Political Economy of Interest Rates and Exchange Rates in Turkey

by

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Abstract

In this thesis, I will apply the literature on exchange rate levels to the case of Turkey between 2011 and 2022. Lira has witnessed a major depreciation in the previous decade and became a severely volatile currency. The Central Bank of the Republic of Turkey (CBRT), under heavy pressure from president Recep Tayyip Erdogan, followed an unorthodox monetary policy by cutting the interest rates despite rising inflation and exchange rates. Several experts have pointed out the mistakes in this policy, showing what CBRT is doing wrong, but there has been a gap in the literature on why this policy is being followed by Turkey. Erdoğan's highly unpopular monetary policy does not comply with the logic of political survival, as defined by Smith and De Mesquita (2003). I will investigate why Erdogan, who has a reasonable likelihood of losing the next elections, insists on this policy despite potential electoral costs. I develop five different hypotheses that might explain why this policy has been stubbornly followed, that might reveal some rational motives of this preference. The thesis reveals that the main aim of AKP governments has been keeping the interest rates low, and that currency depreciation is an undesired consequence of that goal.

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Introduction

Turkish lira has been on a declining trend for more than a decade now. There is a general consensus among academic circles on the reason for this depreciation; AKP's hesitancy to increase interest rates when necessary. Starting from 2021, hyperinflation was added to the problems of the Turkish economy. The empirical puzzle here is AKP's unwillingness to raise interest rates, despite potential electoral costs. Turkey is headed into presidential elections in 2023, and despite major democratic backsliding under AKP; a peaceful change of power is possible. This creates the question of why Erdoğan is so determined to proceed with his low interest rate policy. My goal in this thesis is to provide alternative explanations

It is an accomplished fact that there is a positive relationship between interest rates and exchange rate. A currency would appreciate with an interest rate raise, due to capital inflows it would encourage. Currency depreciation is unpopular among the vast majority of the population, because it causes a decline in the purchasing power of consumers. Yet, keeping interest rates at artificially low levels creates even worse problems, such as currency crises and rising inflation.

Using Öniş's framework, I will investigate the monetary policy making in Turkey based on a clash between two camps within bureaucracy and politics; developmentalists and stabilizers. Developmentalists have been the main advocates of keeping growth rates high, despite the macroeconomic consequences of doing so. They have been in favor of low interest rates and lira undervaluation. Stabilizers, on the other hand, preferred financial stability over monetary expansionism, and aimed to raise the interest rates and control inflation.

I will try to show that the currency depreciation is not simply a result of mismanagement of the AKP government, but it has certain rational motives behind it. At the end of the thesis, I will examine five competing, or complementary, hypotheses regarding the reasons for AKP governments' hesitancy to lower interest rates. Despite the discourses of key government officials, who aim to justify their low-interest policy by arguing that they are following an export-led development strategy by undervaluing the lira, I argue that their main aim is keeping interest rates low, for various reasons. Ensuring credit growth, sustaining short-term economic growth and Islamicizing Turkish economy are some of these reasons. Erdoğan's economic advisors also justify low interest by referring to neo-fisherist ideas.

This thesis contributes to the political economy literature by showing the motivation of governments that have extreme inflationary biases. Erdoğan's referral to Islamic rules about interest might have consequences for all Muslim-majority countries in the world. Thus, if his intention indeed is making Turkey the heart of global Islamic finance, we might see spillover effects in other countries regarding the monetary policy, especially among ideologically similar actors. In the more specific Turkish case, the thesis' contribution is to compare the exchange rate and interest rate based explanations of the AKP's monetary policy. The contribution I make is to argue that low interest rate is the main preference, and that high exchange rate and inflation rate are undesired consequences that are nevertheless sacrificed for the low interest rate goal. I also tried to make a sectoral and interest group based explanation of the monetary policy preferences, which is a novelty about the issue.

Literature Review: four branches of literature

Exchange rate, growth and inflation

Despite its harms, undervaluation of a currency is generally seen as positive for a country's development. Rodrik (2008) says that undervaluation is correlated with higher growth especially among developing countries, as it increases the profitability of the manufacturing sector. Undervaluation causes a decline in purchasing power, raises the price of foreign inputs and increases the burden of foreign credits. Yet, it makes domestic firms more competitive in international markets and contributes to consistent and strong economic growth. It also leads to growth through increasing aggregate investments by reducing real wages (Levy- Yeyati et al, 2013). The benefit of undervaluation is not only high growth, but also high growth on a more sustained basis (Berg et al, 2012). It decreases unemployment by lowering the cost of labor (Frenkel & Ros, 2006). It lowers the risk of financial crises (Reinhart & Rogoff, 2009). Undervaluation causes a country to give positive trade balances on a sustained basis, which in turn causes stable growth rates and resilience against financial crises (Acemoglu et al, 2003). Surjit Bhalla (2012) argues that a currency undervaluation strategy is not the same as export led growth strategy, as currency undervaluation not only aims at the exports sector, but rather it has positive effects for the whole economy (Bhalla, 2012, 23). He points out that there is a negative correlation between acceleration in per capita income growth and currency valuation. He claims that currency devaluation leads to increasing flows of investment and productivity growth, which in turn causes higher growth rates (Bhalla, 2012).

However, inflation emerges as an important variable as well. By increasing the cost of imported inputs and foreign loans, depreciation causes an increase in consumer goods prices, especially in the short run (Leigh & Rossi, 2002; Campa & Goldberg, 2015). Depreciation might affect prices to varying degrees, thus there are different pass-through effects. Pass-through is defined as the effect exchange rate has over inflation. Firms that import more inputs, have more foreign loans, and have lower labor/capital ratios, would face higher pass-through effects. Consequently, these firms need to raise their prices at the rate of depreciation.

Nevertheless, currency depreciation does not always lead to inflation. Many countries succeeded in defending low inflation rates after currency depreciations, such as the UK and Sweden. So, it is possible to lower the pass-through rate, and it has been declining indeed (Marazzi & Sheets, 2007; Ihrig et al, 2006). These used to be mostly developed countries, but Frankel, Parsley and Wei (2012) defend that pass-through rates have been declining among developing nations as well. Mishkin (2008) argues that pass-through rate would be lower in settings where monetary policy is more stable and predictable. Many (Taylor, 2000; Choudhry & Hakura, 2006; Frankel et al, 2012) argue that pass-through would be high where there is high inflation and exchange rate is volatile. Firms in high inflation settings respond more to cost changes, because they expect the monetary shocks to be more persistent. Thus, pass-through would be higher in countries with higher inflation.

Goldfajn and Werlang (2000) argue that real exchange rate misalignment is the most important determinant of inflation in developing countries. Having home inflation is equivalent to the appreciation of home currency vis a vis the trading partner. Both domestic price levels and nominal exchange rate affects real exchange rates. Therefore, real exchange rates matter (Frieden, 2014).

Exchange rate level

“The exchange rate is the most important price in any economy, for it affects all other prices” (Frieden, 2014).

The political economy literature on exchange rates focuses on two main issues; the level of exchange rate and the exchange rate regime. For both of the issues, there are various interest groups based explanations for the employed exchange rate policy. Frieden (1994) argues that tradable producers prefer an undervalued currency, whereas non-tradable and services sectors, mainly the financial industry, demand overvaluation. Non-tradable producers prefer appreciation, because it raises the relative price of their products and often causes the prices of the services sector to rise first (Frieden, 1994). Tradable producers demand depreciation at the expense of the consumers, whose purchasing power declines (Copelovitch & Pevehouse, 2013). Thus, depreciation is often a politically costly decision. Frieden (2014) argues that the more sensitive the incumbents are to voter demands, the more they would be inclined to appreciate the currency.

Many scholars (Bonomo & Terra, 2005; Frieden, 2014, Steinberg, 2015; Huang & Terra, 2016) argue that share of manufacturing in an economy is a strong determinant of exchange rate level. The share also affects electoral cycles of exchange rate. They write that in Asian countries, where manufacturing has a higher share, governments often depreciate the currency before elections, because the median voter benefits from depreciation. Whereas in Latin America, where the manufacturing sector is weaker, incumbents appreciate the currency, since the median voter does not work in manufacturing, and thus demand an increase in his purchasing power (Bonomo & Terra, 2005; Frieden, 2014). De Carvalho Filho and Chamon (2008) claim that Latin American countries often have biases toward currency overvaluation, due to its expansionary effects on domestic purchasing power. The price effects of appreciation are often pro-poor, because tradable goods (mostly food) have a higher share in the consumption baskets of lower income households (de Carvalho Filho & Chamon, 2008). Currency depreciation, on the other hand, disproportionately harms the poor, especially in trade dependent regions (Steinberg, 2021). Higher inflation and higher unemployment rates are frequent consequences of depreciation and they often harm the poor.

Among tradable producers, Frieden (1994) introduces the factor of product sophistication. Standardized goods' producers, some manufacturers and farmers, demand undervaluation, because price is their only way of competing. On the other hand, the producers of differentiated goods, which are often the most important firms, are less affected by exchange rate level. They seldom demand depreciation, but rather stability.

Steinberg and Malhotra (2014) write that the regime type is also important for the level of exchange rate. Democratic regimes have larger selectorates. Governments in democracies seek to receive the support of as many people, or the median voter, to remain in power. Thus, these regimes often overvalue their currencies to boost their electoral support. Autocratic regimes that have smaller selectorates are not bound by electoral pressures, so they have more freedom in implementing an undervaluation policy.

In his book, Steinberg (2015) argues that protectionism benefits concentrated and well-organized interest groups, and the beneficiaries of protectionism are stronger than the losers. Benefits of overvaluation are more evenly spread in the society, making it less visible. This creates a puzzle, because the majority of developing countries goes against strong interest groups and prefers to appreciate their currencies. Steinberg answers this puzzle by stating that special interests are context dependent. Undervaluation often has negative effects on powerful interest groups in the short run. Banks and construction companies oppose undervaluation because it makes it harder for them to pay foreign loans and buy imports. It might also harm manufacturing companies for the same reasons.

He thinks that the design of national labor and financial institutions affects the exchange rate level. State controlled finance and labor systems cause undervaluation, because these are the two main groups that bear the costs of it. Manufacturing sector prefers undervaluation when there are state controlled labor and financial systems. State control over the financial system allows firms to receive cheap credits, thus keeping borrowing costs checked. The lack of state control over labor would result in wage increases after depreciation; state control prevents this (Steinberg, 2015).

Walter (2008) argues that balance sheet considerations also play an important role in firms' exchange rate preferences. Actors prefer exchange rate stability when their perceived vulnerability to depreciation is high. They support depreciation when their vulnerability to monetary tightening exceeds their vulnerability to depreciation. Firms that extensively borrow from abroad, and that import primary and intermediate goods, would have less appetite for undervaluation even if they export.

Forbes (2002) shows that commodity firms have higher productivity and profitability immediately after devaluation, compared to their competitors. He then argues firms with higher labor/capital ratio benefit more from undervaluation. This is because labor is priced in domestic currency, while capital and inputs are priced in dollars. In the short term, devaluation causes a decline in labor costs. But in the long term, it causes the cost of capital to rise, which might outweigh the benefits of cheap labor, especially if the labor/capital ratio of the firm is low (Forbes, 2002). Frieden (2014) makes a similar claim, by writing in sectors where exchange rate changes have a limited effect on prices, thus little pass-through, firms would be less inclined to demand depreciation.

Exchange rate regime

The discussion about exchange rate regimes mostly hovers around the trilemma. Trilemma entails that under free market conditions, a country must choose between monetary autonomy and currency stability. Non-tradable producers prefer autonomy, as currency stability is mostly irrelevant for them whereas the financial sector often cares more about stability than the level (Frieden, 1994). Another factor is the degree of internationalization. Firms with strong international ties, that trade and invest internationally, often prefer stability over level (Frieden, 1994; Steinberg & Malhotra, 2014). Firms with domestic interests, on the other hand, don’t have such a preference, and the latter often outnumbers the former (Steinberg & Malhotra, 2014, 504).

Regimes with broader selectorates, democracies and civil dictatorships, often prefer monetary autonomy over fixed exchange rates, because the median voter prefers the former (Bearce & Hallenberg, 2011).

Steinberg and Malhotra (2014) offer two variables to explain exchange rate regimes: size of the selectorate, and tenure security of governments. Selectorate is defined as those that select the policymakers; its size implies how inclusive it is. Tenure security is the possibility of the incumbent government losing power through regular mechanisms. They argue that since undervalued currencies are usually painful in the short term, it would be popular among monarchies and civilian dictatorships compared to military dictatorships and democracies, thus regimes with smaller selectorates (2014).

