

MACROECONOMICS OF GROWTH AND EMPLOYMENT UNDER POST-2001 TURKEY¹

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December, 2010

Introduction

Following the 1997 Asian crisis, macroeconomic policy designs entered a new juncture. Often termed “*the post-Washington Consensus*” (Rodrik, 2006), the new understanding had been based on factors such as institutional governance, social capital, governance, and importance of credibility in fiscal and monetary policy. In a nutshell, the rhetoric of “*get the prices right*” was replaced by the new motto “*get the institutions right*”. This new policy twist led to a broad consensus of *great moderation* with inflation targeting central banking, fiscal discipline, fully flexible and freely floating exchange rates, open capital accounts, and, along with privatization and increased scope for reduced regulation of the labor market.

Yet, this “*macro stability is the panacea for all evils*” view was not short of problems, both theoretically and pragmatically. For one, with the lessons of the 2008/2009 global crisis leading to “*great recession*” in mind, it is now clear that *price stability, on its own, was not suffice to maintain macroeconomic stability*, as it could not suffice to secure *financial stability and employment growth*. In the words of Akyuz (2006, p.46), ‘...*the source of macroeconomic instability has proven to be not instability of the product markets but asset markets, and the main challenge for policy makers is not inflation, but unemployment and financial instability*’. (*emphasis added*).

Further to this observation, it is ironic that employment creation has dropped off the direct agenda of most central banks just as the problems of global unemployment, underemployment and poverty are taking center stage as critical world issues. Thus, this project was hailed at a critical juncture during when the supreme orthodoxy of mainstream macroeconomics was questioned and alternative directions are now being sought that would allow the developing economies more *political space*. To quote from the terms of research common to all case studies taking a part in this project, “*the available global evidence – harnessed most notably by the Bretton Woods institutions - suggests that concerns about maintaining macroeconomic stability in developing countries has not yielded the growth dividends that were expected, nor have they brought about the much needed structural changes that lie at the root of sustainable and productive employment creation, even in economies regarded as successful examples of a macroeconomic reform agenda*” (ILO, 2010).

¹ Paper prepared as part of the ILO project, “Macroeconomic policy for full and productive employment and decent work for all”, Geneva. I am indebted to Iyanatul Islam, Makiko Matsumoto, Enis Bagdadioglu, Umit Efendioglu, Hakan Ercan, Ebru Voyvoda, and colleagues at Bilkent and the ILO Office, Ankara for their invaluable comments and guidance. Bengisu Vural has provided diligent research assistance and her efforts are gratefully acknowledged. Needless to mention, all views and possible errors are solely mine and in no way implicate any of the colleagues mentioned above.

The post 2001 crisis macro economic trajectory of Turkey was shaped directly with the post-Washington Consensus view in mind. With an exclusive focus of contractionary fiscal policy designed to generate non-interest fiscal surplus targets along with a central bank whose sole mandate was reduced only to sustaining stability of the price level, Turkey had been one of the show-cases of the *great moderation*. The Turkish macro economic growth path was designed and shaped by the IMF, based on the *Staff Monitoring Programme* initially signed 1998. Thus, “1998” is regarded by many analysts as a critical year after which many of the elements of the Turkish macro economic policy design had been structurally transformed.

During the 2000s, despite rapid growth and a significant surge in exports, Turkish economy could not generate jobs at the desired rate. Open unemployment rate which stood at 6.5% in 2000, has jumped to 10.3% in 2002 in the aftermath of the February 2001 financial crisis. Since then the Turkish gross domestic product has increased by a cumulative 30% in real terms until the contagion of the global crisis in October, 2008. Yet, employment generation capacity of this rapid growth had been dismal, and the open unemployment rate could not be brought down below 9%. Despite rapid expansion of production in many sectors, civilian employment increased sluggishly at best, and labor participation remained below its levels as observed during the 1990s.

The *medium term economic program, 2011-2013*, chartered by the Turkish State Planning Organization (SPO) as well documents that unemployment is expected to remain at the plateau of 13% over the programming horizon. A further caution is that Turkish labor market is suffering from informalization and marginalization, with low labor participation rates, lack of health and social safety nets, and increased fragmentation. These assessments are also shared by many other national and international agencies and researchers of the Turkish economy.

According to some interpretations, the meager job creation of the economy is due to the excessive regulatory framework and the imposed tax burden. Turkey indeed has one of the highest tax burdens in its labor markets in comparison to the OECD averages. Tunalı (2003), for instance, reports that the social security contributions of the employers reach to 22%, and together with other taxes on labor employment, create an additional cost burden for employers reaching as much as 35% over net wages. Tunalı further argues that employment protection laws may have increased the insecurity faced by the workers as employees try to avoid severance payments by shifting their labor demand to workers mostly from the informal market. This undoubtedly has adverse consequences for tax revenues and also on the formal industrial relations.

Ercan and Tansel (2006), on the other hand, report that it is the new Labor Act (2003) which is the main source of the problem. The Law is criticized (mostly by the employers’ wing) with the arguments that job security clauses make the employers reluctant about expanding employment. Ercan and Tansel also summarize the workers’ unions’ opposition to this argument stating that it is the first time with the new act that the “flexi-time” and “flexible work” *de-regulations* enter the Turkish labor scene. Yet despite conducive policies towards the desired “flexibilities”, still not enough jobs have been created. In fact, existing studies claim in this regard that labor market regulations and other “distortions” in the *formal* economy may actually not be binding for the larger segment of the labor market (Agénor *et. al.* 2006). Onaran (2002) for instance argue that wages actually exhibit a high degree of flexibility as the power of trade unions has eroded significantly in the past two decades.

