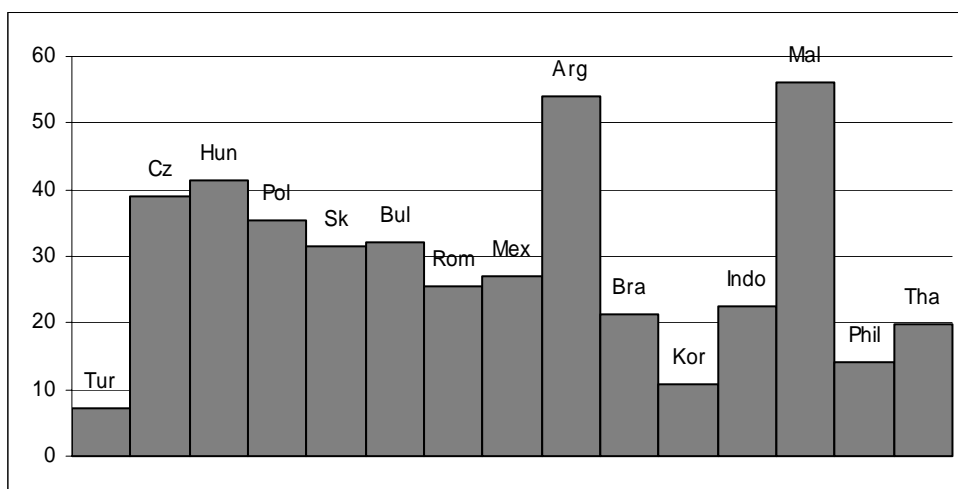
Source: State Institute of Statistics (SIS), and State Planning Organisation (SPO); for wage share SIS and OECD.

The decline in labour costs, the deterioration in the power of organized labour, increased wage and labour market flexibility as well as the opening up to the world economy did not lead to any improvement in the employment creation capacity of the economy, leaving the optimistic expectations of the neoliberal economists unrealized (Onaran 2002). Aggregate employment in aggregate is not responsive to labour costs, but rather to growth, and in particular to the creation of new productive capacity (Onaran/Stockhammer 2005). Table 1 indicates only a slight increase in the unemployment rate in the post-liberalization era; however this is misleading, because the real hike in unemployment has taken place in the urban areas for which the time series data only start in 1988. The urban unemployment rate has increased dramatically during the 2001 crisis, went on increasing the year after the crisis, and has stabilized around this very high rate of 13-14% in the last four years, including 2005. Turkey has been unable to make use of the demographic window of opportunity at a period when its working age population has been increasing faster than the overall population. An important aspect of that is related to the low female employment and labour force participation

rates in the urban areas, which is as low as 19.7% as of September 2005. This is indeed leading to a lower unemployment rate than it would have been, if urban women were participating in the labour market at higher rates; thus it is hiding part of the structural problems in the labour market. The low participation and employment rates of women are not only due to male-dominated domestic division of labour, but also to the working conditions and low wages, which is making most jobs acceptable for only young single women (Baslevent/Onaran 2003, 2004).

The growth rate achieved by Turkey during the post-liberalization era has closely followed the speculative, short-term capital inflows (Voyvoda/Yeldan 2005). Although Turkey championed as one of the highest growing countries in 2004 with a rate of 8.9%, and an expected growth rate of 5.5% in 2005, the continuity of this growth is dependent on the continuity of the capital inflows. In terms of financing the current account deficit and import-dependent growth, short-term credits and to a lesser extent portfolio investment has been important, whereas FDI (Foreign Direct Investment) is of minor relevance. Figure 1 shows the ratio of FDI inward stock to GDP, comparing Turkey with other emerging economies. This ratio is rather low in Turkey (7.3% as of 2004) compared to the IES as well as other Latin American countries like Mexico, Argentina, and Brazil, or Asian countries except for Korea. Even the FDI inflow of 3.2 billion dollars in the 2005 January-October period, which is very high from a historical point of view, is forming only 10% of the total capital inflow in this period. In that respect, Turkey is currently one of the most fragile economies with respect to a change in the risk appetite of the investors, which can lead to an outflow of short-term credits and portfolio investments. This is a point in which the FDI optimists expect that EU could make a positive impact on the fragility of growth in Turkey. However, this is just an improvement in terms of financing the current account deficit, and the long-term problems associated with FDI without a systematic industrial policy remains to be valid, such as increased import dependency, which will be discussed in more detail below.

Figure 1: Inward FDI Stock in relation to GDP (in %) 2004



Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Bul: Bulgaria; Rom: Romania; Mex: Mexico; Arg: Argentina; Bra: Brasilia; Kor: Korea; Indo: Indonesia; Mal: Malaysia; Phil: Philippines; Tha: Thailand  
 Source: Own calculations based on Economic Intelligence Unit (EIU).