Frieden, Leblang and Valev (2010) make a distinction between firms that prioritize stability and firms that prioritize undervaluation. Firms that borrow from, and invest in foreign countries, demand fixed rates for greater certainty. Thus, open economies often have some sort of a fixed exchange rate. Duckenfeld and Aspinwall (2010) study the case of Britain and argue that firms that trade with the EU favor a fixed exchange rate, and other firms do not have such a preference.

Aklin, Arias and Gray (2022) claim that many people understand currency politics through the lens of inflation. People who are concerned with inflation often support fixed exchange rate regimes. Benefits from price stability often overweigh the benefits of floating exchange rates for consumers. The positive effects of depreciation would not be realized if the government has little credibility. The relationship between trade preferences and exchange rate preferences might be broken in the presence of inflation (Aklin et al, 2022). They also discuss that there is a positive correlation with inflation concerns and opposition to currency depreciation.

Mechanisms: how governments affect exchange rates

Steinberg (2015) writes that governments value exchange rates by intervening in foreign exchange markets, altering interest rates, changing tax rates and government spending levels, and regulating international capital flows. Central banks can keep exchange rates undervalued by buying foreign currency, by selling bonds. Higher interest rates often lead to overvaluation, by attracting foreign investments and causing the relative value of the currency to rise (Quinn et al, 2017). Putting restrictions on capital inflows might be another way, because capital inflows appreciate domestic currency (Steinberg, 2015).

In another paper, Steinberg and Shih (2012) claim that tradable industries do not always prefer an undervalued exchange rate, but do so when they don't get enough compensation, so undervaluation is a policy of last resort. They argue that interest groups have a major influence in authoritarian regimes, and that authoritarian governments often adjust exchange rates according to their interests. Nevertheless, they argue that exporters may benefit more from targeted commercial policies like export subsidies and preferential loans. Because manufacturers also care about exchange rate stability, as well as domestic purchasing power. Steinberg and Shih (2012) show that even in countries like China, where the state is often known to have high autonomy, strong interest groups like exporters find mechanisms to influence government policy.

Steinberg (2016) argues that state banks reduce the costs of undervaluation, thus support for undervaluation increases with the presence of state banks. He shows that workers and non-tradable sectors are often harmed by undervaluation, and its damages might be higher than its benefits for manufacturing firms in some contexts as well. Undervaluation increases the costs of foreign inputs, and it takes time for the firms to adjust their sales and prices. When state banks become important, they lobby for undervalued currencies. State owned banks cause benefits of undervaluation to overweigh the losses by giving cheap credits to the manufacturing sector (Steinberg, 2016).

Most recently, Steinberg (2022) argues that both sociotropic and pocketbook theories of voting would expect a decrease in support for the incumbent, in the case of a currency crisis. He claims that pocketbook theories expect this result, because currency crises reduce purchasing power by raising inflation, raise unemployment rates, and lower growth rates. Then he states that regions that are more dependent on international trade are affected more severely from currency crises, as depreciation causes more inflation, through higher pass-through rates. Low income voters are particularly harmed by currency crises, because they spend more on consumer goods (Fajgelbaum & Khandelwal, 2016). Another reason is that low income voters are damaged worse from job market consequences.

Good and bad monetary policy

A good economic policy would be expected to result in price stability, higher employment, and higher economic growth. Monetary policy is one of the tools to achieve these goals. Yet, the success indicator of monetary policy has often been limited to low and stable inflation, for instance by the IMF (2016). Influenced by such ideas, many countries, including Turkey, defined inflation targeting as the main objective of their central banks.

Yet, as Friedman (1968) implies, monetary policy-making might not be purely a technocratic issue. He argues that attempts at bringing inflation down might result in a surge in unemployment rates. Contractionary monetary policy causes interest rates to rise, resulting in many job losses. Thus, we can argue that there is a tradeoff between low unemployment and low inflation, and that the monetary policy is ultimately political. Governments might prioritize growth, inflation targeting and employment creation, all of these priorities would have different societal beneficiaries and losers.

Therefore, I will argue that the Turkish case cannot be solely understood from a good policy-bad policy dichotomy. Using a political economy perspective, I will claim that there are different societal actors in action, and the AKP's monetary policy cannot be understood independently of these actors. Understanding the state-business relations in Turkey and the clash between stabilizers and developmentalists, would be essential to further this point.

The Case of Turkey

Turkish lira has depreciated sharply in the last ten years. The main reason behind this is believed to be the monetary policy of the Central Bank of Republic of Turkey (CBRT), influenced by President Recep Tayyip Erdoğan's ideas about interest rates. Erdoğan claims that interest rates and inflation are positively correlated, thus, in order to reduce inflation, the CBRT should cut interest rates (Hoffman, 2021). He imposes this unorthodox view on CBRT governors as well. CBRT governors are either encouraged to cut interest rates, or forced to resign. This has caused many CBRT governors to keep the interest at artificially low rates, or to resign. As a result, the current policy rate remains at 14%, whereas the official inflation rate recently reached 70% (BBC, 2022). This leaves us with an unusual real interest rate of -56%.

The Economist's Big Mac Index aims to determine whether a currency is undervalued by comparing Big Mac prices in the base country, and the compared country. According to the most recent report, Turkish lira is the second most undervalued currency in the world, as Economist calculates that it is 67.9% undervalued against the US dollar (The Economist, 2022b). The index shows that Turkish lira is increasingly undervalued against the US dollar since 2011, the last year it was overvalued.

Turkey emerges as a deviant case in terms of its monetary policy, having very low real interest rates, a highly depreciated and volatile currency, expanding current account deficit and declining foreign exchange reserves, defined by slumpflation by many (Öniş & Kutlay, 2021). Such developments are met with confusion by economists (Goujon, 2018). The decline in the value of

Turkish lira was particularly striking; between 2011 and 2022, the US dollar appreciated 722.42 % against Turkish lira (Figure 1).

Moreover, it creates a puzzle for political scientists as to why this policy is being followed, despite its potential electoral costs. Steinberg's (2022) research on Turkey shows that currency crises reduce average citizens' support for the incumbent. He estimates that 6.6% depreciation resulted in a 1.6% decrease in government approval, and reduced the probability that an individual intended to vote for the government by 7%. These effects were stronger in more trade-dependent regions, but the effect extends to all regions.

Historical context

Export-oriented industrialization is not a novel phenomenon in Turkey. Starting from February 1980, consecutive Turkish governments aimed to bolster Turkish industrialization and economic development through exports (Güvercin, 2020). Firms were incentivized to export more through subsidies, export credits and devaluations. Lira appreciation, increasing wages and the rising share of non-tradables halted this process in the 1990s.

After the IMF backed reforms in 2001, the new regulatory neoliberalism (Bakir & Öniş, 2010), as well as lower political risks due to democratization, allowed some increases in exports. Nevertheless, exchange rate appreciation, import dependency, construction-based growth, and the continuing rise of the non-tradable sector prevented a return to export-oriented industrialization.

AKP's persistent electoral support might be attributable to its economic performance, helped by global liquidity (Öniş, 2012). The party broadened its electoral base by introducing new redistribution mechanisms, allowing them to win over the urban poor. This implies that AKP built its electoral support on outcome legitimacy.

State-business relations

The state has always been more autonomous in Turkey (Öniş, 1992), compared to European countries. This can be attributed to the extensive centralization, and lack of a vibrant civil society in the Ottoman Empire. Starting from the late Ottoman era, successive governments realized the need to create a national bourgeoisie, a Turkish business class. Political economy literature in Turkey mostly focuses on this process, how the state created and shaped business groups. The AKP created a loyal business class as well (Esen & Gümüşçü, 2017), by punishing dissenters and awarding loyalty. Yet, this does not mean that the relationship is one way, business groups increasingly affect politics as well. The relative moderation and liberalization of AKP's policies in the early 2000s are attributed to the interests of the rising Islamic capital (Gümüşçü, 2010). Yağcı (2021) states that Turkey is unique among state-permeated capitalisms, due to the presence of strong business associations that are influential political actors. Thus, despite displaying a significant amount of autonomy, the Turkish state is not immune to interest group politics.

AKP's ascend to power, and its persistence in government, cannot be understood without reference to its relationship with certain business groups. Islamic business associations, MÜSİAD being the most important among them, developed in parallel to political Islamist

National Outlook movement in Turkey. These associations have been part of AKP's electoral coalitions since the beginning (Buğra & Savaşkan, 2014). In fact, they were not only passive supporters, but they also contributed to the transformation of the National Outlook movement from Islamism to conservative democracy by supporting the reformists, which founded AKP (Tok, 2015). The traditionalists in the movement were in favor of a statist economic model, whereas the reformers were in favor of an export based open economy. Tok (2015) argues that MÜSIAD supported AKP due to its economic liberalism.

AKP used economic policy mechanisms to support loyal business groups, and the preferences of these groups shaped AKP's economic policies (Dorlach & Savaşkan, 2018). Yet, MÜSİAD has always been critical of AKP's relationship with the IMF and other Western financial institutions, being against Turkey's membership to the EU as well. Instead, MÜSİAD prefers regional integration, or integration with East Asia, favoring their development strategies (Buğra & Savaşkan, 2012; Tanyılmaz, 2015). For them, the government should bargain more with the real economy, regardless of IMF's demands, and that the regulation of the financial sector should be in line with the needs of the real sector. MÜSİAD was also more critical of independent regulatory institutions and regarded that they should be more accountable (Öniş, 2004). On the other hand, TÜSİAD always kept an ideological distance with AKP. TÜSİAD is the association representing secular big business interests (Öniş & Türem, 2001). Despite being affirmative of the AKP's economic performance in its early years, it has never been part of the coalition.

Against the "secular" big business groups, AKP sought to establish a loyal business class. Esen and Gümüşçü (2017) identify three mechanisms of this process; public money has been shifted toward these crony firms, they were favored in privatizations of state owned enterprises, and they received private capital that were transferred from disloyal groups. They also show that loyal companies in construction, mining, health and energy sectors were assisted by the government to capture a greater amount of public rent.

Despite arguing that the government is the more influential actor in this process, Kimya (2018) acknowledges the presence of rent seeking and state capture in Turkey, calling it cronyism. He argues that while fighting petty corruption, AKP gave way to grand corruption, which is cronyism. Kimya (2018, 368) identifies a group of mostly construction firms that grew due to grand corruption. In his research, Gürakar (2016) shows that the vast majority of these new companies are either owned by AKP politicians themselves or their relatives, or by those that have informal ties to AKP politicians. The unwillingness of the AKP to reform the opaque nature of political party finances implies that the party has a certain relationship with these business groups (Kimya, 2018, 369), or they are intertwined through family and other informal relationships.

Ocaklı (2018) states that recently there has been a pattern of growing state-business collaboration, and blurring of the boundaries between the two. He argues that AKP has two motivations in doing so, generating resources for its populist policies and capital accumulation for construction companies. Karatepe (2016) identifies the reason behind the clientelistic relations between AKP and certain construction companies as expanding the financial base of the party. Esen and Gümüşçü (2021) argue that the triangular relationship between AKP, certain businesses and the urban poor, contributed to the resilience of the party. AKP is dependent on businesses for allocation of goods to the urban poor. Businesses are dependent on AKP through public procurements, construction permits, cheap credits and tax reasons. The urban poor are dependent on both of them for social services and charity. Esen and Gümüşçü (2021) argue that the partisan allocation made these groups dependent on AKP, as they fear a future redistribution in the case of a government change. This caused the collapse of Turkish democracy.

Although historically state has been the dominant actor in state-business relations in Turkey, business groups are becoming increasingly powerful. They lobby and bargain through powerful business associations, and aim to shape government policies. One recent novelty under the AKP rule has been the blurring of boundaries between politics and business, as many businessmen join politics in the ruling party, and vice versa. AKP's triangular electoral coalition between loyal businesses and the urban poor might explain their electoral resilience, despite deteriorating economic performance.

The construction industry

AKP relied on the construction sector to provide short-term growth, which implied lower interest rates and easier access to credits (Dorlach & Savaşkan, 2018; Karatepe, 2016). Besides, cheap housing policy has been one of the driving forces of support for AKP (Ocaklı, 2018). Owning a house also increases life satisfaction, and encourages further consumption. Finally, as a labor intensive sector, construction provides employment (Yeşilbağ, 2016). This pro-short term growth stance was supported by MÜSİAD, the Anatolian business association, and criticized by TÜSİAD, the secular capital (Yağcı, 2019). The growth coalition, as defined by Yağcı (2019, 762), explains how interest groups influence monetary policy making in Turkey. Two actors of this coalition, AKP and certain businesses have shared goals of short-term development and are mutually dependent. AKP relies on growth due to its output legitimacy, while businesses rely on the construction sector for short-term gains. Thus, although it is not clear how exactly these businesses influence government policy, I argue that both components of the coalition share the same objectives and rely on each other for their survival. Yet, business groups might be the primary actor here, as they lobby AKP to take increasingly unpopular economic actions. Cheap and easy credit demands of the construction sector caused AKP to reduce real interest rates, which in turn caused a tumbling inflation and a currency crisis.