An alternative hypothesis is that the jobless growth problem is regarded as a direct symptom of the current IMF program as implemented in Turkey together with an excessively open capital account and widespread financial speculation. According to this line of thought, due to virtually unregulated capital account and given the high real rates of interest prevalent in the Turkish financial markets, Turkey is observed to receive massive inflows of short term finance capital. As a result, the domestic currency, *TL*, appreciates and Turkey suffers from a widening current account deficit. Appreciated currency brings forth a surge in imports together with a contraction of labor intensive, traditional export industries such as textiles, clothing, and food processing. This leads to contraction of formal jobs and increased informalization of economic activities (see Yeldan (2006), Pamukçu and Yeldan (2005)). This is the hypothesis that will guide the conduct of this study.

The purpose of this project report is to address the extent to which the current macroeconomic framework contributes to the problem of “joblessness” in Turkey in the context of the Millennium Development Goals as adopted by the UN Millennium Summit in December 2000. In particular, it will focus on issues of overall macroeconomic environment, impact of the fiscal and monetary policies, exchange rate policy and capital account management on employment and labour market outcomes. The analysis is to be carried out not only on the basis of assembling empirical evidence but also on assessments of the analytical background that was responsible for the design of the policies over the 2000s; such as inflation targeting monetary policy; free floating exchange rate regimes with misalignment; erupting external deficits, and fiscal austerity. In particular, extensive use will be made of the IMF country reports on Turkey, including in particular, the most recent article IV consultations, to analyze the evolution of the contemporary macroeconomic framework.

I organize this report under four broad sections. First, I discuss the recent developments in the OECD countries and the global economy at large in terms of patterns of growth, internal and external balances and employment generation. Next, I provide a broad overview of the recent macroeconomic developments in Turkey. Here I study the evolution of the key macroeconomic prices such as the exchange rate, the interest rate and price inflation, and report on the post-1998 macroeconomic path of the Turkish economy and compare and contrast these developments against key changes in the labour market. Here I will exclusively assess the various macroeconomic policies in four areas (monetary policy, fiscal policy, exchange rate policy and capital account management) in the context of recent internal and external shocks that hit Turkey. It will be argued that macroeconomic management in Turkey today places too much emphasis on stability and credibility dimensions and too little on prudential, protective and allocative dimensions

I report on the effects of the *global recession* on the Turkish economy and the labor markets in section III, along with the extent and size of the fiscal stimulus measures that had been taken. I highlight the adjustment patterns in the product and the labour markets against the backdrop of the global crisis. Finally, in section four, I offer some policy recommendations on an alternative, employment-friendly macroeconomic framework. This will mean a movement away from a preoccupation with stability and credibility dimensions of macroeconomic policy that focus almost exclusively on inflation, debt management and fiscal austerity, to an approach that emphasizes prudential, protective and distributional dimensions that have a direct bearing on coping with economic volatility and structural transformation. This will mean much more emphasis on the role that the central bank can play in credit allocation, on ensuring stable and competitive real exchange rates, on engendering

sustainable fiscal resources to support the UN-led '*social protection for all*' initiative, employment-intensive public investment in infrastructure, active labour market policies, education and training to enhance skills and employability. We will argue that this paradigm shift will require much greater policy space that will only be possible if the Turkish government reduces its reliance on inflows of foreign capital (hot money), adopts a more flexible interpretation of inflation targeting and avoids rigid fiscal rules.

An appendix is reserved for a thorough report on consultations with key individuals ranging from bureaucrats, trade labor unions and employers associations to academics. These consultations are designed to highlight the diversity of views on macroeconomic policy under investigation and are to be guided by the issues specified above under each policy instrument.

I. State of the Global Economy, Current Trends on Growth and Employment

The global economy is experiencing its worst crisis since the 1929 Great Depression. Initially dismissed as mostly a routine financial turbulence in the summer months of 2007, the crisis conditions accelerated slowly, yet secularly, to reach an officially declared full-fledged recession in US and UK by the last quarter of 2008. Over the course of 2008, the International Monetary Fund (IMF) had to revise its growth projections for the world for the upcoming year three times, down from a celebrated 4.4% initially, to 2.4% in November, and then to a mere 0.5% in late January of 2009. Many international financial institutions (IFIs) followed the suit. Considering the well-accepted notion that for the world economy a rate of growth below 2.5% is taken by many economists as the threshold for "*global recession*", the grim reality behind these numbers becomes clear.

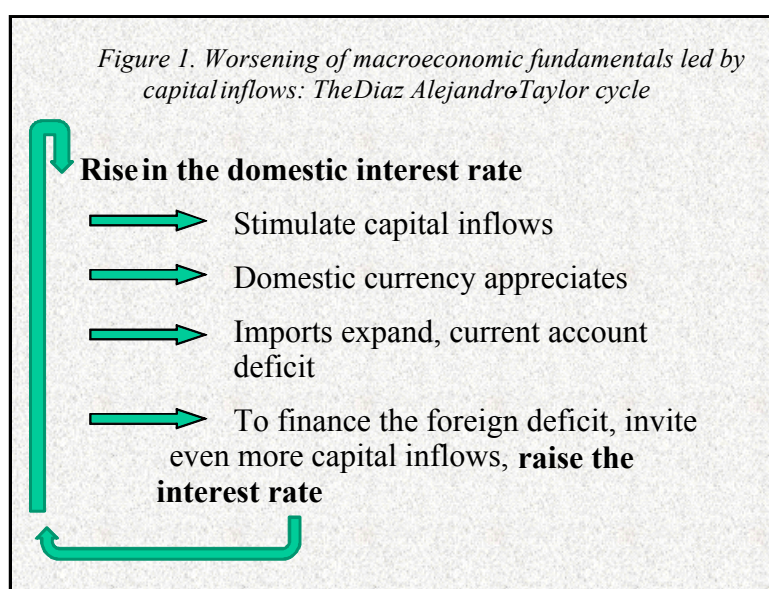
The global crisis is expected to take a heavy toll on the laboring masses and those heavily indebted and foreign finance-dependent economies. The International Labor Organization (ILO) warned in early 2009 that the openly unemployed will increase by as much as 50 million individuals by 2010, bringing total unemployed to 230 million, or to 7.1% of the global labor force.