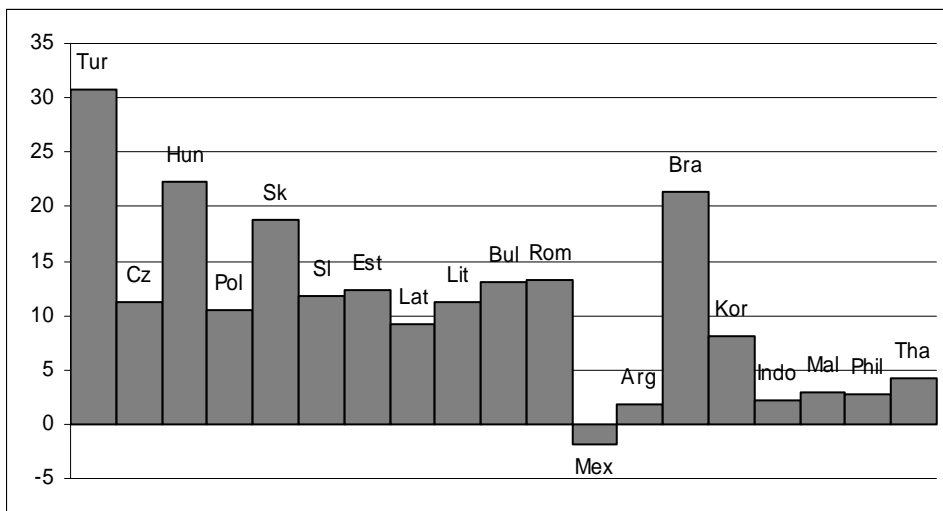
Another important aspect about how the current account deficit has been financed in the last three years is the increase in the net errors and omissions, which reflects the unregistered capital flows. The informal inflows have reached record levels particularly in 2003 and 2005 (January-July), with rates of 62.8% and 35.2% of the current account deficit respectively. This might be related to the inflows from Iraq as well as the reversal of domestic capital flight and a shift of informal foreign-currency savings back to local currency. Whatever the reason is, it is certainly not a continuous and reliable source of finance.

The financial arbitrage or return on government debt instruments (GDI) in dollar terms,<sup>2</sup> which has been the major reason behind the capital inflows has been 32.3 in 2004, and the real GDI interest rate was still 13.1% in spite of the declining trend. Figure 2 compares the financial arbitrage (based on deposit interest rate) across the emerging markets. Turkey has offered the highest return on speculative inflows in 2004

<sup>2</sup>  $(100 * (1 + \text{interest rate on government debt instruments})) / (1 + \text{depreciation rate of the local currency}) - 1$

(30.8%), followed by Hungary and Brazil. Interestingly, most other countries, which have already experienced and learned from a currency crisis, are avoiding high rates of financial arbitrage. The returns on hot money are much higher in the CEECs compared to other emerging economies except for Turkey and Brazil. The arbitrage opportunities together with the optimistic expectations also have led to a high rate of increase in the stock market index in dollar terms in 2004, in particularly in the CEECs, followed by Turkey and Mexico. The critical risk indicators of Turkey and the CEECs seem not to be discouraging for the private short-term profit seeking capital flows, as will be discussed in more detail in section 4.

Figure 2: Financial Arbitrage (in %) 2004,  
 $(100 * ((1 + \text{deposit interest rate}) / (1 + \text{depreciation rate}^*) - 1))$



Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Sl: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania; Mex: Mexico; Arg: Argentina; Bra: Brasilia; Kor: Korea; Indo: Indonesia; Mal: Malaysia; Phil: Philippines; Tha: Thailand

\* % change in exchange rate defined as local currency / \$

Source: Own calculations based on Economic Intelligence Unit (EIU).

The hike in the real interest rates (see Table 1) in the post-liberalization era has offered profitable short-term financial investment opportunities

for not only the foreign investors, but also for the domestic non-financial business as well as banks. The state has been the net borrower throughout this period. The budget deficit of the 1970s, which was a result of the government's cheap supply of inputs to the private business in order to create a national capitalist class, was transferred to the 1980s. In 1980s the state borrowing in order to improve the infra-structure to facilitate the integration of private business into the world economy during the initial phase of the structural adjustment program has worsened the public sector balance. Accumulation of debt through time turned interest costs and the principal payments of the public debt into the major cause of new public borrowing. The share of interest payments in total budget expenditures has increased dramatically in the post-liberalization era (see Table 1), reaching to levels above 40% in the 2000s. This process has turned public borrowing into a mechanism, which transfers tax payments of the wage earners to the capitalists (Yeldan 2001).

In terms of the long term growth potential of the economy and the prospects for investment, this volatile, speculation-led, and pro-capital growth pattern has not induced an improvement in the investment performance of the economy throughout the 1980s and 1990s. Total investment as a ratio of GNP just stagnated on average terms, and in particular the manufacturing investment/value added ratio was halved in the post-liberalization era, as can be seen in Table 1. The export boom in manufacturing (Table 1), was basically made possible by increasing the rate of utilization of capacity generated by the import substituting industrialization, rather than creating new capacity (Senses 1989; Metin-Ozcan et al. 2001, Yenturk 1999, Yenturk/Onaran 2000). In the meantime, the import dependency of the economy also increased, turning current account deficits into a chronic structural problem. The growth regime based on increased capacity utilization rather than new investments has not been helpful in overcoming the structural bottlenecks and climbing up the industrial ladder towards high technology, high value added, high-skill industries (Independent Social Scientists 2005). Turkey is still in the labour intensive, low skill industry segment of the international division of labour, and the EU enlargement is also not a project to change this pattern.

Total investments started to recover in the 1990s after the liberalization of capital accounts. But the effect of capital flows on investment was an indirect effect, mainly through the consumption boom