For the construction industry, the main aim is to lower interest rates rather than exchange rates. Lower interest rates allow construction firms to receive cheaper credits, and stimulate the housing sector as consumers receive housing credits. In fact, currency depreciation harms the construction sector by raising the prices of their imported inputs. The Turkish Contractors Association occasionally calls for the government to pay their exchange rate based losses (Bal, 2022).

AKP governments strengthened TOKI (Housing Development Administration of Turkey), by giving it a privileged status. The enormous housing projects started by AKP governments created enormous opportunities for construction companies (Karatepe, 2016). But TOKI not only provides cheap housing, but also collaborates with private companies in more luxury apartments, in TOKI owned lands. In return, AKP buys the loyalty of these companies, and receives electoral support by supplying cheap housing (Ocaklı, 2018).

The capital inflows and the overvalued exchange rate in the 2002-2007 era allowed the construction industry to boom by receiving cheap foreign credits (Karatepe, 2016), and importing inputs at convenient prices. After the currency crises, the construction based capital accumulation regime required interest rates to remain low at any cost (Yeşilbaş, 2016), as the construction companies became dependent on domestic credits. Thus, exchange rate depreciation deprived the industry from its cheap credit and input sources, and they started to rely extensively on domestic credits.

The construction sector seems to occupy a special place for AKP leaders, due to its vanguard role in the high growth rates reached in the early years of the party. The sector is still seen as a necessity for ensuring high growth. Construction sector often demands lower interest rates, while opposing exchange rate depreciation.

Interest groups and rent seeking

One of the main advocates of Erdogan's monetary policy has been the small and middle sized businesses. SMEs in Turkey, represented by the Union of Chambers and Commodity Exchanges of Turkey (TOBB), constitute 64.5% of the total turnover of the enterprises, 56.3% of the country's exports, and 73.8% of its workforce (TOBB, 2020). Only 12.4% of the enterprises are in the manufacturing sector, and they employ 23.4% of the employees among all SMEs. The rest are mostly non-tradable producers. Thus, the majority of the SMEs would have no reason to support depreciated exchange rates. Majority of the country's exports are realized by SMEs, but among them, only 31.3% of the exports are realized by the industry sector (TOBB, 2020). The share of exports of SMEs in total Turkish exports only accounted for 31.1%, the rest was mostly trade exports. Thus, despite employing the majority of the workforce and realizing most of the exports, SMEs do not represent the major industrial exporters of the country.

In 2019, TOBB president Hisarcıklıoğlu stated that high interest rates are the main obstacle before production and investment (TOBB, 2019). Hisarcıklıoğlu praises Erdoğan for his bold moves in cutting interest rates and states that they are monitoring the situation with pleasure. Yet, he claims, not even the current rate is good enough and there needs to be further cuts to ease financing for firms.

The tourism sector is claimed to be another beneficiary of depreciation, as a cheaper Lira would make Turkey a more attractive option for foreign travelers. Before the pandemic, in 2019, tourism revenues constituted almost 4% of the GDP, and Turkey received 45 million foreign tourists, making it the sixth most popular tourist destination worldwide (Çelgin et al., 2021). Çelgin, Gökcü, Gül and Kazdal (2021) argue that a 10% increase in tourist inflows increase GDP by 0.7%. A higher exchange rate stimulates demand for tourism and increases the revenues of the tourism sector (Arslan & Çetiner, 2020). On the other hand, this makes it harder for Turkish travelers to go abroad (Tuncer, 2021).

The Turkish Assembly of Exporters (TIM) also expressed their satisfaction with the interest rate cuts. TIM president Gulle stated that lowering interest rates would stimulate exports and the real economy (Turkiye İhracatçılar Meclisi, 2021). In an article published by TIM, economist Emre Alkin argues that lowering interest rates would contribute to growth by lowering the credit costs (Alkin, 2020).

Yet, construction is arguably the most rent seeking sector in Turkey. Among ten companies in the world that get the most public tenders, five of them are Turkish construction companies (IndyTurk, 2020). Construction industry is mostly interested in lowering the cost of credits rather than depreciation. Cheaper housing credits often enable higher real estate sales, thus boosting the construction industry. The Association of Housing Developers and Investors cheered Erdogan's decision to cut interest rates, as it would stimulate the real estate market (BloombergHT, 2021). The interest cut was only for first hand real estates, and did not include second hand estates. Therefore, it can be argued that it aimed to boost further construction.

We would expect the financial sector to oppose depreciation, as it reduces foreign credit opportunities, as well as the speculative arbitrage revenues (Nur Uğurlu, 2021). Yet, the Turkish financial sector, mostly composed of commercial banks, does not complain loudly about the depreciation and negative real interest rates. In fact, Turkish banks, both public and private, have announced record profits in 2021, with a 57.4% increase. Yet, economist Erol Taşdelen (2022) argues that these rates do not capture the reality. Banks have benefitted from the lira protection scheme (LPS)(introduced later), as the value of Turkish lira has been more or less stabilized since then. The scheme also allowed banks to receive credits from the CBRT with 14%, and from investors with 17%, then selling it to the treasury with 23%. Yet, previous exchange rate depreciation weakened the foreign denominated loan borrowing opportunities and raised the costs of such loans (Taşdelen, 2022). Besides, monetary uncertainty, negative real rates and inflationary pressures are expected to drive currency volatility (FitchRatings, 2021). Consequently, despite massive increases of profit in terms of Turkish lira, depreciation resulted in a 11% decrease of profits in US dollar terms (Taşdelen, 2022). Turkish banks failed to increase their dollar profits for four consecutive years. The dollar-based meltdown in the balance sheets of banks, stands out as the main source of unrest with monetary policy in the financial sector. In the ordinary plenary session of TÜSİAD in March 2022, previous president and current head of the advisory council, Tuncay Özilhan, criticized monetary policy for penalizing savings (Sözcü, 2022). He argued that negative real rates prevent savings from turning into investments, but rather into construction and imports.

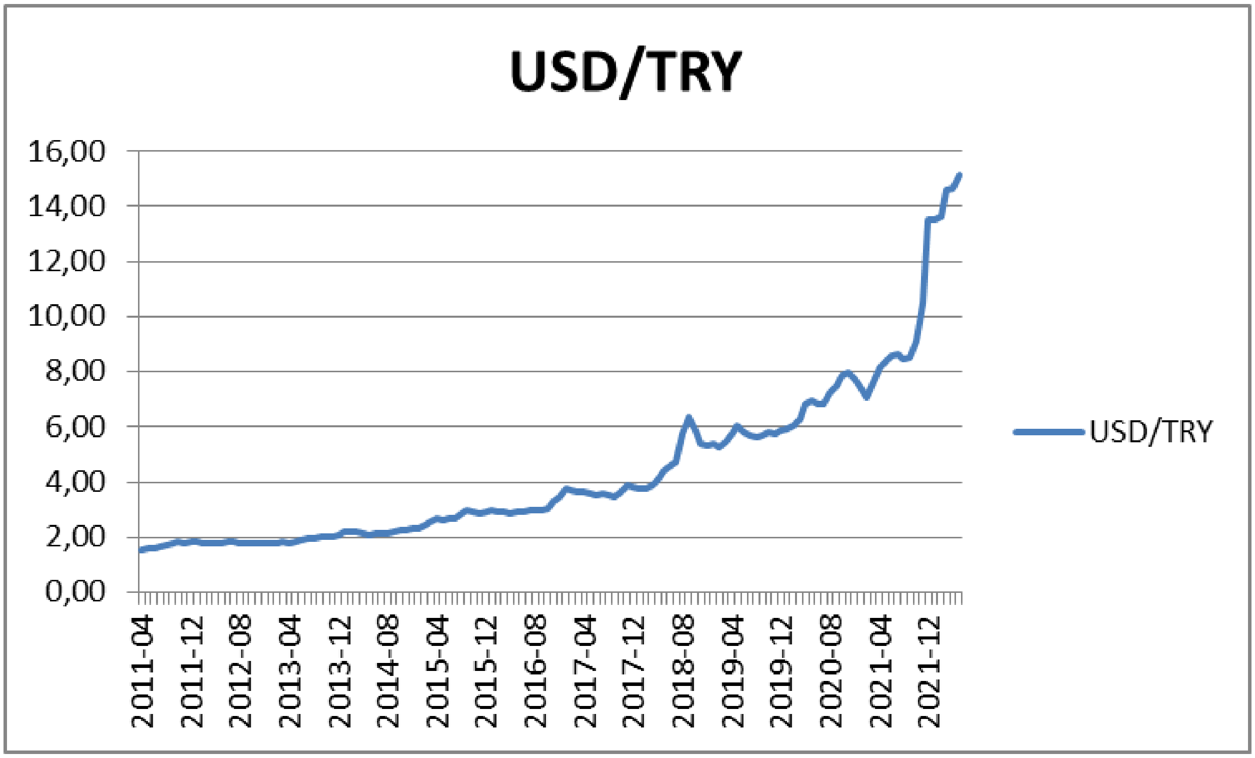
Overall, certain exporters and the tourism sector seem to benefit from a weak lira. SMEs, domestic oriented producers and the construction industry, on the other hand, benefit from the current policy due to low interest rates, rather than depreciated exchange rates. All of these sectors are part of Erdoğan's growth coalition, and support the developmentalists among policy makers. Bigger exporters, and firms that are more integrated with the Western markets, as well as the financial sector, seem to be the losers of the current monetary policy. Whereas the financial sector prefers a stronger lira, to increase foreign borrowing opportunities, TÜSİAD firms demand higher interest rates to lower inflation and to reduce exchange rate volatilities.

Developmentalists vs stabilizers

Although the clash between developmentalists and stabilizers became manifest in 2011, its origins date back to the early years of the AKP governments. The developmentalists, either supporters of Erdoğan now or his opponents back then, criticized the early AKP governments for overvaluing the lira, widening the current account deficit, weakening the manufacturing sector and making the economy over dependent on foreign capital flows (Gür et al., 2019). Orhangazi and Yeldan (2021) argue that the high interest rates at the time attracted foreign capital, and led to a speculation-led growth period. Turkish lira appreciated as much as 70% between 2001 and 2009, which was used to lower the inflation rate. Another criticism has been that the government failed to capitalize on the abundance of foreign capital by investing in low productivity sectors, most important being the construction sector. The overallocation of resources to the construction sector caused the sector to grow faster than manufacturing. Concerns about premature deindustrialization emerged (Rodrik, 2015). The high growth rates of the era are attributed to the global liquidity environment and the government is blamed for fragilizing the economy by choosing a problematic growth path, which eventually resulted in the crises of the late 2010s (Orhangazi & Yeldan, 2021). Thus, the dominant narrative that highlights the economic successes of early AKP governments always had their critics. The government needed to rely on low interest rates to follow its growth path, which became increasingly harder due to unfavorable global conditions.

Figure 1

USD/TRY 2011-2022
USD/TRY 2011-2022



Note. *The graph shows a steady depreciation of Turkish lira, accelerating after 2018. Copyright 2022 by CBRT.*

Ziya Öniş (2019) defines the new political economy of Turkey as new developmentalism, or state capitalism. After the 2001 crisis, Kemal Derviş, the vice prime minister at the time, assumed the role of a policy entrepreneur and implemented the policies of regulatory neoliberalism. Öniş argues that AKP adopted his policies in their early years. Yet, AKP's neoliberalism took a developmental turn after 2011. Turkey adopted the Turkish Industrial Strategy Document in 2011, in which the plan is to become the production base of Eurasia (Kutlay & Karaoğuz, 2018).

After that, CBRT became a contestation arena between the defenders of financial stability and developmentalist interventionists (Öniş, 2019), who were in favor of expansionary monetary policies, lowering interest rates and undervaluation of Turkish lira. Öniş (2019) identifies the first camp as former deputy prime minister Ali Babacan, former CBRT governor Erdem Başçı and former finance minister Mehmet Şimşek. All of whom either left the party or politics eventually. More recently, former CBRT governor Naci Ağbal and former finance minister Lütfi Elvan can be added to this list. The developmentalist camp consisted of two strong men, Erdoğan and his son-in-law, former finance minister Berat Albayrak. Erdogan opposed stabilizers, stating that Turkey is in need of investment, employment and production (Kutlay, 2020). Two of Erdoğan's economic advisors, Yiğit Bulut and Cemil Ertem, are also known to have a great impact on Erdoğan's low interest policies. Bulut has been arguing that an interest lobby is aiming to damage Turkey by raising interest rates, and urging Erdoğan to lower the rates (Dombey, 2014).