What is more revealing in our conjuncture is that the current crisis had not been initiated in the so-called emerging markets of the global periphery, but erupted directly in the developed centers of the global economy. What lie at the root of the crisis is not the usual common accusations of "corrupt" governments of crony capitalism, with their over-interference to the market rationality, but the upfront irrational exuberance of the "free" markets, with their unfettered workings guided by the private profit motive.

Thus, by whatever means the current crisis episode will dwindle into a new kind of austerity, one lesson remains clear: it is no longer possible for the global economy to return to the patterns of trade and finance constructed in the post-1980 era. The world economy has exhausted the dogmas of "free" trade, "liberalized" finance, and "flexible" labor markets where the motive for private profit seeking was taken as the unabated single rule for efficient allocation of resources leading to global welfare, human rights, civilization, and prosperity. The post-1980 phase of the world economy, which is often characterized as *neoliberal globalization*, was identified by a wide-encompassing restructuring of both the economic realm consolidating the realm of the markets, and the political aspects of this realm —the states.

The results as we know, however, were quite unexpected. There had been successful growth episodes in countries such as China and India where the standard recipe was not followed in verbatim; and there had been cases of costly adjustments as well as financial crises such as Mexico 1994; East Asia, 1997; Brazil, 1999; Turkey, 2001; and Argentina, 2001. Overall, the picture had been that some countries managed to achieve rapid, sustainable growth with only a modest set of reforms; while some others had been led into deeper chaos and stagnation after implementing an ambitious array of reforms.

Indeed, under this *standardized policy package* of macroeconomic re-structuring, crises erupted mainly due to premature financial liberalization; lack of governance; and lack of the rule of law. Typically countries which had been following the policies of “*end the financial repression*” (a la McKinnon, 1973 and Shaw, 1973), liberalized their financial sector too prematurely, and too hastily without any respect to their macroeconomic fundamentals. To see the external adjustment mechanisms more closely, note that in these economies the aftermath of capital account deregulation often led to increased interest rates. Based on the motive to combat the “fear of capital flight”, this commitment stimulated further foreign inflows, and the domestic currency appreciated inviting an even higher level of short term capital and hot money inflows into the often shallow domestic financial markets. Under these conditions the initial bonanza of debt-financed public (*e.g.* Turkey) or private (*e.g.* Mexico, Korea) spending escalates rapidly and severs the fragility of the shallow financial markets in the home country. Eventually the bubble bursts and a series of severe and onerous macro adjustments are enacted through very high real interest rates, sizable devaluations, and a harsh entrenchment of aggregate demand accompanied by the short term “hot money” outflows. Elements of this vicious cycle are further studied in Adelman and Yeldan (2000), Calvo and Vegh (1999), Dornbusch, Goldfajn and Valdés (1995), Diaz-Alejandro (1985), and more recently referred to as the *Diaz-Alejandro-Taylor cycle* (following Diaz-Alejandro (1985) and Taylor (1998)). A schema of such events is portrayed in Figure 1.



At the initiation of the cycle the economy is under threat of capital flight with pressures to set the domestic interest rates high. Coupled with various “market friendly reforms” dictated by international financial institutions, and a consequent re-structuring of the institutional infrastructure more in line with the interests of finance capital, foreign capital inflows are stimulated, with mostly “hot” characteristics. The domestic currency appreciates and imports expand leading to widening current account deficit. A brief period of rapid growth together with high investment and consumption demand ensues. Most probably, inflationary pressures are also alleviated as costs of imported intermediates become cheaper.

This bonanza, however, is not off-limits and the widening current account deficit leads to external fragilities and a rise in the sovereign risk premium. This needs to be combated and the international finance capital has to be called back with a new round of even higher interest rates. The economy is trapped into a vicious cycle with high interest costs, appreciated currency, and ever-expanding current account deficits.

In a nutshell, the characteristics of this cycle typically involve the following: (i) International capital market has been the major source of shocks; (ii) Flows have largely originated from and been received by the private sector; (iii) The financial crises have mostly hit emerging market economies that were considered to be highly credible and successful; (iv) The rise of capital inflows has been characterized by a lack of regulation, on both the supply and the demand sides.

This structure is shared as a common theme in the background to the currency crises of the 1990s. A closer look at the recent financial crisis histories, such as 1994 Mexico and Turkey, 1997 East Asia, 1998 Brazil and Russia, and 2001 Turkey and Argentina, will reveal that all these episodes had a common operational history in terms of the *Diaz-Alejandro – Taylor cycle*. Its detrimental effects, however, were not limited only to increased fragility and crisis-prone dynamics, but were also among the prime causes of stagnant fixed investments in industry and sluggish employment gains. Turkey is a prime example of such an indigenous economy that was trapped into the dictates of finance capital, suffering from the aforementioned cycle.