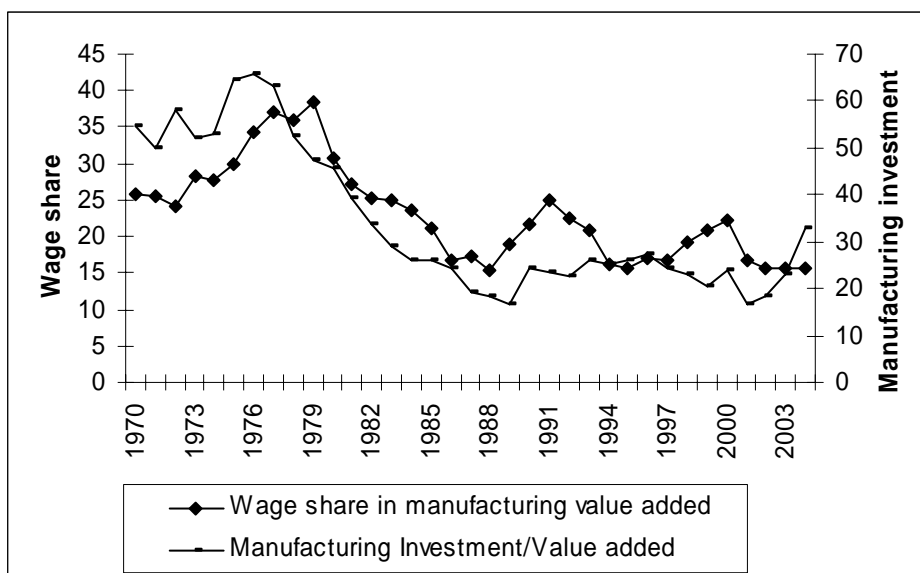
and the appreciation of the local currency, which made capital imports cheaper (Ulengin/Yenturk 2001). Moreover, this recovery was mostly based on investment in the non-tradable sectors, and the increase in manufacturing investment was much slower (Yenturk 1999). The 2001 crisis has been another significant shock to investment.

Until 2000 clearly investment has responded little to pro-capital redistribution of income (Onaran/Yenturk 2001, Onaran/Stockhammer 2005). Following the decline in the wage share (also in unit labour costs), the negative effects of a decline in domestic consumption on investment was barely offset by the positive effects of increased exports and profitability. Based on evidence from the pre-liberalization period as well as from the first two decades of liberalization era, it is clear that investment is not profit-led. However, as can be seen in Figure 3, since the recovery after the 2001 crisis, there has been a speeding up in manufacturing investment, which also continued in 2005 along with the decline in the wage share,<sup>3</sup> which looks like a regime shift towards a profit-led investment pattern, although it is not possible to say how long it would last. Maybe until the next crisis... This new upsurge in investments is financed by short-term private debt and is motivated by the appreciated exchange rate, which makes the imported capital goods cheaper. This invites three sources of fragility: an increasing debt/equity ratio; the financing of this debt by short-term foreign capital, whose continuity is not guaranteed; and the appreciation of the currency, which causes unsustainable current account deficits, prepares the ground for pessimistic expectations, and the reversal of the capital flows. In the 1990s Turkey had faced speculation-led growth with a modest increase in investment rates, which did not help to solve the structural problem of import dependency and current account deficit. Today, in the face of the increase in investment, speculative short-term capital inflows are not perceived as a problem. However history of capitalist development is full of cases of increase in investment based on speculative and fragile financing patterns and over-indebtedness, followed by a crisis. Yes, it “can happen again”. Investment based on cheap currency and dumping labor is not sustainable. Although Turkey is more familiar with the problem of deficiency of productive capacity, over-accumulation may also turn into a problem, particularly when the source of demand is more

<sup>3</sup> The income distribution figures are only available until 2004.

and more dependent on export markets, which makes the economy sensitive to international demand shocks. This is particularly the case at a time when an international contraction in export markets is expected to follow a possible crisis in the US economy. The over-accumulation in Korea was one of the reasons that triggered negative expectations about the sustainability of growth in face of a contraction in world demand in the eve of the Asian crisis.

Figure 3: Wage share and investment in manufacturing in Turkey in % (1970-2004)



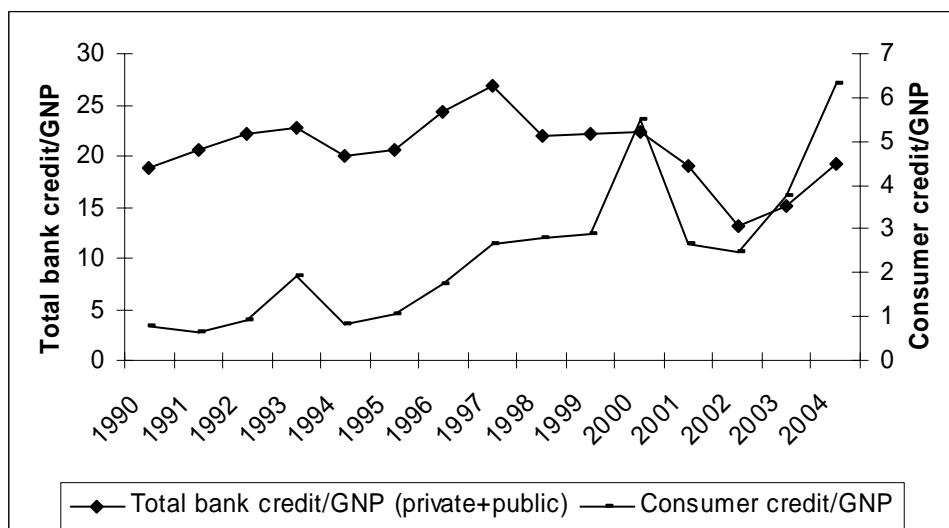
Source: SIS, SPO; for wage share SIS and OECD.

Another source of fragility in Turkey is the increase in household debt. While the total credit/GNP ratio is still not at a high rate, the ratio of consumer credit to GNP has increased from a ratio of 2.5 in 2002 to 6.3 in 2004 – a level even higher than the 5.5% in 2000, before the crisis (see Figure 4). While in 2004 automobile loans were forming an important part of the increase, since 2005 housing loans have been the major source. During the January-November 2005 period, the housing loans surged by 298% in real terms (Yapi Kredi Bank Economic Research Department (YKB) 2005). An important part of the increase in total



investment in 2005 has been due to construction, particularly in housing. Investment in this area could have been socially desirable, but we should also ask who benefits from this housing boom. Without any systematic public housing project, in a country with very unequal income distribution, upper middle class and the new elite are likely to be the segments, which are generating the demand for luxury housing. This debt-led construction boom can lead to an over-accumulation of housing without meeting the requirements of the people in most need.