One well-known challenge took place between Babacan and Bulut in the first half of the 2010s. After a political crisis that caused depreciation in 2013, Babacan advised a recovery package, which included a raise in interest rates as well. Babacan told Erdoğan that an interest rate hike is necessary to restrain depreciation. Erdoğan rejected his proposal, citing Bulut, who disagreed with Babacan (Cumhuriyet, 2014).

Starting from the late 2010, CBRT, led by Başçı, aimed to avoid overheating in the economy due to excessive capital flows, and prioritized financial stability (Yağcı, 2018). They introduced macroprudential policies to halt the overvaluation of Turkish lira and widening in the current account deficit (Kara, 2016). Financial stability was announced as a new objective of the CBRT alongside price stability. New reserve requirement ratios and interest rate corridors were introduced. Overall, CBRT tried to lower credit growth and stabilize the financial system.

Yet, such actions lowered the growth rates and provoked reactions from some politicians. Politicians blamed CBRT for sluggish growth rates. Numerous government officials voiced their demand for lower interest rates, endangering central bank independence (Demiralp & Demiralp, 2019). Deputy Prime Minister at the time, Babacan, was in support of the macroprudential measures and stability, whereas leading politicians within AKP were in favor of a developmentalist approach. Erdoğan criticized the CBRT harshly by rejecting high interest rates, arguing that it was impossible for the real sector to invest with such high interest rates (Dombey, 2015). Ministers of trade, who were in favor of a weaker lira, often sided with Erdoğan. Consequently, Babacan was not reappointed as a minister in the new government in 2015, and Başçı was not reappointed when his first term ended in 2016.

There have been ups and downs in monetary policy. Despite increasing influence of the developmentalists, stabilizers held the post of finance ministry until 2018, first with Şimşek and then with Ağbal. Ağbal emphasized the importance of financial stability from his first day in the office (Milliyet, 2015). He later acknowledged that there is a tension between economics and politics, regarding interest rates (Srivastava, 2016). Başçı was replaced by Murat Çetinkaya as the CBRT governor until 2019.

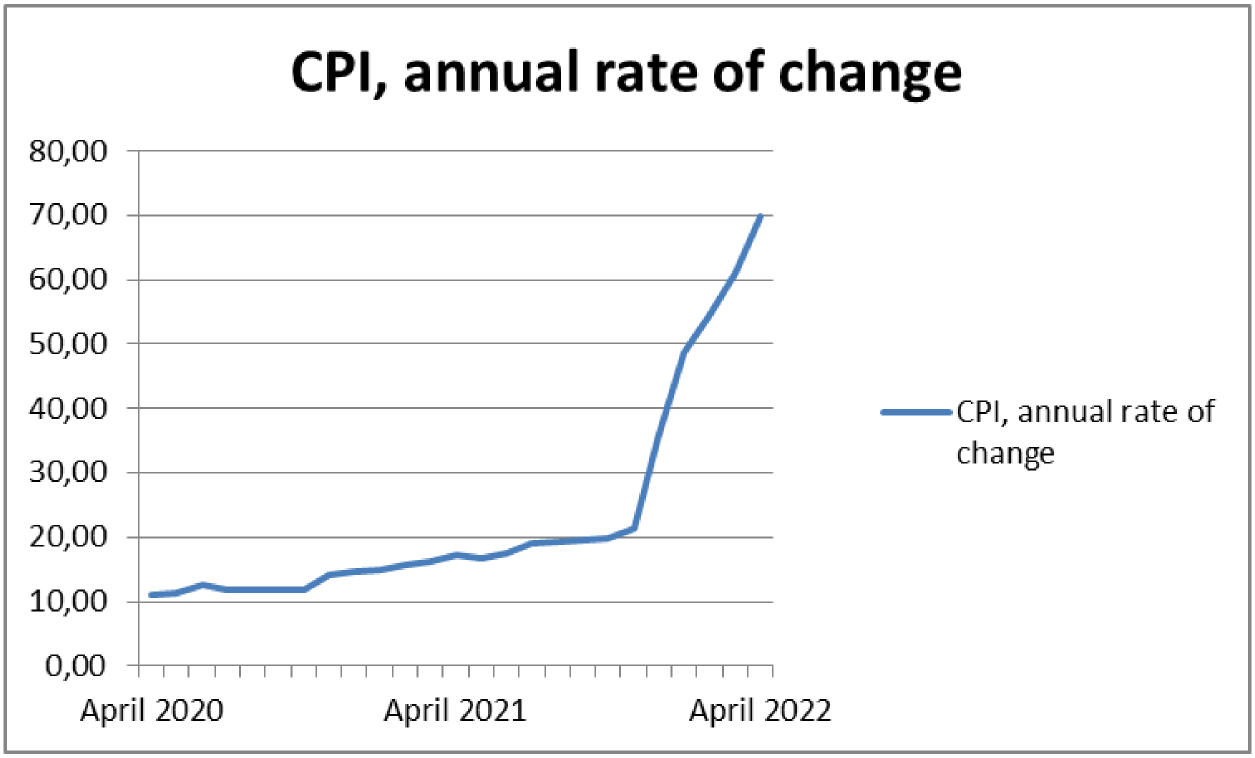
The immediate market reaction to the appointment of Berat Albayrak to the post of Ministry of Finance in 2018 was utterly negative. Markets were not convinced of Albayrak's commitment to bring inflation to single digit levels (Blitz, 2018). Albayrak’s term in office became a period when Erdoğan’s economic beliefs were applied almost without any obstructions. Çetinkaya was replaced by Murat Uysal, who signaled that he will work in parallel with Erdoğan and Albayrak, and slashed the interest rates by 4.25%, lowering it to 19.75% (Pitel, 2019). Until his removal from the office, Uysal cut the rate to 8.25%. In this one year period from 2019 to late 2020, the USD value of Turkish lira declined from 5 to 8.

After that, there were some signals that the government was willing to adopt a more conservative policy in late 2020. Finance Minister Berat Albayrak, who was one of the main supporters of undervaluation, resigned and was replaced by Lütfi Elvan. Ağbal was appointed as the new central bank governor. Ağbal and Elvan initiated interest rate hikes, which stopped the depreciation of Turkish lira. Yet, Ağbal resigned in March 2021. CBRT initiated a 5% cut in policy rates in September. Elvan followed him by resigning in December. Afterwards, there have been no further hikes. Recently, real interest rates have declined as low as -56%, due to tumbling inflation and unwillingness of the central bank to raise interest rates.

All of these imply that Erdoğan is against interest rates, or high interest rates. This creates a puzzling situation, in which the government stubbornly follows a monetary policy that decreases the purchasing power of consumers and causes inflation to surge, only a year before presidential elections. Governments often have inflationary biases, but they often recognize that failing to control inflation might lead to their removal from the office. People with fixed income would be disproportionately harmed by inflation, because the prices of goods increase while their incomes remain steady. Not surprisingly, such policies caused major frustration among Turkish voters.

Figure 2

Annual rate of changes in CPI (%), 2022



Note. The graph shows a sharp increase in annual CPI after November 2021. Copyright 2022 by Turkstat.

The government seems to be aware of the problem, thus they introduced a new measure to curb Turkish lira's depreciation on 21st of December, 2021. This was not, however, the convenient way of raising interest rates. In order to prevent domestic investors from increasingly investing in foreign currencies, the Turkish treasury introduced LPS (Sönmez, 2022). The scheme guaranteed the investors that keep their savings in lira to compensate for their exchange rate losses. This measure was rather successful in strengthening lira in the first place, preventing its depreciation, and stabilizing its value. Despite still being largely undervalued, Turkish lira was rather stable since the introduction of this measure. Yet, trying to curb the currency crisis without limiting monetary supply had another consequence, a major hike in inflation. Figure 2 shows that the inflation rate started to rise rapidly, around the introduction of the new scheme, and eventually hit 70% in April 2022 (Turkstat, 2022).

Interest group supporters of the camps

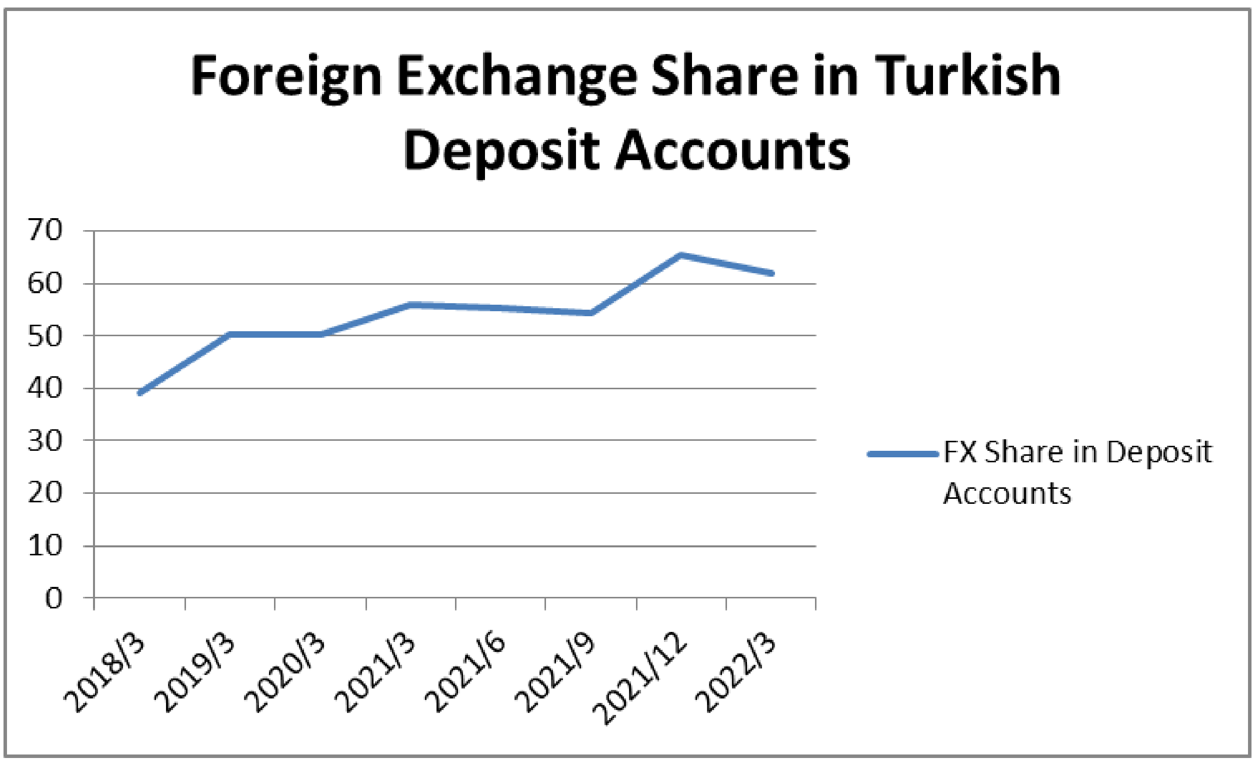
Yağcı's (2018) interviews with business representatives revealed sectoral preferences for the monetary policy at the time. SMEs, and the association MÜSİAD, often preferred lower interest rates because they had poorer relations with financial institutions. Whereas holdings, often associated with TÜSİAD, either own banks, or they have better relationships with banks. This causes them to prioritize inflation targeting rather than cost of credits. Thus, Yağcı (2018) argues that developmentalists reflected the preferences of SMEs and MÜSİAD, whereas stabilizers were reflecting TÜSİAD interests.

As mentioned previously, interest groups support or criticize the current policy for different reasons. There are two main considerations, interest rates and exchange rates. Developmentalists receive support from societal groups either for exchange rate depreciation or for low interest rates. Those are often firms that prioritize cheap credits, SMEs, certain exporters, and labor-intensive industries. Stabilizers are supported by firms that are highly integrated with world markets, the financial sector (mostly private banks), and firms with foreign liabilities, capital-intensive industries and exporters with more imported inputs. This, more or less corresponds to the cleavage between MÜSİAD and TÜSİAD.