II. Turkey’s Macroeconomic Experience with the Age of Policy Reform

II-1. Overview: Rapid growth, yet with serious fragilities

Turkey and the IMF signed a *Staff Monitoring Program* in 1998 to enable closer supervision and control of the Turkish economy by the IMF staff. Turkey experienced a severe economic crisis in November 2000 and again in February 2001 when it was following the *exchange-rate based disinflation program* led and engineered by the IMF.² During the year 2001 the GNP fell by 7.4% in real terms, consumer price inflation soared to 54.9%, and the currency lost 51% of its value against the major foreign monies. The burden of adjustment fell disproportionately on the laboring classes as the rate of unemployment rose steadily to 10% and the real wages were reduced abruptly by 20% upon impact in 2001 and have not recovered to this day till the eruption of the *great recession*, 2007-2010.

² The underlying elements of the disinflation program and the succeeding crisis are discussed in detail in Akyuz and Boratav (2004); Ertugrul and Yeldan (2003), Yeldan, (2002), Independent Social Scientists Alliance, 2006.

The IMF had been involved with the macro management of the Turkish economy both prior to and after the crisis, and provided financial assistance of \$20.4 billion, net, between 1999 and 2003. Following the crisis, Turkey implemented an orthodox strategy of raising interest rates and maintaining an “overvalued” exchange rate. The government followed a contractionary fiscal stance, and promised to initiate further steps towards “market friendly” reforms.

The post-crisis economic and political adjustments were mainly overseen by the then newly founded *Justice and Development Party* (AKP) which came to power enjoying absolute majority in the parliament in the November 2002 elections. Though maintaining the pro-Islamic political agenda, the AKP nevertheless distanced itself from the previous “national view” orthodoxy of the traditional Turkish Islamic movement. The AKP refurbished itself with a more friendly view towards the West, ready to do business with the global finance capital and willing to auction-off the strategic public assets to the trans-nationals. On the political arena, the AKP had given unequivocal support to the US interests in the Middle East including the then approaching war in Iraq.³

The post-2001 IMF program in Turkey relied mainly on two pillars: (1) fiscal austerity that targets a 6.5 percent surplus for the public sector in its primary budget⁴ as a ratio to the gross domestic product; and (2) a contractionary monetary policy (through an *independent* central bank) that exclusively aims at price stability (via inflation targeting). Thus, in a nutshell, the Turkish government is charged to maintain *dual* targets: a *primary surplus* target in fiscal balances (at 6.5% to the GDP); and an *inflation-targeting* central bank⁵ whose sole mandate is to maintain price stability and is divorced from all other concerns of macroeconomic aggregates.

According to the logic of the program, successful achievement of the fiscal and monetary targets would enhance “credibility” of the Turkish government ensuring reduction in the country risk perception. This would enable reductions in the rate of interest that would then stimulate private consumption and fixed investments, paving the way to sustained growth. Thus, it is alleged that what is being implemented is actually an *expansionary* program of *fiscal contraction*.

The table 1 summarizes the macro economic developments under close IMF supervision.

³ In fact, many analysts draw parallels with the declaration, in the summer of 2002, of the three-party coalition government granting no support for the US plans to invade Iraq and the decision to hold early elections later in the same year.

⁴ *i.e.*, balance on non-interest expenditures and aggregate public revenues. The primary surplus target of the *central government budget* was set 5% to the GNP.

⁵ The target was set at 5% on consumer price inflation for 2006, and 4% for 2007 and 2008.

Table 1

Basic Characteristics of the Turkish Economy Under the IMF Surveillance, 1998-2006									
	Staff Monitoring Program Initiated	Contagion of Emerging Market Financial Crises	IMF-Directed Dis-inflation Programme	Financial Crisis	IMF-Directed Post-Crisis Adjustments				
					Under the three-party Coalition Government	Under the Pragmatic	and Western-friendly Islamism of the AKP		
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Real Rate of Growth									
GDP	3.1	-5.0	7.4	-7.4	7.6	5.8	8.9	7.4	6.1
Consumption Expenditures									
Private	0.6	-2.6	6.2	-9.2	2.0	6.6	10.1	8.8	5.2
Public	7.8	6.5	7.1	-8.6	5.4	-2.4	0.5	2.4	9.6
Investment Expenditures									
Private	-8.3	-17.8	16.0	-34.9	-7.2	20.3	45.5	23.6	17.4
Public	13.9	-8.7	19.6	-22.0	14.5	-11.5	-4.7	25.9	-0.2
Exports	12.0	-7.1	19.2	7.4	11.0	16.0	12.5	8.5	8.5
Imports	2.3	-3.7	25.4	-24.8	15.7	27.1	24.7	11.5	7.1
Macroeconomic Balances (As Ratio to the GNP, %)									
Aggregate Domestic Savings	22.7	21.2	18.2	17.5	19.2	19.3	20.2	17.1	16.6
Aggregate Fixed Investments	24.3	22.1	22.8	19.0	17.3	16.1	18.4	20.3	23.1
Budget Balance	-7.0	-11.6	-10.9	-16.2	-14.3	-11.2	-7.1	-2.0	-0.8
Public Sector Borrowing Requirement	9.3	15.5	11.8	16.4	12.7	9.3	4.7	-0.4	-3.0
Current Account Balance	1.0	-0.7	-4.8	2.4	-0.8	-3.4	-5.2	-6.2	-7.9
Stock of Foreign Debt	55.4	71.0	63.4	92.7	77.5	57.1	50.4	46.9	50.4
Macroeconomic Prices									
Rate of Change of the Nominal Exchange Rate (TL/\$)	71.7	60.6	28.6	114.2	23.0	-0.6	-4.9	-5.7	6.9
Inflation (PPI)	71.8	53.1	51.4	61.6	50.1	25.6	14.6	5.9	9.4
Inflation (CPI)	84.6	64.8	54.9	54.4	44.9	25.3	10.6	7.7	9.6
Real Interest Rate on GDIs ^a	29.5	36.8	4.5	31.8	9.1	15.4	13.1	10.4	7.9
Real Wage Growth Rates ^b									
Private Sector	-0.9	8.6	-2.6	-14.4	-5.0	0.5	4.8	1.6	1.9
Public Sector	5.5	18.3	15.6	-11.5	0.5	-5.3	4.7	7.9	-3.0
Sources: SPO <i>Main Economic Indicators</i> ; Undersecretariat of Treasury, <i>Main Economic Indicators</i> ; TR Central Bank <i>data dissemination system</i> .									
a. Deflated by the Producer Price Index									
b. Based on real wage indexes (1997=100) in manufacturing per hour employed, Turkstat data.									