Figure 4: Total credit and consumer credit in Turkey (1990-2004)



Source: SPO.

The accumulation of household debt is already not free of problems. In the meantime, the past-due credit card receivables as a ratio to total credit stock increased from 4.5% in 2004 to almost 7.5% in September 2005 (YKB 2005). Although this is still below the levels that were reached after the 2001 crisis, the trend is going towards that level rather quickly.

Meanwhile, the stock of the public sector debt as a ratio to GNP has decreased from the record level of 69.2% during the 2001 crisis to 52.3% as of 2004, and although it has continued to decline in 2005 it is still much higher than the pre-crisis level of 29.0%. The development in the foreign debt stock (public and private) with a ratio of foreign debt/GNP

of 54.0% in 2004 is similarly high. However, the decline in foreign debt since 2001 is mostly due to the appreciation of the currency, and the stock itself is still very high and continues to be a big risk factor in case of depreciation. In the meantime, the share of private sector's foreign debt in total debt has increased to 42.2% in 2004 and further to 46.8% as of the third quarter of 2005.

The standard orthodox recipe against all these problems is still inflation targeting and fiscal discipline, ignoring the speed of fragility that is being accumulated in the private sector, based on speculative financing patterns. The public sector has paid back its debt regularly, withdrawing from all its social responsibilities, and obeying the orders of the domestic and international creditors. Basically in the post-2001-crisis period, growth as well as the fall in the interest rate due to lower inflation rates have served this purpose. Excluding the interest payments, the public sector as a whole has achieved a primary surplus of 8.9 % as a ratio to GNP as of 2004. Thus the 4.7% borrowing requirement of the public sector as a ratio to GNP in 2004 was completely due to the interest payments. The emphasis on fiscal discipline under these conditions shows clearly that the government and the international institutions are only interested in the payment of the debt, and are denying the responsibility for any other structural problem.

The expectations of the domestic as well as the foreign investors are not significantly disturbed by these fundamental structural problems, because they are built on short-termism. At the end of 2005, Moody's Investors Service has upgraded Turkey's foreign-currency sovereign ratings based on an evaluation that the political and economic reforms in the past four years have begun to pay off. At the side of the domestic investors, according to the real sector confidence index, after a deterioration at the beginning of 2005, the expectations of the real sector began to improve starting from the second half of the year (YKB 2005). This recovery is an outcome of the recovery in investment expectations, whereas the export prospects are stagnant at the decreased level. Meanwhile, the consumer confidence index has deteriorated more intensively in 2005, and there has been only a negligible recovery lately in this respect. Under these conditions, the realization of the expected profits from the investment projects is becoming riskier.

#### 4. “Can it happen again?”

In this section we will compare the values of some commonly accepted, major leading indicators of fragility and crisis<sup>4</sup> for Turkey and the CEECs as of 2004<sup>5</sup> with the values of the same indicators in ten Asian and Latin American countries before their crisis year (Turkey in 1993 and 2000, Mexico in 1994, Indonesia, Thailand, and Korea in 1996, Malaysia and the Philippines in 1997, Brazil in 1998, Argentina in 2000). The indicators that are discussed below are current account deficit as a ratio to GDP as well as international foreign exchange reserves, short term foreign debt as a ratio to total debt and international foreign exchange reserves, and appreciation rate of domestic currency. The purpose of this comparison is two fold: First, we want to discuss the degree of fragility in Turkey, the new member states of the EU and other candidates in CEE, with an effort to see whether opening up leads to similar weaknesses in all these economies, in spite of the optimism built around the EU membership. Second, we compare these indicators with the cases of earlier crises, to show, on the one hand, how close these indicators are to the ‘red zone’, and on the other hand, that agents’ evaluation of risks do not follow a pre-determined rule of thumb.

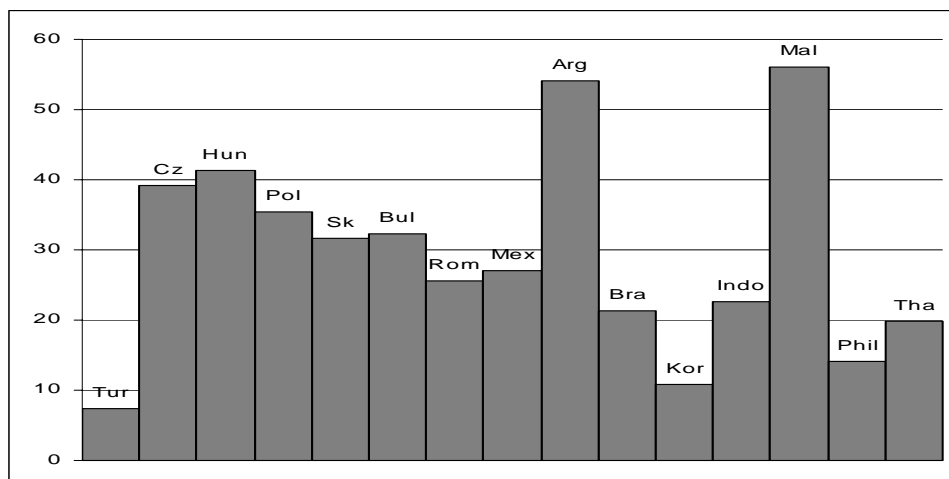
Turkey, along with the CEECs is the only emerging economy that is still suffering from a chronic current account deficit. Mexico also has a deficit, but a rather low one, and all other countries, which have experienced a currency crisis, are now trying to keep their currencies competitive and to avoid a current account deficit. As of 2004, the current account deficit is unfortunately the only criteria, at which Turkey is catching up with Hungary. The estimated current account deficit/GDP ratio is 6.1% in Turkey for 2005 (YKB 2006), and 8.8% in Hungary in 2004. The ironical fact is, that this deficit ratio is much higher than the same ratios in Turkey before the crises of both 1994 (3.6% in 1993) and 2001 (4.9% in 2000). Although Turkey and Hungary are the two extreme examples, Figure 5 shows that the situation is not very relieving for most of the other CEECs as well. The values of the current account deficit/GDP ratio before the crisis in ten other cases of crisis in Asian and

<sup>4</sup> See Goldstein (2005) and Goldstein et al. (2000).