Coping mechanisms against inflation and depreciation

Figure 3

Foreign exchange share in Turkish deposits

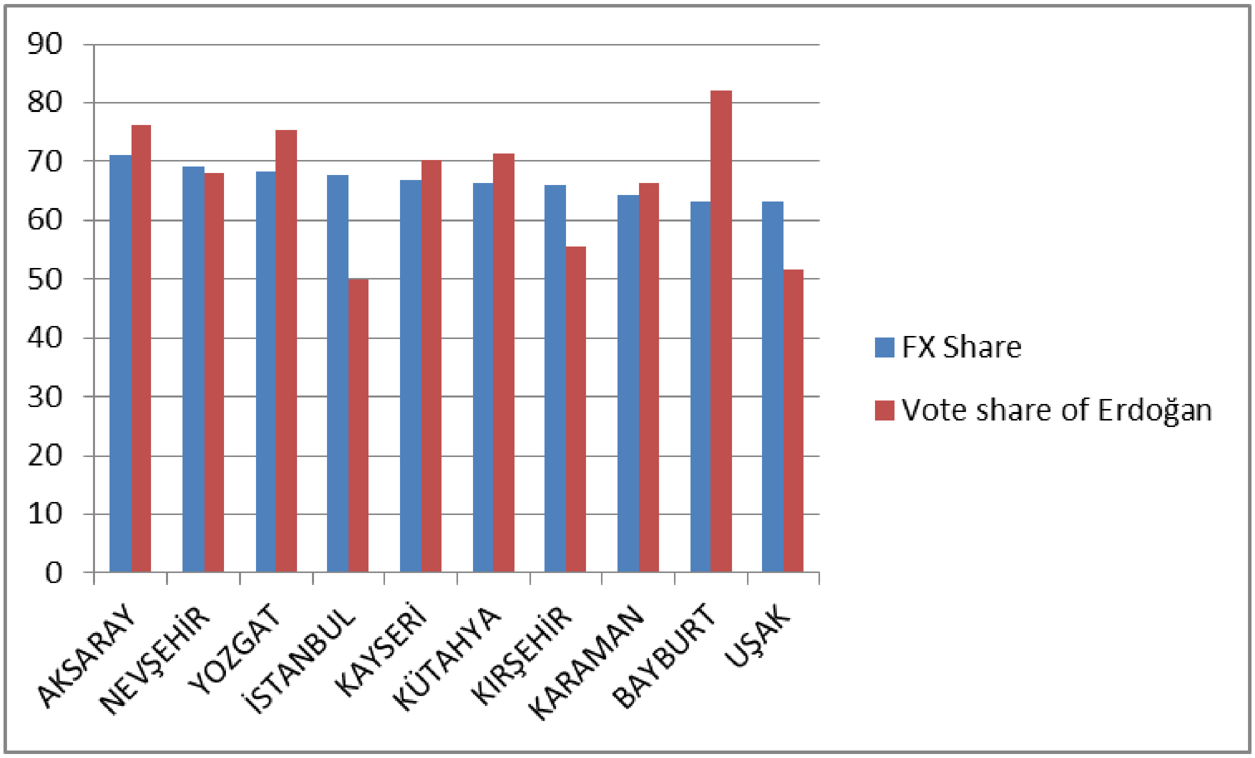


Note. Copyright 2022 by BDDK (Turkish Banking Regulation and Supervision Agency)Finturk

One point that Steinberg (2022) misses might be the coping strategies Turkish people have developed to protect themselves against inflation and depreciation. Except for a break in the period 2003-2011, inflation and depreciation have always been serious problems for Turkey. Thus, to guard against inflation, Turkish people preferred to keep their savings in foreign currencies or in gold. Since the 27.6% dip of foreign exchange deposits in 2011 (Özcan Ertürk, 2021), the share of foreign exchange in deposit accounts has been on the rise. Figure 3 shows the recent increase in dollarization, due to worsening inflation and deteriorating trust to monetary policy makers. The LPS caused a decrease in foreign exchange and gold savings. The share of foreign exchange deposits have decreased from 65% to 61%, between December 2021 and March 2022. The same is true for gold deposits. Proportion of gold deposits to lira deposits have declined from 38% to 34% in three months. Yet, the combination of foreign currency and gold deposits still make up 66% of total deposits (BDDK, 2022). This shows that lira depreciation and inflation might have a limited impact on the purchasing power of Turkish people, as they defend most of their savings against such losses. Thus, this would limit the electoral impacts of depreciation and inflation as well.

Figure 4

Erdoğan's vote share in 2018 presidential elections, in the cities with higher dollarization rates

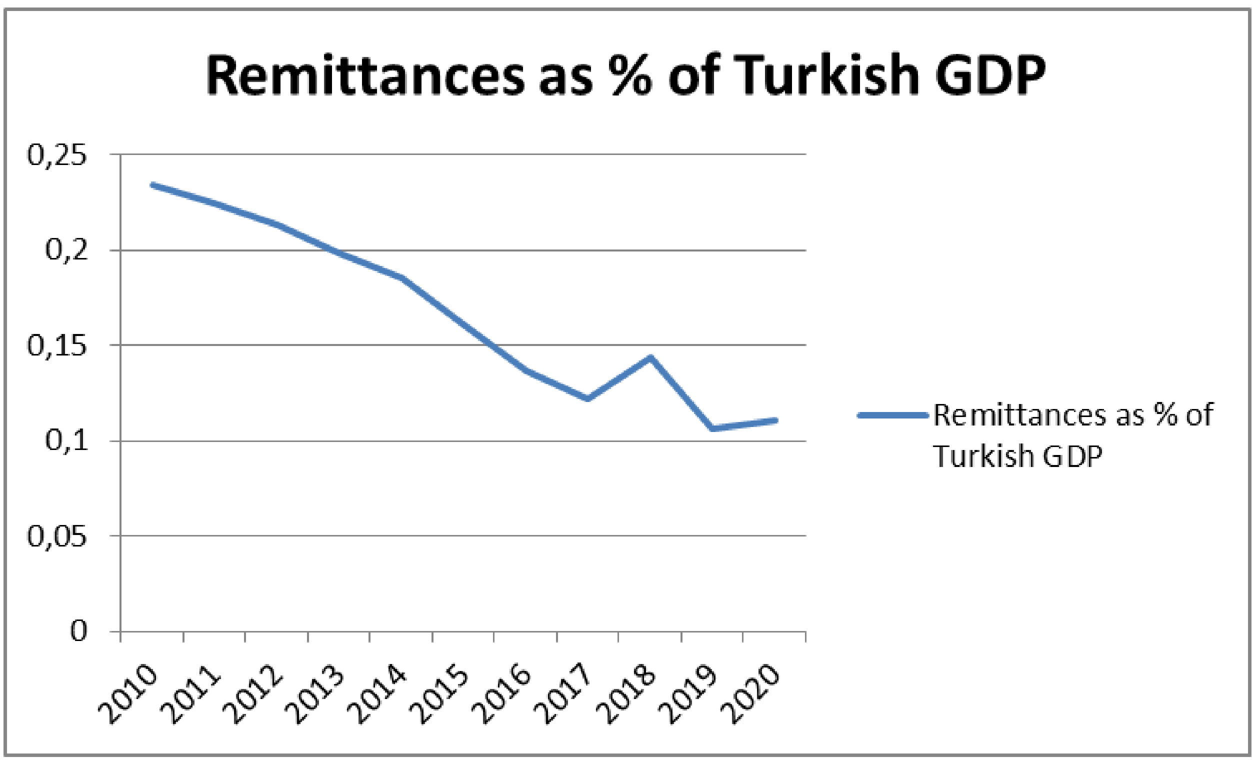


Note. Copyright 2022 by BDDK Finturk and YSK.

Another important consideration here is that the cities that invest the most in foreign currencies are also the ones that vote predominantly for the AKP, perhaps with the expectation of Istanbul. Figure 4 shows that the 10 cities with the highest foreign exchange deposit shares (BDDK, 2022), have all voted for Erdoğan in the 2018 presidential elections (YSK, 2018). This might explain the resilience of AKP in these cities, despite deteriorating economic performance.

Figure 5

Remittances as % of Turkish GDP



Note. Copyright 2022 by World Bank.

Another coping mechanism has been the remittances received from relatives in foreign countries. Remittances often increase in troubled times by working countercyclically, therefore act as an insurance against external financial shocks (Singer, 2010). This reduces the costs of lost monetary autonomy for governments, as remittances provide some protection against volatility. Consequently, Singer (2010) finds that remittances are positively correlated with fixed exchange rates. Figure 5 shows the migrant remittances to Turkey between the years 2010 and 2020. Share of remittances in Turkish GDP has declined from 0.23% to 0.11% in ten years (World Bank, 2022). The figure shows that remittances have a low share in Turkish GDP, much lower than the 5% threshold given by Singer (2010), and have decreased substantially since 2010. Therefore, remittances might have a smaller use as a coping mechanism against inflation. Nevertheless, received remittances are mostly spent on daily expenses, to improve the standard of living (Koç & Onan, 2004; Tansel & Yaşar, 2010).

The coping mechanisms that Turkish people developed to protect their savings against inflation and exchange rate depreciation might have a palliative effect on the decline in their purchasing power. Majority of Turkish citizens keep their savings in either foreign exchange or in gold. Remittances may also play a role here, but to a lesser degree. Such coping mechanisms would reduce economic opposition to the government, and are indeed the most widespread in AKP strongholds.

Competing, or complementary, hypotheses

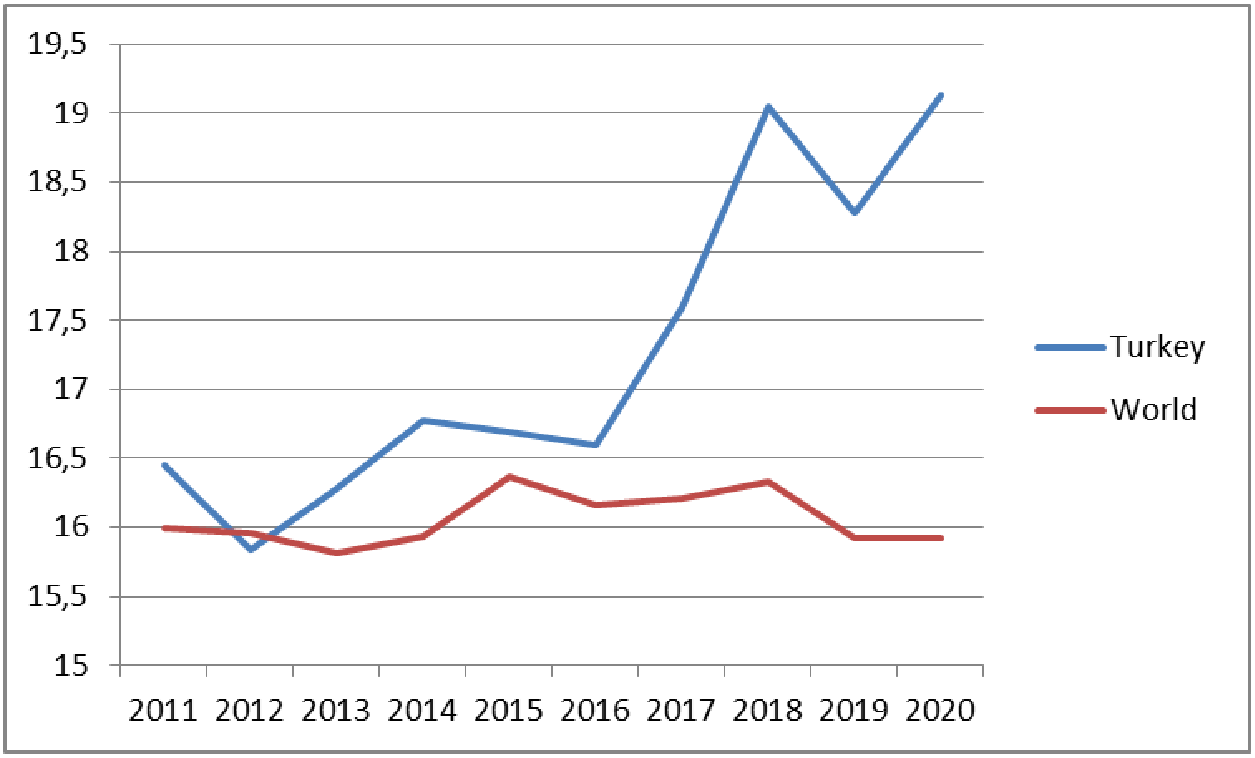
AKP's monetary policy is unique in many ways. One of the lowest real interest rates and one of the most undervalued exchange rates in the world, and easily the highest inflation rates among OECD countries, are the defining features of this policy. In this section, I will examine five competing, or complementary, hypotheses regarding the reasons for this policy. The scope size of this thesis only allows preliminary investigations regarding these hypotheses, thus further research will be necessary and welcomed.

1. AKP governments' aim has been transforming Turkey into a production economy, through export based growth.

Application of the Theory on H1

Figure 6

Manufacturing, value added (% of GDP) – Turkey, World



Note. Copyright 2022 by World Bank.