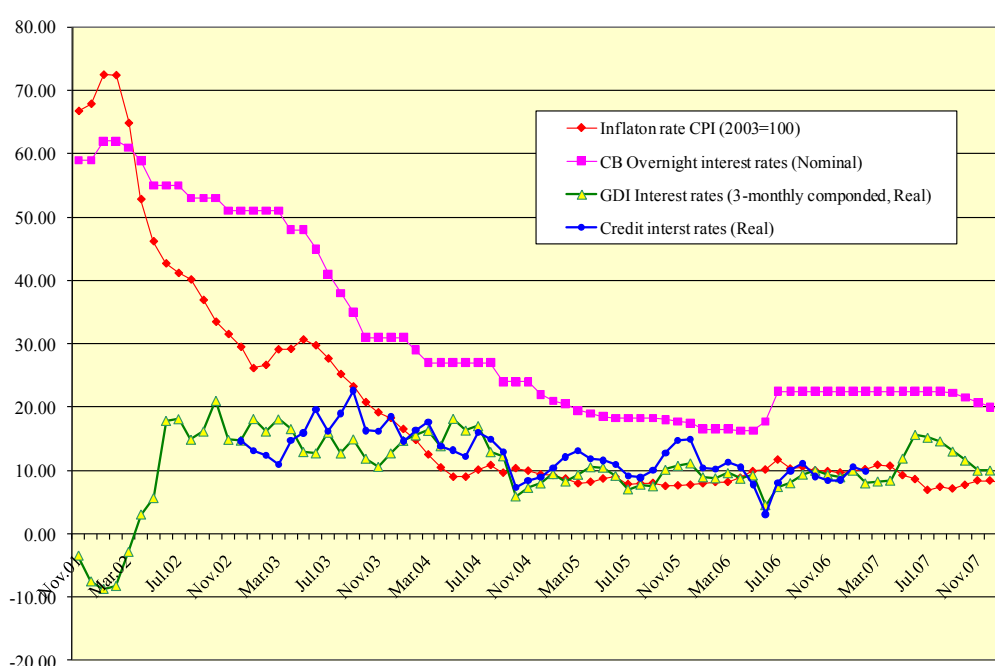
The post-crisis adjustments of the Turkish economy came at a very unique conjuncture of the global economy. First of all, growth, while rapid, showed quite peculiar characteristics. It was mainly driven by a massive inflow of foreign finance capital which in turn was lured by significantly high rates of interest offered domestically; hence, it was *speculative-led* in nature (*a la* Grabel, 1995). The main mechanism has been that the high rates of interest prevailing in the Turkish asset markets attracted short term finance capital, and in return, the relative abundance of foreign exchange led to overvaluation of the *Lira*. Cheapened foreign exchange costs led to an import boom both in consumption and investment goods. The overvaluation of the *Lira*, together with the greedy expectations of the arbitrageurs in an era of rampant financial glut in the global finance markets, led to a severe rise in its foreign deficit, and hence, in external indebtedness. Hence, the post-1990 Turkey operating under a liberalized, open capital account reveals much of the adjustment mechanisms of the *Diaz-Alejandro-Taylor cycle* in its external economy.

A further characteristic of the post-2001 era was Turkey's *poor job creation* pattern. Rapid rates of growth were accompanied by high rates of unemployment and low participation rates. The rate of total unemployment rose to above 10% after the 2001 crisis, and despite rapid growth, has not come down to its pre-crisis levels. With the available bonanza of relatively cheap imports, Turkey had been consuming the products of "foreign economies" causing a lower value added production at home. Thus, the problem of poor job performance

and the fragility embedded in the increase of the current account deficit were, in fact, manifestations of the same conundrum.

Another key characteristic of the period was the inertia of interest rates. Inertia of the real rate of interest is enigmatic from the successful macro economic performance achieved thus far on the fiscal front. Even though one traces a decline in the general plateau of the real interest rates, the Turkish interest charges are observed to remain significantly higher than those that prevail in most emerging market economies. The credit interest rate, in particular, has been stagnant at the rate 16% despite the deceleration of price inflation until the 2008 global recession. (See Figure 2).

Figure 2. Inflation (CPI) and Real Interest Rates.



Source: TURKSTAT, www.tuik.gov.tr .