<sup>5</sup> The data for 2005 for our indicators were not available at the time when this paper was written.

Latin American countries are also shown in the graph on the left hand side. Hungary, Estonia, Latvia, Lithuania, and Romania have deficit ratios higher than all the other countries on the eve of their crises, Bulgaria has a ratio higher than in nine cases, Turkey and Czech Republic have a ratio higher than in seven cases of crisis. Even Poland and Slovakia have ratios that could be perceived to be high in the face of a contagion effect following a crisis in the region.

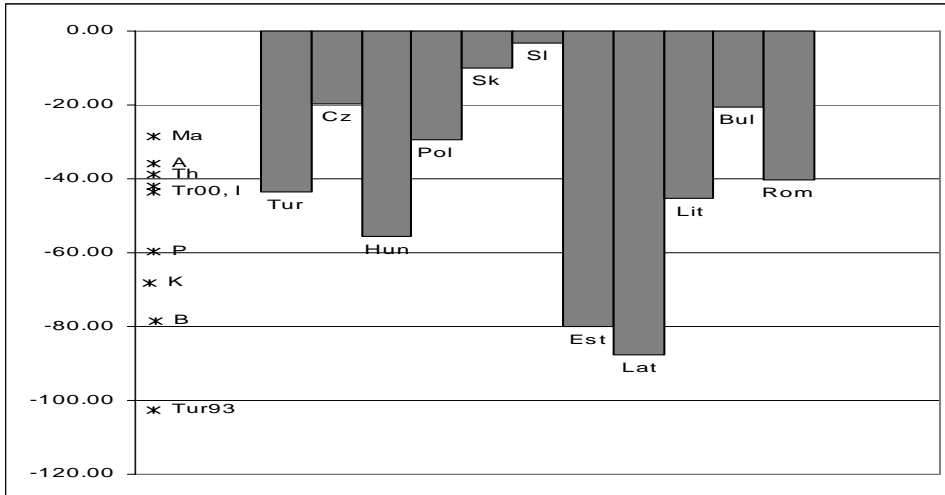
*Figure 5: Current Account Deficit in relation to GDP (in %), 2004 for Europe and crisis years of others*



I: Indonesia 96, K: Korea 96, M: Malaysia 97; P: Philippines 97; Th: Thailand 96; A: Argentina 00, B: Brazil 98; Me: Mexico 94; Tur93 and Tur00: Turkey 93 & 00  
 Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Sl: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania  
 Source: Own calculations based on Economic Intelligence Unit (EIU).

While the ratio of the current account deficit to GDP compares the deficit with the size of the economy, the ratio of the current account deficit to foreign exchange reserves of the Central Bank gives an idea about the ability of the country to finance capital outflow in case of a reversal in the direction of the international flows. In that respect, the picture looks a little better, but not fundamentally different for many countries, as can be seen in Figure 6. Estonia and Latvia have the highest rates. Hungary, Turkey, Lithuania, and Romania have ratios close to or worse than in five of the earlier crisis cases.

Figure 6: Current Account Deficit in relation to FX Reserves (in %),  
2004 for Europe and crisis years of others



Mexico 94 not in graph: -472,5

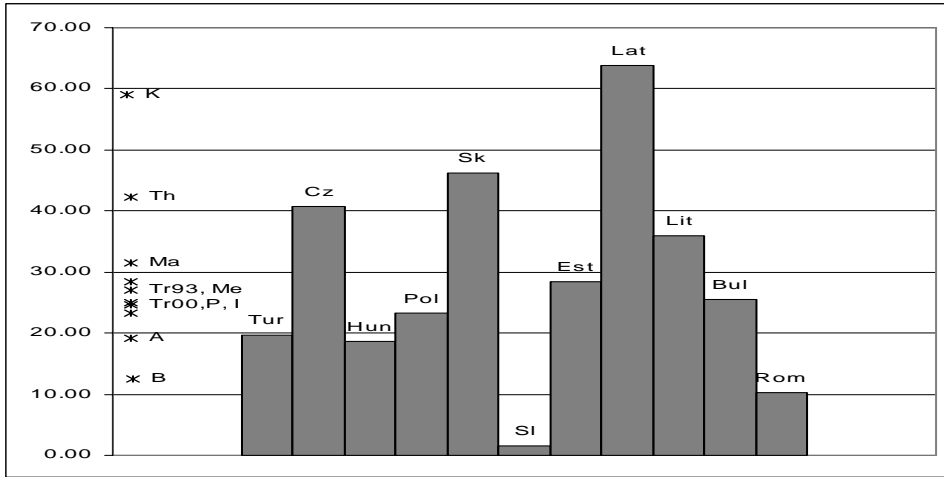
I: Indonesia 96, K: Korea 96, M: Malaysia 97, P: Philippines 97, Th: Thailand 96, A: Argentina 00, B: Brazil 98, M: Mexico 94, Tur93 & Tur 00: Turkey 93 and 00.

Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; SI: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania

Source: Own calculations based on Economic Intelligence Unit (EIU).

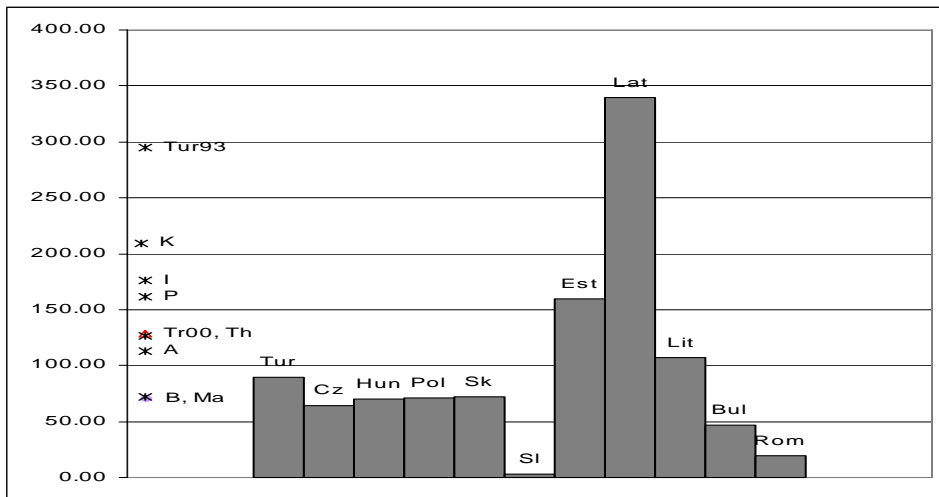
In terms of the foreign debt related risk indicators, the turn-over risk, i.e. the ratio of short term foreign debt in total foreign debt, which can be seen in Figure 7, is highest in Latvia, Slovakia and the Czech Republic reaching or going beyond the ratios in nine former crises. Lithuania and Bulgaria follow them. The ratio in Poland, Turkey and Hungary is just above the ratios in two crisis cases, but are approaching to the critical rate of 25-30% observed in many former crisis cases. To indicate the hardship of the country to finance its short-term debt with its reserves, the ratio of short-term foreign debt to foreign exchange reserves is shown in Figure 8; this ratio is quite high again in the Baltic States, particularly in Latvia. Turkey comes next, approaching the 'red zone' with a rate slightly lower than 100% (89.5%).

Figure 7: Short-term Foreign Debt in relation to total Foreign Debt Stock (in %), 2004 for Europe and crisis years for others



I: Indonesia 96, K: Korea 96, M: Malaysia 97, P: Philippines 97, Th: Thailand 96, A: Argentina 00, B: Brazil 98, M: Mexico 94, Tur93 & Tur 00: Turkey 93 and 00.  
 Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Sl: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania  
 Source: Own calculations based on Economic Intelligence Unit (EIU)

Figure 8: Short-term Foreign debt Stock in relation to FX Reserves (%), 2004 for Europe and crisis years for others

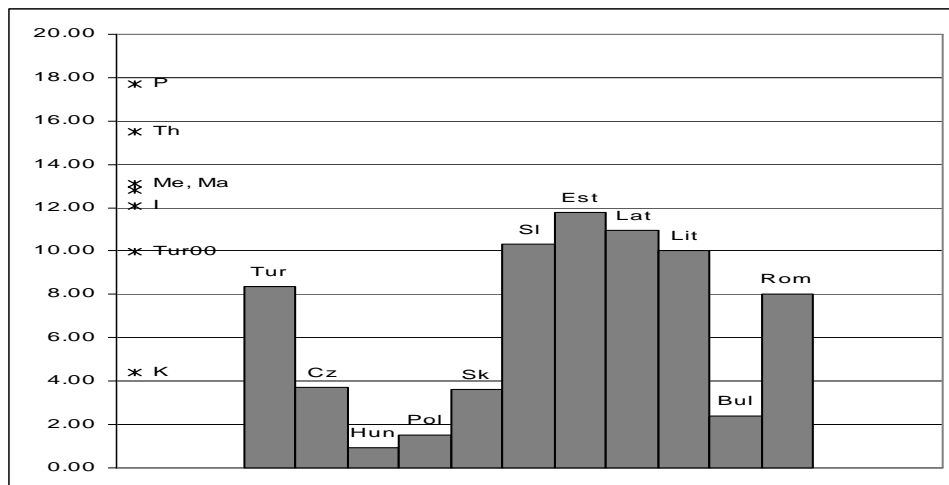


Mexico 94 not in graph: 626%  
 I: Indonesia 96, K: Korea 96, M: Malaysia 97, P: Philippines 97, Th: Thailand 96, A: Argentina 00, B: Brazil 98, M: Mexico 94, Tur93 & Tur 00: Turkey 93 and 00.  
 Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Sl: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania

Source: Own calculations based on Economic Intelligence Unit (EIU).