The Turkish case can be classified as an undervalued exchange rate and a floating, in fact severely volatile, exchange rate regime. This implies that Turkey has a strong manufacturing sector, and strong state control over the financial sector and the labor (Steinberg, 2015). Figure 3 shows that manufacturing as a percentage of GDP has been rising in Turkey since 2010, as opposed to the rest of the world. Thus, we can argue that Turkish manufacturing has become increasingly powerful, especially since the developmentalist turn in 2011. Below, Table 1 shows that the percentage of services in Turkish GDP remains significantly below the world average. Share of employment in manufacturing is also above the world average, and around the same level of East Asia & Pacific average, as shown in Table 2. Thus, arguably there are many people in Turkey that would benefit from an undervaluation strategy, due to growth in exports.

Table 1

Employment in industry (% of total employment) (modeled ILO estimate) - Turkey, East Asia & Pacific, Latin America & Caribbean

Unit	Most Recent Year	Most Recent Value
Turkey	2020	54.2
World	2019	64.8

Note. Copyright 2022 by World Bank.

Table 2

Employment in industry (% of total employment) (modeled ILO estimate) - Turkey, East Asia & Pacific, Latin America & Caribbean

Unit	Most Recent Year	Most Recent Value
Turkey	2019	25
East Asia & Pacific	2019	26
Latin America & Caribbean	2019	20

Note. Copyright 2022 by World Bank.

Yet, such an argument would ignore other economic problems that the current undervaluation policy causes, hyperinflation being one of them. Many surveys illustrate how the majority of the Turkish population is critical of the economy management (Steinberg, 2022; Euronews, 2021; BirGün, 2022). Does that mean AKP is rather insensitive to voter demands?

Steinberg (2022) introduces the polarization factor to explain this puzzle. He argues that non-economic factors play a major role in Turkish politics, and that high political polarization reduces the importance of economic considerations for pro-AKP voters. Yet, he finds that depreciation has a significant and negative relationship with support for the AKP. Depreciation's effects were stronger in more trade dependent regions, and among lower income voters in these regions (Steinberg, 2021).

The mechanisms that AKP uses to build consent for undervaluation also matter. State banks, as mentioned by Steinberg (2016), play an important role in Turkey by giving very cheap credits, and to stimulate certain sectors. Partisan welfare provision has been the defining feature of AKP's patronage. AKP deliberately channeled funds to constituencies that support them (Yılmaz & Bahirov, 2018), and used social policy to keep its electoral coalition despite deteriorating economic performance. Social spending has increased and new social assistance programs were introduced (Orhangazi & Yeldan, 2021). Esen and Gümüşçü (2021) point to the non-official foundations, that are funded by connected businessmen, which give financial assistance to the politically loyal urban poor. This made the urban poor even more dependent on the AKP, fearing redistribution in the case of a government change.

Another important consideration for Turkey is the regime type. Using Steinberg and Malhotra's (2014) model, we would expect Turkey to have currency overvaluation, especially before elections. Turkey, despite being a flawed one, remains a democracy, where a peaceful transition of power is possible in the next elections. The 2018 local elections brought opposition victories in many urban areas, which were for long time AKP strongholds. Currently many polls show that the opposition alliance has a lead over Erdoğan (Samar, 2022). Thus, the size of selectorate is large and tenure security is considerably low in Turkey. Yet, AKP sticks to undervaluation, even before elections.

Turkey is similar to East Asian countries in many aspects, such as the share of manufacturing and services in GDP, as well as the share of manufacturing in employment. One might expect an undervaluation strategy in this country, due to the strength of manufacturers and vast number of people working in manufacturing. However, such an expectation would disregard the mounting economic problems in Turkey, hyperinflation being the most important. Even though AKP has a reasonable likelihood of losing power in the next elections, they insist on following the same policy. Political polarization, and AKP's consent building mechanisms might explain this phenomenon.

Steinberg (2015) argues that manufacturers would demand undervaluation if there is state control over the financial system and labor. State control over the financial system ensures that credits remain cheap, and the control over labor ensures that the wages do not increase as much as the degree of depreciation, so that firms can protect their cost efficiency. We have seen that there is strong state control over the financial system, mostly through public banks. The state control over labor has been expanding under AKP governments as well. Bozkurt-Güngen (2018) argues that AKP pressured labor to insulate its neoliberal agenda from the beginning. She claims that such authoritarian techniques were necessary to lower labor costs. Collective involvement of the labor in policy-making processes has been undermined, which led to the atomization of the Turkish laborers. AKP weakened the trade unions and banned many strikes for national security reasons (Evrensel, 2018). Boratav (2022) writes that the share of wage earners in Turkish GDP has declined 6.8% between 2016 and 2021.

Evidence

To support this hypothesis, we need evidence of the government encouraging exports and deliberately trying to suppress Turkish lira. One of Erdogan's main motivations seems to be depreciating Turkish lira to enhance international competitiveness for Turkish exports. He keeps referring to transforming the Turkish economy into a production based economy, praising the Chinese model (BBC News Türkçe, 2021). Erdogan claims that lowering interest rates would encourage Turkish exports and foreign investments to Turkey. He aimed to prey on the restructuring of global supply chains and promoted Turkey as a new base of production and logistics, stealing the role of China. Lira depreciation would indeed lower the costs of Turkish labor and assets for foreign investors, yet, high inflation, political risks and a volatile currency creates serious disincentives for foreign investors.

Mustafa Kutlay (2020) explains this change by pointing out the increasing influence of non-Western powers on Turkey's developmental policies. The new long term goal in 2011 was established as transforming Turkey to the production base of Eurasia (Kutlay, 2020). The plan was to develop medium and high tech industries, in cooperation with the private sector. This has also caused increasing state intervention in the economy correlated with the rising authoritarianism.

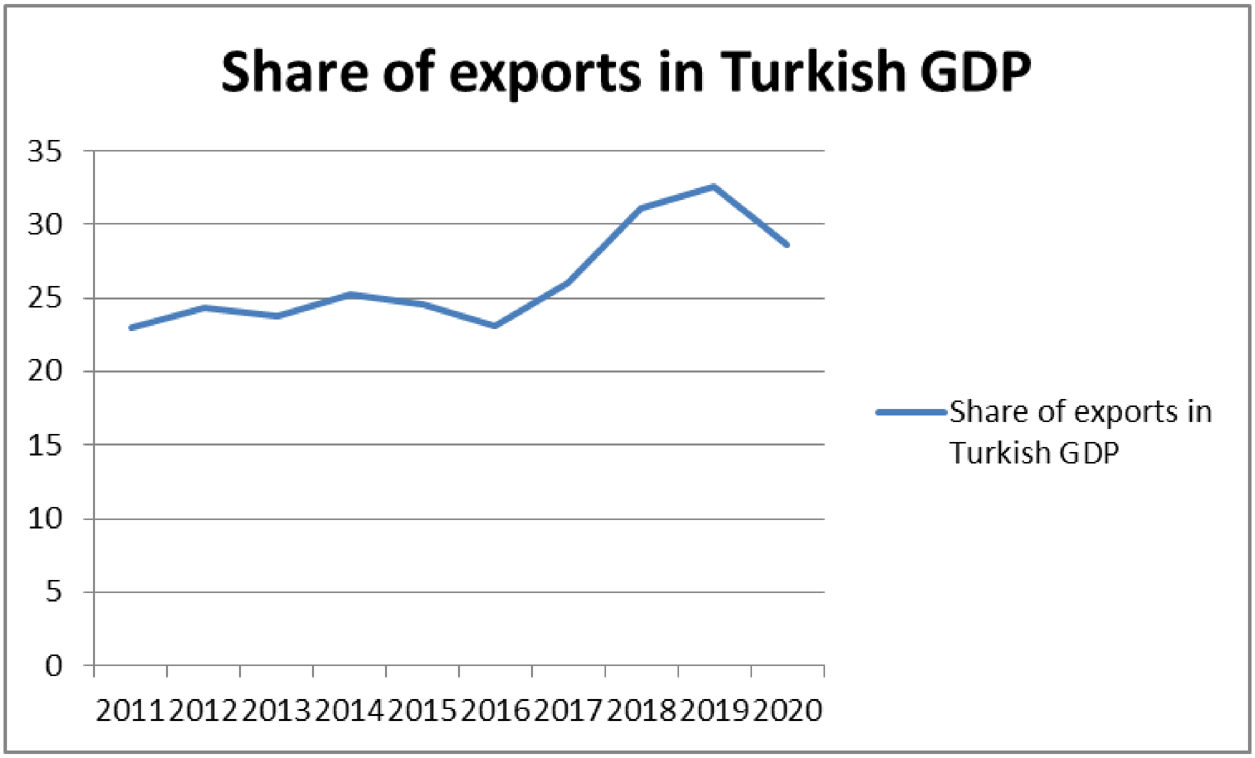
Cemil Ertem, economic advisor of Erdoğan, claims that the new production based economic paradigm was shaped during Erdoğan's presidency period, so after 2014 (Ertem, 2018b). Ertem then states that some found it dangerous for the Turkish economy to grow faster than the world average, after 2012. He argues that higher growth rates among developing nations limits the rents received by developed nations. This allowed developing nations to develop independent initiatives from developed nations. Then, he claims that both Keynesian and liberal theories have been trying to limit the growth of developing nations. Ertem writes that both of these theories try to limit the growth of developing countries to their debt capacities. Whereas the road that needs to be followed should be technology intensive development (Ertem, 2018b). So developing nations, like Turkey, should reject orthodox policies imposed by developed nations, and aim to develop through indigenous technologies. High real interest rates render such policies impossible (Ertem, 2018c). Figure 6 indeed shows that the share of exports in Turkish GDP has been on rise between 2011 and 2020 (World Bank, 2022a).

Berat Albayrak emerges as the main advocate of the competitive exchange rate. In his recent book (2022), providing the defense of his term in office, he states that he aimed to further

Turkey’s economic independence with the competitive exchange rate. In his book, he writes that the competitive exchange rate would also narrow the current account deficit. He argues that a one percent increase in the real exchange rate increases exports by 0.6 percent and reduces imports by 0.9 percent. The imported intermediate goods in Turkish exports are lower than what is popularly known. Albayrak implicitly criticizes the economic policy of the stabilizer camp before him, writing that if there are exports with a higher share of imported intermediate goods, that is because of the overvalued lira before his term. Regarding the question about equilibrium exchange rate, Albayrak claims that equilibrium is reached when the economy grows by 5% without a current account deficit.

Figure 7

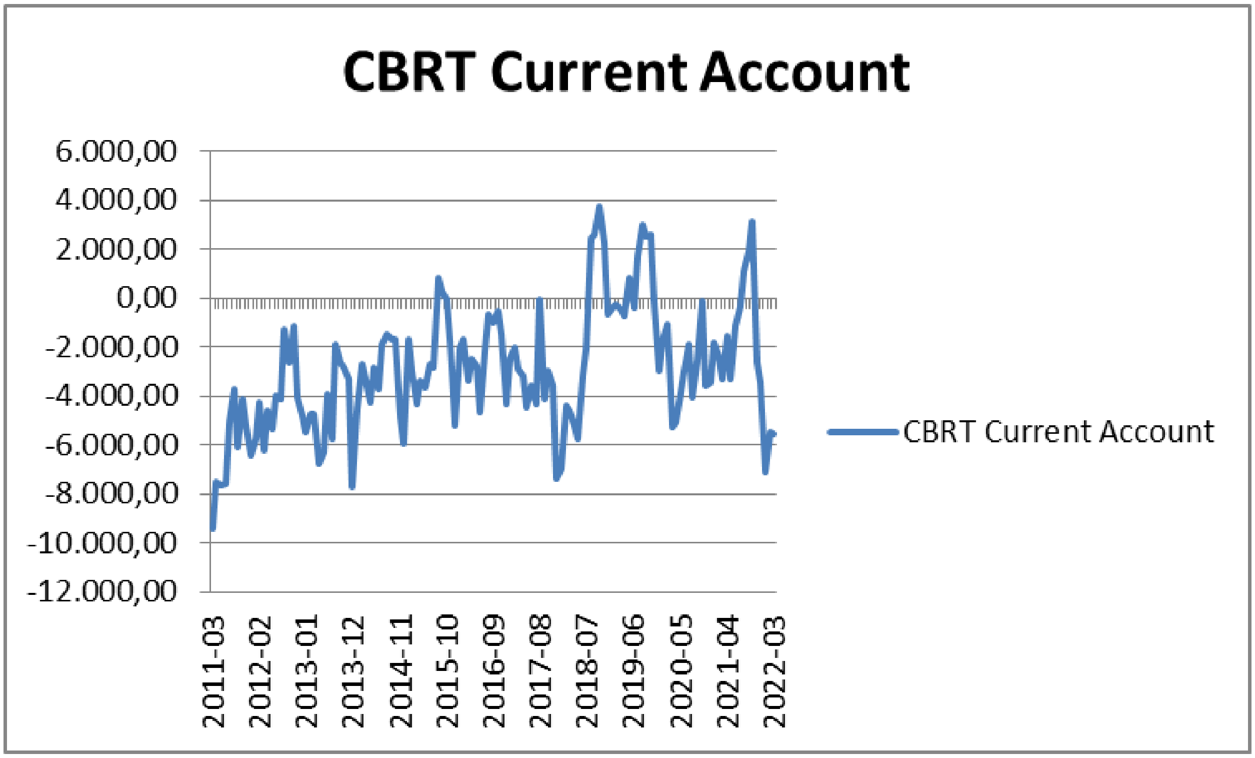
Exports of goods and services (% of GDP) - Turkey



Note. Copyright 2022 by World Bank.