High rates of interest were conducive in generating a high inflow of hot money finance to the Turkish financial markets. The most direct effect of the surge in foreign finance capital over this period was felt in the foreign exchange market. The over-abundance of foreign exchange supplied by the foreign financial arbitrageurs seeking positive yields led significant pressures for the Turkish Lira to appreciate. As the Turkish Central Bank has restricted its monetary policies only to the control of price inflation, and left the value of the domestic currency to the speculative decisions of the market forces, the *Lira* appreciated by as much as 60% in real terms against the US\$ and by 25% against Euro (in producer price parity conditions).

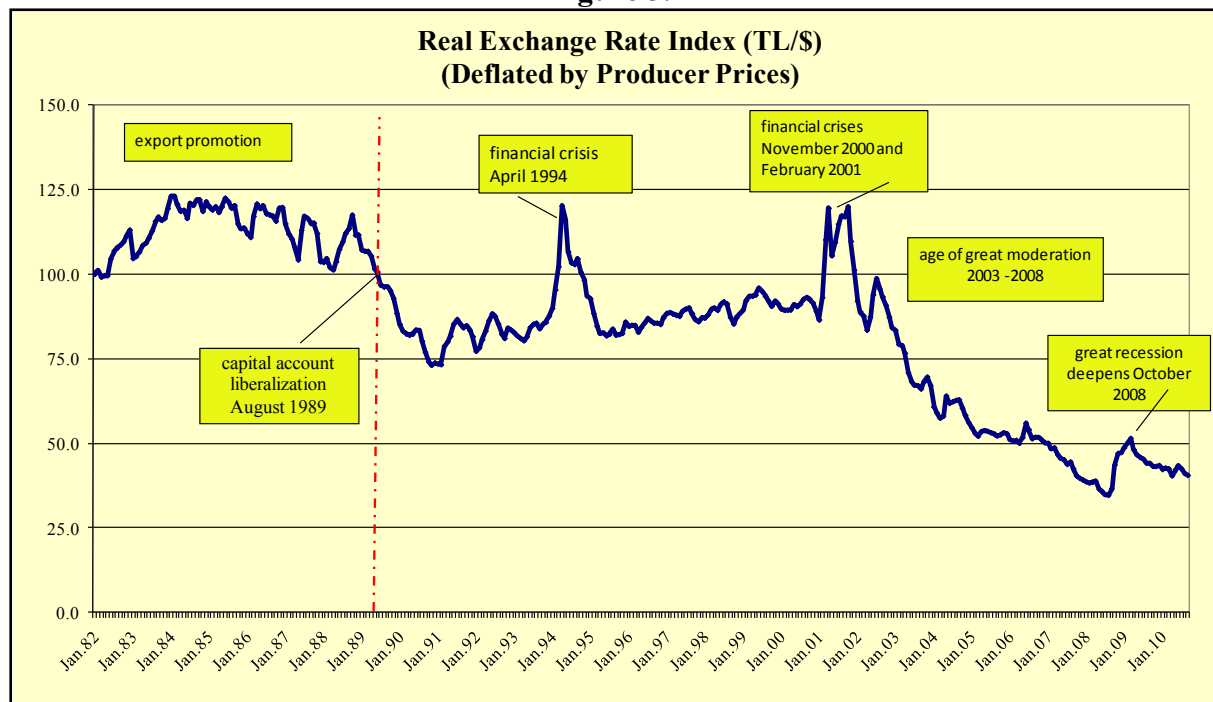
I will now turn our attention to the long history of the exchange rate movements in Turkey. Figure 3 portrays the path of the *bilateral* (vis-à-vis the US\$) real exchange rate (in PPP terms, with producer prices as the deflator) over a very broad time horizon. The fixed

exchange rate regime was abandoned in January 1980 and the Turkish Lira (TL) was left to a downward slide mainly for the objective of promoting exports. A substantial support for export manufacturing was further granted which involved tax rebates, duty free import allowances and subsidized credit. As observed from the Figure, TL was mainly on a real depreciating trend over the 1980's.⁶

Turkey has completed its financial liberalization with full deregulation of the capital account in August, 1989. Consequently, with the advent of elimination of controls on foreign capital transactions and the declaration of convertibility of the Lira in 1989, Turkey opened up its domestic asset markets to global financial competition. In this setting, the Central Bank had to abandon its traditional instruments of monetary control and had become directly liable to conditions of financial arbitrage in the global markets.

The immediate three year period after the 1989 reforms was marked with a virtual elimination of the “foreign exchange gap” which had crippled the Turkish macro balances for almost four decades. With the eruption of “hot money” inflows enabling abundant foreign exchange, Turkish commodity markets were all of a sudden flooded with cheap imports. Erratic movements in the current account, a rising trade deficit (from 3.5% of GNP in 1985-88 to 6% in 1990-93 and then again by 8% in 2000-2001) and a drastic deterioration of fiscal balances showed the unsustainability of the post-1989 model, with the eruption of severe financial crises of April, 1994 and November 2000 to February, 2001.

Figure 3.



Source: TR Central Bank and TURKSTAT.

⁶ Note that in the figure an upward movement of the exchange rate index signals *depreciation* of the Turkish Lira, and the reverse movement is an indication of its appreciation.

The Central Bank of Turkey (CBRT) was granted its *independence* from political authority in October 2001. What follows, the central bank announced that its sole mandate is to restore and maintain price stability in the domestic markets and that it will follow an *implicit* inflation targeting until conditions are ready for full targeting. Over 2002 and 2003 the CBRT targeted its “net domestic asset position” as a prelude to full inflation targeting. Finally in January 1, 2006 the CBRT has announced that it will adopt full-fledged inflation targeting.