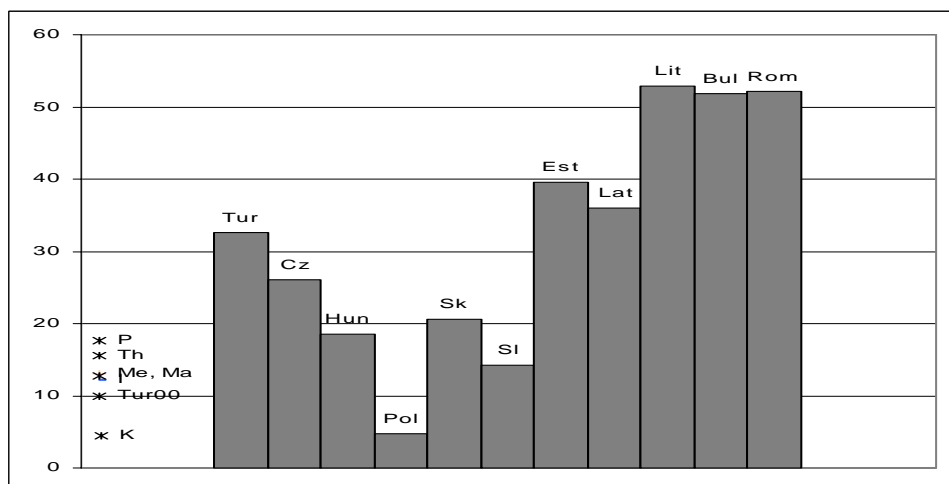
Figure 9 shows the developments in the foreign exchange rate in 2004 and the former crises, which has been an outcome of the capital inflows, and a cause of the current account deficits. An overvalued currency increases the expectations for a correction, since the sustainability of the current account deficit becomes more and more suspicious. Goldstein et al. (2000) argue that real exchange rate overvaluation is one of the best performing leading indicators of a crisis. The appreciation rates in the real exchange rate (trade weighted effective) in the Baltic States and Slovenia in 2004 are already beyond that in the 2000 Turkey crisis. Turkey itself with an appreciation rate of 8.4% in 2004 and Romania are approaching this level. However, in terms of the cumulative appreciation rates with respect to 1995, all countries other than Poland are within or even beyond the 'red zone' of the earlier crisis, as can be seen in Figure 10. It must also be noted that Korea the critical rates can differ significantly even among the former crisis. For example 4.4% of appreciation had been enough in the Korean case under the contagion effect. In Turkey the rate of appreciation since the 2001 crisis has been 43.1% until 2004, which is an alarming signal, even if one accepts that there has been some overshooting in the rate of depreciation in 2001. Figure 11 shows the development of the real exchange rate based on the dollar and euro basket for Turkey since 1987. The exchange rate has achieved its highest over-valued rate of the last two decades, and is at a higher level than before the 2001 crisis as well. Goldstein et al. argue (2000) that given the high current account deficit and the rate of appreciation, it is hard to argue that Turkish Lira is not overvalued.

Figure 9: Appreciation of the real exchange rate (trade-weighted basket, in %), 2004 for Europe and 24 month before crisis for others



I: Indonesia 96, K: Korea 96, M: Malaysia 97, P: Philippines 97, Th: Thailand 96, A: Argentina 00, B: Brazil 98, M: Mexico 94, Tur93 & Tur 00: Turkey 93 and 00. Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Sl: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania  
Source: Own calculations based on EIU. For the former crisis: Uygur (2001), Esquivel/Larrain (1999).

Figure 10: Appreciation of the real exchange rate (trade-weighted basket, in %), 1995-2004 for Europe and 24 month before the crisis for others

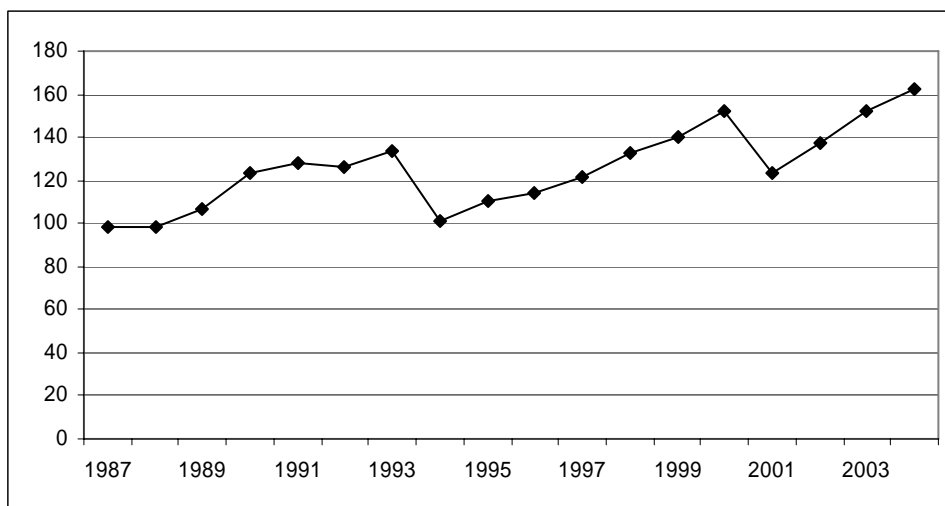


I: Indonesia 96, K: Korea 96, M: Malaysia 97, P: Philippines 97, Th: Thailand 96, A: Argentina 00, B: Brazil 98, M: Mexico 94, Tur93 & Tur 00: Turkey 93 and 00. Tur: Turkey; Cz: Czech Republic; Hun: Hungary; Pol: Poland; Sk: Slovakia; Sl: Slovenia; Est: Estonia; Lat: Latvia; Lit: Lithuania; Bul: Bulgaria; Rom: Romania



Source: Own calculations based on EIU. For the former crisis: Uygur (2001), Esquivel/Larrain (1999).

*Figure 11: Real exchange rate index in Turkey, 1987-2004 (1\$+1.5€, 1987=100)*



Source: SPO.