Figure 8

CBRT Current Account



Note. *Copyright 2022 by CBRT. Despite some improvements in the balance of payments, volatilities have increased and there has been a sharp decline between October 2021 and February 2022.*

Sectoral preferences

Sectoral preferences regarding monetary policy seem to carry a great importance in the Turkish case. Nur Uğurlu (2021) shows that MÜSİAD firms, who often operate in furniture, food and textiles industries, have low foreign loans and high export incomes. Thus, it makes sense for MÜSİAD firms to support the current undervaluation policy. Whereas the relatively high number of firms that operate in plastics, machinery and motor vehicles sectors among TÜSİAD firms, makes undervalued lira less beneficial for these firms.

We would also expect labor-intensive and low-technology firms to prefer an undervaluation strategy, as these firms would be less harmed by imported intermediate goods. Using OECD data, Nur Uğurlu (2021) shows that MÜSİAD firms indeed use more labor-intensive production techniques. TÜSİAD firms are classified as medium-technology. MÜSİAD, together with other representatives of SMEs and exporters such as TOBB and TİM, have always preferred a weaker lira (Akçay, 2009). Considering the special relationship between MÜSİAD and AKP, it makes sense for the former to influence monetary policy in accordance with their preferences.

2. AKP governments' main aim has been cutting interest rates, irrespective of exchange rates.

To support this hypothesis, we need evidence that AKP aims to lower interest rates, without intending to depreciate Turkish lira.

Akçay (2020) argues that the growth model followed under AKP governments was mostly based on credit growth. Thus, he says interest rates have always been the main concern, and rises in interest rates were seen as more dangerous than rises in the exchange rate. Nur Uğurlu (2021) writes that the AKP governments did not follow a deliberate competitive exchange rate policy. According to her, the depreciation in lira was rather caused by the changes in the global environment, deterioration of the economic basis and political crises.

Erdoğan, and other officials, often blamed foreign powers and speculators for the fall in the lira's value. Foreign actors, especially the US, have indeed contributed to the depreciation of lira by introducing economic sanctions against Turkey. One significant event was when the US president at the time Donald Trump tweeted that he will sanction Turkish steel and aluminum when Albayrak was giving a speech (Financial Times, 2018). US sanctions to pressure Turkey to free Andrew Brunson, an American pastor who was imprisoned in Turkey after the 2016 coup attempt, constitutes another foreign action that depreciated lira's value. Such events allowed Erdoğan to argue that economic attacks by foreign powers have been the reason for lira's depreciation. Regardless of whether this is true, this implies that lira's depreciation in 2018 was not a deliberate move.

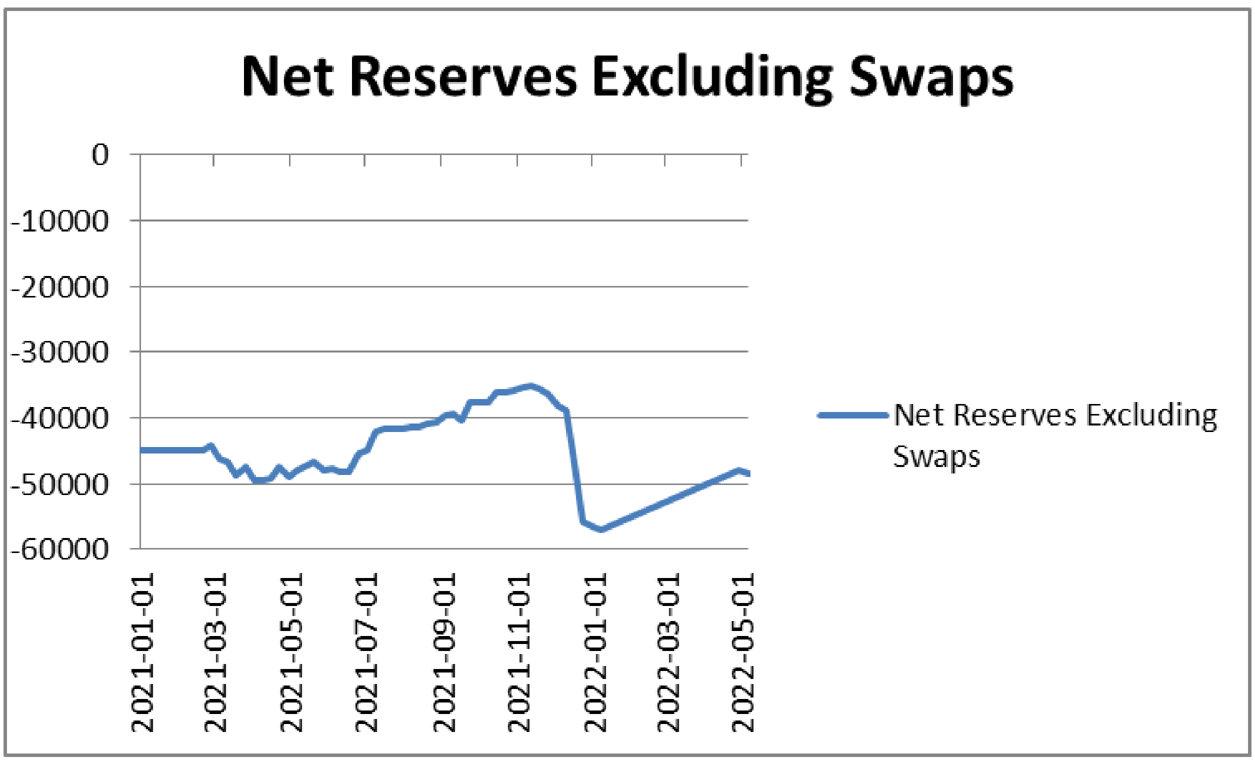
In December 2021, Erdoğan stated that he has always been against interest, and that high interest rates prevented many countries from developing. He argues that only those that earn money through money would lose from lower interest rates. People should not be concerned with exchange rate and inflation, as these would rise today and fall tomorrow (Independent Türkçe, 2021). Here, Erdoğan implies that a lower exchange rate was not the goal, but a consequence of the actual goal of low interest rates.

Besides, several government officials bragged about lowering the exchange rates on numerous occasions. Government officials often criticized speculators, who were buying foreign currencies, expecting a further decline in lira. In a demonstration in March 2019, Albayrak stated that "some have dreamed that one dollar would be worth 7, 8 or 10 lira during the economic war. We reduced it to 5 liras" (Yalçın, 2019). Erdoğan often criticizes those who invest in foreign currencies (Türk, 2018), and eventually introduced his LPS to discourage such actions that depreciate lira. Following Erdoğan's announcement of LPS, the dollar exchange rate declined from 18 to 12 in one night.

Apart from their words, deeds of government officials should also be examined. One important mechanism to check is the foreign exchange transactions of the CBRT. Central banks try to slow down the depreciation of their currencies by selling foreign currencies. A decline in the foreign exchange reserves of the CBRT would imply that the bank is trying to defend Turkish lira. On December 1 2021, CBRT announced the first intervention to foreign currencies in the market after 7 years. Since then, the bank continued selling foreign exchange despite net reserves excluding swaps reaching -48.52 billion dollars (Aşçı & Gülberk, 2022).

Figure 9

Net reserves of CBRT excluding swaps



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There have been several claims that the CBRT has burned hundreds of billions of dollars to stop the melting in lira. Babacan pointed out the inconsistency in AKP's rhetoric about the benefits of weaker lira. He asks, "If depreciation of Turkish lira is good, then why is CBRT trying to defend the lira by selling foreign exchange?" (Tuncer, 2021b). Korkut and Orhangazi (2022) suggest that the government has burned nearly 100 billion USD, as well as Goldman Sachs (Reuters, 2020) from the foreign currency reserves since the second quarter of 2020, trying to prevent depreciation. The government gave up on the fourth quarter, since foreign currency reserves became negative. Korkut and Orhangazi (2022) also point to the newly introduced capital control measures. AKP governments introduced limits on Turkish banks' swap operations in London, as well as initiating increasingly high taxes on purchase of foreign currencies in domestic markets. These measures suggest that the AKP has been trying to prevent further depreciation of Turkish lira.

Another mechanism the government employed has been the LPS. The main goal of LPS was to discourage dollarization and by giving higher yields in lira deposit accounts. Government guaranteed that if exchange rate losses exceed the interest gains by maturity, they would pay for the difference. This way, the government promised dollar profits in lira deposits. It is clear that the government aimed to prevent lira depreciation with this act. LPS has suppressed the exchange rates since its introduction, yet the inflation rate rose much rapidly (Figure 2). Since the exchange rate could not adapt to the rising inflation, it remained overvalued and caused exporters to lose their price advantages. This can be visible by the expanding foreign trade deficit since the introduction of the LPS (Korkmaz, 2022).

Some criticize the government for ignoring other factors to reach international competitiveness. Yeldan (2021) argues that lira depreciation is insufficient to provide growth and international competitiveness. He suggests that depreciation would only be useful if it is accompanied with an increase in total factor productivity, which has been declining.

Interest group based explanation

Exchange rate appreciation is often preferred by manufacturers, specifically exporters, whereas it is opposed by the finance and construction sectors. Saygılı et al. (2010) show that the bulk of the manufacturing industry in Turkey has shifted from labor-intensive to capital-intensive production tecniques in the 2000s. This has made a competitive exchange regime less favorable by the manufacturing sector in Turkey. Akçay's (2009) study shows that TÜSİAD firms, who carry out the majority of the industrial production, indeed prefer high interest, and an appreciated lira, due to foreign financing opportunities and imported inputs. Therefore, the most powerful Turkish industrial manufacturers and exporters do not demand a weak lira.

Nur Uğurlu (2021) argues that manufacturers with less foreign liabilities and more labor intensity, mostly corresponding to MÜSİAD firms, support the developmentalists' monetary policy. Construction sector supporting the current policy shows that the actual intention of the policy is not competitive exchange rates but rather low interest rates (Nur Uğurlu, 2021).

Çiçek (2021) argues that the government is especially favoring the construction industry with the low interest rate policy. The increase in credit growth would lead to higher demand in the housing market and eventually rescue growth rates (Çiçek, 2021). The share of construction in the Turkish economy rose significantly under AKP, from 4.5 to 8.6 in 14 years (Öniş & Kutlay, 2021). Construction industry is often harmed by currency depreciation, as they mostly import their inputs and sell their products on the national market. They try to compensate for their losses by pressuring the government to lower the price of housing credits and increasingly sell real estate to foreigners. The so-called “gang of five”, five construction companies that are accused of receiving special treatment from the government and of being crony firms, have been under public scrutiny for some time. These companies have been blamed for receiving preferential treatment in public procurements, especially in mega infrastructure projects (Karabağ, 2020). Most of these projects are made in public-private partnerships, financed by government guaranteed World Bank credits. Critics accuse the government of transferring wealth to these companies from taxpayers’ money. The unfair competition and unfair business environment this special treatment creates constitutes another criticism (Karabağ, 2020). Construction companies receive income guarantees in foreign exchanges in public-private partnerships, receive credits with the guarantorship of the treasury and public banks borrow on their behalf (Özgür, 2020).

Public banks are not treating different interest rates equally, as they have a tendency to cut the rates that benefit key business sectors. The most recent interest cuts do not include consumption credits, while including housing credits. According to Sinan Saygılı of Duvar newspaper (2021), economist Yalçın Karatepe argues that the interest cut for housing credits reflects a certain preference of the government, favoring the better off. By not lowering consumption and personal finance credits, the government transfers public resources from the needy to the construction industry and those that can afford new estates. Public banks give housing credits way below market rates to rescue the construction sector. In the most recent housing credit package, on 10th of May 2022, Erdoğan announced that first-time home buyers will be given loans with a maturity of up to 10 years and 0.99 percent monthly interest for purchases worth up to 2 million liras (BBC News Türkçe, 2022). Public banks give housing credits with 12% annual interest, at a time when annual inflation hit 70%. This was a clear transfer of wealth in the interest of the construction industry, causing inflation and exchange rate depreciation. Most recently, during his meeting with members of the Istanbul Chamber of Industry, Finance Minister Nurettin Nebati announced a credit package with an interest of 9% and a maturity of two years (Cumhuriyet, 2022).