The 2000’s was the era of *great moderation* together with flexible (floating) exchange rate regimes, independent, inflation targeting central banks with the objective of price stability and freely mobile capital flows. Turkey witnessed severe appreciation of its currency, the *Lira*, over 2003 to 2008. The *Lira* had appreciated by as much as 60% in real terms against the US dollar. The onset of *great recession* in October of 2008 had caused depreciation of the TL somewhat, yet well short of maintaining its real level of January 1982.

The structural overvaluation of the TL, not surprisingly, manifests itself in ever-expanding deficits on the commodity trade and current account balances. As traditional Turkish exports lose their competitiveness, new export lines emerge. Yet, these proved to be mostly import-dependent, assembly-line industries, such as automotive parts and consumer durables. They use cheap import materials, are assembled in Turkey with low value added, and are re-directed for export. Thus, being mostly import-dependent, they have a low capacity to generate value added and employment. As traditional exports dwindle, the newly emerging export industries had not been vigorous enough to close the trade gap.

Consequently, starting in 2003 Turkey has witnessed expanding current account deficits, with the figure in 2007 reaching a record-breaking magnitude of \$38.1 billion, or 6.7% as a ratio to the aggregate GNP. In appreciation of this figure, it has to be noted that Turkey traditionally has never been a current account deficit-prone economy. Over the last two decades (80’s and 90’s) the average of the current account balance hovered around plus and minus 1.5-2.0%, with deficits exceeding 3%, leading to open crises as in 1994 and 2001, during when significant currency depreciations had taken place. Thus, the mechanics behind the culminating current account deficit of the post-2001 period can only be understood in the context of the speculative transactions embedded in the *finance account* of the balance of payments. Table 2 summarizes the relevant data.

Data in Table 2 indicate that the finance account has depicted a net surplus of 16.4 billion over the period, 2003 through 2007. About a third of this sum (\$51.2 billion) was due to credit financing of the banking sector and the non-bank enterprises, while a sum of \$42.1 billion originated from *non-residents’ portfolio investments* in Turkey. *Residents* have exported financial capital at the magnitude of \$10.1 billion, and if one interprets the *net errors and omissions* term of the BOP accounts as an indicator of *domestic hot money flows* (see e.g. and Akyuz, 2004; Boratav and Yeldan, 2005), the total sum of *net speculative finance capital inflows* is calculated to reach \$41.2 billion over the post-2003 adjustments under the AKP administration.

Table 2. Selected Indicators on Balance of Payments and Foreign Debt (Millions US\$)

	2001	2002	2003	2004	2005	2006	2007	Total over 2007-2003
Exports (fob)	34,373	40,124	51,206	67,047	76,949	91,944	113,185	400,331
Imports (fob)	-38,106	-47,407	-65,216	-90,925	-110,479	-133,268	-160,702	-560,590
Trade Balance	-3,733	-7,283	-14,010	-23,878	-33,530	-41,324	-47,517	-160,259
Current Account Balance	3,392	-1,524	-8,037	-15,604	-22,603	-32,192	-38,031	-116,467
Finance Account Balance	-14,643	1,161	7,098	17,679	43,623	42,966	50,029	161,395
Foreign Direct Investment by Residents Abroad	-497	-175	-499	-859	-1,078	-934	-2,107	-5,477
Foreign Direct Investment by Non-Residents	3,352	1,137	1,752	2,847	10,029	19,918	21,864	56,410
Non-Residents' Portfolio Investments in Turkey	-3,727	1,503	3,851	9,411	14,670	11,402	2,780	42,114
Residents' Portfolio Investments Abroad	-788	-2,096	-1,386	-1,388	-1,233	-4,029	-2,063	-10,099
Other Investment, Net	-12,983	792	3,380	7,668	21,235	16,609	29,555	78,447
Net Errors and Emissions	-1,759	118	4,941	2,267	2,181	-149	17	9,257
Change in Reserves (-: Increase)	12,924	212	-4,097	-4,342	-23,200	-10,625	-12,015	-54,279
Foreign Debt Stock	113,592	129,532	144,098	160,927	169,050	205,727	247,418	117,886
Short Term Foreign Debt Stock	16,403	16,424	23,013	32,215	37,746	40,969	41,747	25,323