The relevant question is whether these indicators are above the critical values that would be an invitation to crisis. Dornbusch (2001, cited in Uygur 2001) had argued that the red region of crisis begins with 25% real appreciation and 4% current account deficit/GDP ratio. According to the Sustainable Current Account Deficit indicator of Goldman-Sachs (GS-SCAD), the acceptable ratio to GDP is 2.1% for both Turkey and Mexico (Uygur 2001). According to these arguments the 2001 crisis was to be expected in Turkey. So did something change since 2001? The current account deficit in 2005 and 2006 is estimated to be between 6-6.5% of GDP (YKB 2006). These rates are similar to the alarming US current account deficit ratio. The current account deficit/GDP ratio in Hungary, the Baltic Countries, and Bulgaria and Romania are even higher than Turkey. The Czech Republic and Poland have also ratios higher than 4%. But as of now, the investors' risk appetite does not seem to be disturbed.

This is a clear indicator of changing conventional wisdom in the market. But the question is for how long? The answer depends first on

recent history, and how recently and how badly investors were punished by volatility in the returns, and how long the recent boom has been continuing (Grabel 1995). A dealer cannot afford to be conservative for a long time, since no one can be sure when the accumulated fragility will lead to a crisis. He/she has to follow the conventional wisdom and try to invest the funds as profitable as the other dealers, if he/she wants to keep his/her job. Second, shocks that are not necessarily intrinsic to these economies may play a major role. Thus a postponement of the solution to the US current account deficit will be important for the continuity of the deficits in Turkey and the CEECs.

Currently, the change in the conventional wisdom about the risk perceptions is not really supported by a positive structural change, but it is a response to the so-called EU anchor. This anchor operates through two mechanisms. First, it is a guarantee like the IMF stand-by agreements that the country will stick to liberal policies, fiscal discipline, and will avoid capital controls, which all secure the mobility of capital flight as well as the funds to finance debt payments. The second mechanism is through FDI optimism. The EU anchor, which guarantees the stability of the political regime, property rights, and the markets, is expected to attract FDI, and this is a more secure way of financing the deficit. However, FDI inflow can also be interrupted when the country faces a severe crisis. Moreover, even in the case of FDI there is no empirically validated reason to believe that the structural problems that generate current account deficits will be removed. Quite on the contrary, FDI has been a reason for higher trade deficits. Mencinger (2003) reports that multinational enterprises contributed more to imports than to exports, and the spill-overs from single firms to the sector does not seem to be relevant, which leads to a dual economy with significant productivity differentials. Blaas and Lorant (2006) discuss the current account problem, which comes with enlargement in Hungary. Fillat-Castejon/Woerz (2005) find that the impact of FDI on growth and productivity as such is often weak, and FDI often turns out to be an important contributor to growth in combination with investment or exports. This finding calls for a systematic industrial policy, particularly in the catching-up economies. In the absence of such a policy, EU enlargement has so far led to the “peripheralization” of the CEECs via specialization in low skill, labour intensive industries, and there seems to be no automatic mechanism ensuring that these countries will eventually

climb up the industrial ladder (Onaran/Stockhammer 2006, Ellingstadt 1997, Blaas/Lorant 2006). FDI, which has initially taken the form of privatization, has also destroyed the room for industrial policy in these countries through state enterprises. The privatization of the financial sector and financial deregulation has meanwhile made a selective credit policy harder.

The integration to the EU economic zone creates another source of fragility via the appreciation of the currencies. The first reason for that is the standard boom-bust cycle related with capital inflows. More optimism and capital inflow leads to the appreciation of the currency, which prepares the ground for the reversal of the capital flows. The second reason is the effort of these countries to peg their currencies to euro because of preparing for the entry to the monetary union. But given the productivity and inflation differentials, this process invites real appreciation. If these countries are serious about the monetary union, it will be their last chance for a currency adjustment before they adapt the euro. At this point the international investors are also expected to adjust their risk perceptions. In the case of Turkey, the euro is seen as a far away but desired target in the markets. But many mainstream economists, as well as the central bank itself, argue that the floating exchange rate regime is a flexible and reliable shock absorber. However, given the current rates of appreciation of the local currency in Turkey, it is also not clear why a floating exchange rate regime should prevent hard lending.

These indicators points at the relevance of Minsky's question: Can "It" happen again? The answer of this paper is "yes," although it is not possible to guess when, since the expectations are not simple functions of quantitative indicators, but they evolve endogenously through the course of the history, based on conventions and unforeseeable shocks.

## *5. Conclusion*

The paper shows that in terms of overvaluation of the local currency and the current account deficit as a ratio to GDP or reserves, Turkey as well as some CEECs, in particular Hungary, the Baltic States, Bulgaria, Romania, and the Czech Republic are in the 'red region' of vulnerability, compared with the former values before crises in East Asia, Turkey and

Latin America. The paper also shows for the case of Turkey that this is the outcome of the structural problems of the economy based on speculation-led growth. It is also argued that speculation, and fragile growth pattern is an intrinsic outcome of the market economies.

So the question is what makes this so obvious a fact be ignored by the investors as well as the domestic policy makers and international organizations. At the side of the investors, it is the short-term profit seeking motive that they have to follow, the endogenous evolution of the expectations, and self-fulfilling prophecies. On the side of the politicians, first they try to post-pone a crisis as long as they are in power. Second, the obvious measures like capital controls are not in the interest of the national and international capital that they are representing. Third, in terms of the national and international engagements and the class character of the government, they are not in a position to take a step against the structural problems of the economy that lead to chronic import dependency. This would require a systematic industrial policy, narrowing down the profitable areas of investment and the mobility of the private capital.

The economic policies of the EU will not in itself generate effects that are different from the IMF stand by agreements and the domestic neoliberal policies. They will, on the contrary, make it even harder to implement policies that would limit the mobility and speculative activities of capital.

The policy lesson of this analysis is that markets can not prevent systemic risk, but only postpone it and make it bigger. There is need for a democratic, but yet regulatory intervention to make the economy meet the needs of the people. Only then we can talk of a European enlargement project that can make a difference.

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