3. AKP governments' goal has been stimulating the economy in the short run, for electoral purposes.

Öniş (2019) writes that the main aim of developmentalists was to stimulate the economy for short term support. Some sectors were particularly prioritized. Lowering interest rates enabled consumers to receive cheap housing credits, thus stimulating the construction industry. Boratav and Orhangazi (2022) agree, suggesting that low interest rates were required for the continuance of the current growth pattern. They argue that AKP decided to expand credits to maintain high growth rates, which eventually led to a currency crisis.

Demiralp and Demiralp (2019) argue that verbal interventions to CBRT increased significantly after 2011. This phenomenon cannot be explained by electoral concerns alone, because elections happened as frequently before 2011. It can be explained by economic downturns, but this has limitations as well. Although growth rates remained high in the post-2011 period, this did not prevent a rise in unemployment. Intervening in independent institutions creates certain costs, leaders only intervene when perceived benefits exceed the costs. Non-democratic regimes create less costs for intervening in central banks and less resilience for central banks to resist such interventions. AKP always had a preference for low interest rates, this preference transformed into aggression when AKP's dependence on public support increased. The economic and political challenges AKP faced after 2011 increased the risk of losing office. AKP responded to these challenges by intervening in CBRT more aggressively.

Çiçek (2021) argues that the main motivation of the government has been ensuring high growth rates in the short term, through keeping the interest rates low. This causes serious damage to the Turkish economy, mainly through cost channels. Even though the CBRT portrays currency depreciation as the main goal, it is in fact a side effect of keeping the interest rates artificially low to keep credit growth high (Çiçek, 2021). Lira's depreciation is not deliberately ensued for competition reasons, or to narrow the current account deficit, but rather an involuntary consequence of the low interest rate policy, to promote growth.

In early June 2021, Finance Minister Nebati stated that *"*we preferred to grow with inflation. Otherwise, we could have employed harsher measures to combat inflation. We could have made sharp interest rate hikes. Then, the production would have stopped. We restrained the exchange rate by introducing the LPS. We preferred production and growth. Manufacturing firms, exporters benefit from this system, but not the low income households…We make arrangements to increase the incomes of our low income citizens. Thereby, we try to protect them against inflation*"* (Selvi, 2022). Here, Nebati provides ample evidence for the H3. Providing economic growth, regardless of its consequences, remains as the main goal of AKP. Thus, they orient the economy to reach high growth, sacrificing price stability. They use LPS to protect lira, and fiscal policies to lower the dissatisfaction of lower income households.

4. The reason behind AKP's determination to cut interest rates is Islamic concerns, or turning Turkey into the center of global Islamic finance.

Erdoğan's opposition to interest rates has Islamic roots as well, as all kinds of interest are forbidden in Islam. Erdoğan stated that nobody should expect him to lower interests, and he would do what the Islamic teachings order him to do (Birgün, 2021). As a politician who has always been involved in Turkish Islamist politics, Erdoğan's economic ideas should have been influenced by Necmettin Erbakan, the leader of the Islamist National Outlook movement, his previous leader. In his book "Fair Economic Order", Erbakan (1991) calls for an end to interest. He opposes earnings from interest, as this is not a deserved income. He writes that banks pay interest either by printing money, in this case causing inflation and creating injustice for others, or by the savings of a producer, creating injustice for that producer. Erbakan claims that capital owners can receive unearned revenues and exploit people through interest, and that interest causes a wealth transfer from the poor to the rich. These unjustified revenues push people into degeneracy and cause moral collapse of societies (Erbakan, 1991).

Erbakan proposes lifting all interest and taxes, and argues that prices would consequently decline. Yet, neither his book nor Islamic teachings had a clear answer about whether interest equal to the inflation rate is permissible. In his fatwa (Islamic teaching given by a qualified legal scholar), Hayrettin Karaman (2008) writes that interest equal to inflation rate should not be considered forbidden, as not taking interest in an inflationary period would harm the lender and cause injustice. This "inflation difference" was not named interest, as the latter being strictly forbidden by Islam. Nevertheless, such clarifications were not used to justify bank interests, bank interests remained forbidden as banks operate on interest revenues on principle (Özel, 2000).

Erdoğan was a follower of such ideas at the time. In 2006, at the D8 summit, Erdoğan called on other Muslim leaders to redefine interest, and only call it interest if it is above the inflation rate (Sabah, 2006). Apparently Erdoğan abandoned these ideas in his later years. In 2020, Erdoğan said "Islamic economics is the key to solve the crisis", whereas Albayrak announced their aim to make Turkey the interest-free financial center of the world (İstanbul Zaim University, 2020). Erdoğan increasingly frequently started to base his policies on Islamic economic principles and called on other Muslim leaders to combine their economies on such principles (Shahid, 2021).

These imply that Erdoğan's monetary policy might be a part of a general plan of Islamicizing the Turkish economy. Lowering interest rates, with the ultimate aim of abolishing them, would allow Turkey to become the center of Islamic finance all over the world.

5. AKP's monetary policy has been based on neo-fisherist principles.

Erdoğan's unconventional monetary policy need not have Islamic roots, it might have some basis in the Western economic thought as well. Some of his advisors have addressed neo-fisherism (The Economist, 2022a). In his famous equation, Irving Fisher argued that nominal interest rates equals the sum of real interest rate and inflation. Since real interest rates are determined by economic fundamentals, therefore are fixed, higher nominal rates would lead to higher inflation (The Economist, 2022a). According to the theory, central banks could reduce inflation by decreasing their interest rate targets. Erdoğan, perhaps unconsciously reaching the same conclusion, thinks that higher borrowing costs causes firms to raise their prices, leading to higher inflation (Gaggar, 2021).

Another economic advisor of Erdoğan, Cemil Ertem, is known for his neo-fisherist ideas. Ertem argues that in developing countries like Turkey, inflation is the result of not only excessive demand, but also a production based structural problem (Ertem, 2018a). Citing Fisher, he claims that a rise in nominal interest rates would lead to an increase in expected inflation. Then, he states that the conventional central banking practices have been falsified by the 2008 financial crisis. High real rates would lower aggregate demand, and eventually lead to a recession. Consequently, Ertem states that Erdoğan's economic ideas are in line with contemporary economic theory (Ertem, 2018a).

Neo-fisherism has been challenged by several economists throughout the last decade, who argued that it is not a convenient way to run an economy. This is especially relevant for developing countries, who have much less credibility in applying such unconventional policies during rising inflation. When developing countries do not raise interest rates in the face of soaring inflation, they break the trust of foreign investors, who rally out of the national currency (Gaggar, 2021).

Conclusion

In this thesis, I aimed to find out the reasons for the unconventional monetary policy of the AKP governments in Turkey, for the period of 2011-2022. Turkish lira has lost a significant amount of value since 2011 and remains to be one of the most undervalued currencies in the world. AKP governments increasingly intervened in the independence of the CBRT and obstinately opposed interest rate raises, causing several currency crises and continuing currency depreciation. The hesitation to raise interest rates also caused hyperinflation, as Turkey has one of the highest inflation rates in the world as of May 2022, and sluggish growth rates.

Turkey, despite being an increasingly imperfect one, remains a democracy. Elections take place, although there are questions about their fairness, and there is a reasonable likelihood of a peaceful transition of power in the 2023 presidential elections, given the increasing popularity of the opposition alliance. Considering that undervalued currencies are often unpopular among large segments of the society, AKP's stubborn opposition to raising interest rates creates a puzzle for political scientists, considering its potential electoral costs.

I examined four branches of the political economy literature on exchange rates; its relationship with growth, level, regime and mechanisms to affect it. Afterwards, I investigated the case of Turkey. The state-business relations in Turkey often skewed toward the former, but businesses are becoming increasingly powerful and influential. I explained how AKP's relationship with certain business groups, especially MÜSİAD members and construction companies, have developed over time. I tried to show how policies are made as a result of the bargaining between politics and business.

Then, I analyzed the structure, strength and abilities of various sectors in the Turkish economy. I identified their sectoral interests regarding the exchange rate policy and how they affect policy-making processes. I argued that different sectors support or oppose AKP's monetary policy for different reasons. Domestic oriented sectors care more about interest rates, whereas those sectors that trade internationally care more about exchange rates. I claimed that SMEs, domestic oriented producers and the construction sector benefit from low interest rates, whereas the tourism sector and certain exporters benefit from undervaluation. Bigger exporters, globally integrated firms and the financial sector oppose the current policy, the latter for undervaluation, the former two for both interest rate and exchange rate reasons.

Afterwards, I identified the clash between developmentalists and stabilizers in monetary policy making. Stabilizers have been prioritizing financial stability and have a more conventional approach toward interest rates. They have been supporters of a strong lira and rather higher interest rates. Developmentalists, contrarily, prioritize growth rates and demand lower interest rates for that. Stabilizers received support from TÜSİAD, whereas developmentalists have been praised by those who prefer low interest rates and lira undervaluation.

I asserted that the damage of undervaluation might have been lower than expected for Turkish households, as they developed coping mechanisms against inflation and depreciation to defend their savings. Dollarization, gold deposits, and to a lower degree, remittances, raises the immunity of Turkish households' to currency crises. Thus, I argued that the political costs for the government would be less than anticipated.

In the final part, I developed four competing or complementary hypotheses to explain the reasons for AKP's insistence on its unpopular monetary policy. In the first hypothesis, I stated that AKP might be aiming to transform Turkey into a production hub, through competitive exchange rates. The strength of manufacturing sector in Turkey, and statements by Albayrak or Erdoğan's advisors, supply evidence for this hypothesis.

The second hypothesis argues that the main aim is to lower interest rates, irrespective of exchange rates. This view suggests that weak lira is only an undesired consequence of low interest rates. For this, I use discourses of government officials who shift blame for the currency depreciation, and foreign exchange transactions of the CBRT. CBRT's foreign exchange reserves have been melting for some time, implying that the government is trying to defend the lira by burning foreign exchange. Influence of the powerful interest groups who demand lower interest rates, most importantly the construction sector, provides another evidence.

The third hypothesis argues that the monetary policy aims to stimulate the economy in the short term, either through credit growth or through a rise in exports. This implies that the government in fact does not have long term plans, but only aims to stimulate growth rates before the elections to increase its stature. The fourth hypothesis states that Erdoğan's hostility toward interest rates has Islamic roots and his monetary policy is a part of a grand plan of Islamicizing Turkish economy. The fifth hypothesis highlights the Western roots of this unorthodox policy, which is in line with neo-fisherist ideas. Erdoğan's economic advisors indeed cited Fisher on numerous occasions to provide scientific backing for their policies.

Overall, I argue that the first hypothesis does not hold. I believe that the main consideration for AKP has been lowering the interest rates, for several reasons. Currency depreciation has been an undesired consequence of this preference, and the AKP governments have done whatever they could to prevent further depreciation, except for raising interest rates on a consistent basis. The export-led development was only developed as a justification after further depreciation could not have been prevented by the government. The hesitancy to raise interest rates has numerous reasons, as I have explained in the rest of hypotheses. While doing this, AKP governments based their actions on Islamic theory of interest as well as neo-fisherist ideas. Promoting credit growth, benefitting powerful interest groups, stimulating economy in the short run, and transforming Turkey into an Islamic economic system have all been simultaneously the goals of the low interest rate policy.

I believe that Turkey has not seen the worst yet. The government does not display any regrets, and signal that they will continue with the current policy on all costs. After successfully stabilizing the value of Turkish lira for five months, LPS is not anymore able to defend the currency. Starting from May 2022, lira started to depreciate again. Inflation continues to rise, and according to non-official calculations, it is much higher than the official estimation. ENAG (2022), an independent inflation research group, calculates it as 160%, whereas Steve Hanke's (2022) calculation is 108%. I expect the medium and long term political consequences of AKP's artificially low interest rate policy to be increasing support for a) actors that are more reliable regarding economic management, and b) the nationalist right. The inflationary atmosphere that AKP created would foster popular demand for financial stability, strengthening the hand of stabilizers. On the other hand, economic crises often empower nationalist right-wing parties. High inflation and a currency crisis, combined with a refugee crisis, create a suitable environment for the nationalist right to develop in Turkey.

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