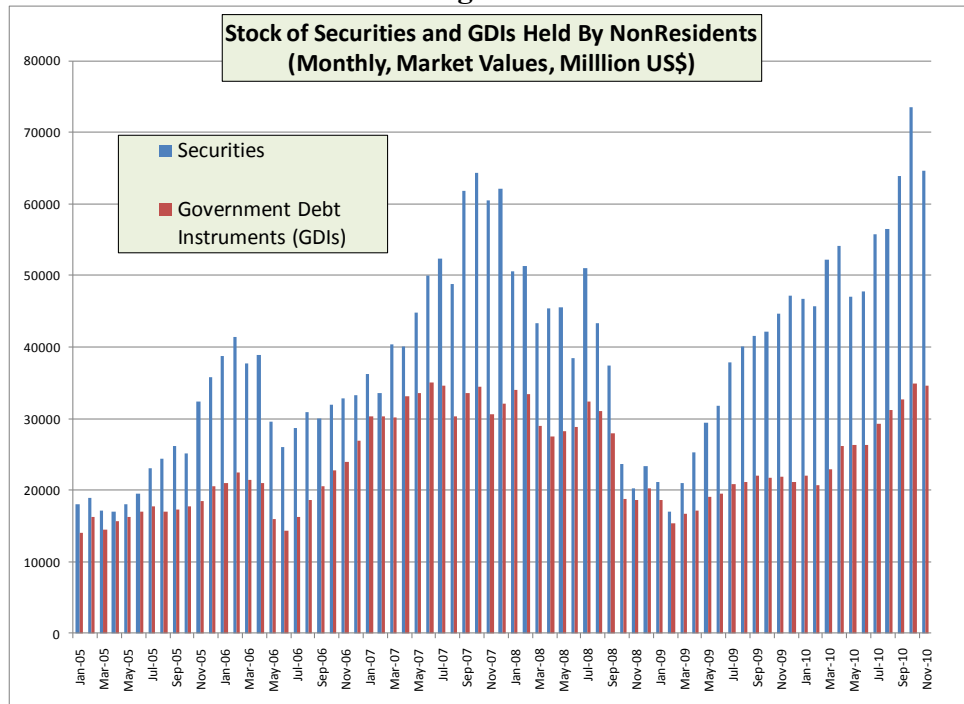
Source: TR Central Bank (www.tcmb.gov.tr)

The *foreign direct investment* (FDI) is taken as an important source of financing the current account deficit especially after 2005. The BOP data reveal a sudden increase in the flow of FDI monies totaling \$40.7 billion in 2006 and 2007. However, looking at the components of FDI more closely, it would be revealed that the bulk of the aforementioned flow had been due to privatization receipts plus real estate and land purchases by foreigners. Neither of these items are sustainable sources of foreign exchange, and they were driven by speculative arbitrage opportunities rather than enhancing the real physical capital stock of the domestic economy.

Over its period of administration, 2003-2007, the *first* AKP government succeeded in attracting a total of \$94 billion of “hot money”. This stock was fed upon two sources: (i) foreigners’ holdings of government debt instruments and (ii) foreigners’ holdings of securities at the Istanbul Stock Exchange Market. This aggregate stock of hot money reaches to almost the total cumulative current account deficit over the post-2001 crisis period.

In figure 4 I disclose the stock of “hot money” since 2005 to current date. The stock of hot money had reached its peak in December of 2007 with a total sum of 94 billion dollars as indicated. With the widening of the global crisis in 2008, the hot money flows were reversed and in February of 2009 it reached its lowest value of 65 billion dollars. The rebound of the hot money flows was equally abrupt in 2010. The rapid expansion of global liquidity following the fiscal stimulus measures is now being channeled into the emerging market economies with Turkey capturing a lion’s share. The widening of the current account deficit under this new speculative attack is unavoidable under conditions of severe appreciation of the Lira.

Figure 4.

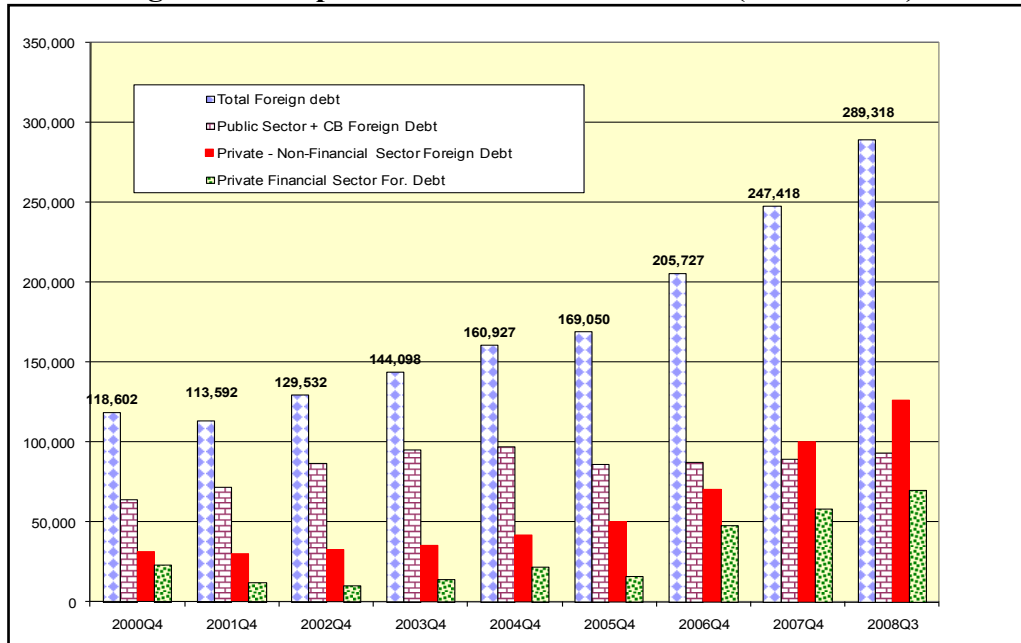


Source: TR Central Bank (www.tcmb.gov.tr)

A significant detrimental nature of hot money-led balance of payments financing was foreign debt intensity. The stock of external debt has increased by a total of \$150.2 billion over the end of 2002 to the end of the third quarter of 2008 (just before the global crisis had hit Turkey). This indicates a cumulative increase at a rate of 82.3% in US dollar terms over a period of 5.5 years. This persistent external fragility is actually one of the main reasons why Turkey had been hit the hardest among the emerging market economies in the post 2008 global crisis.

Another facet of the external fragility of the Turkish balance of payments regards the *composition* of debt. As far as the post-2001 era is concerned, a very critical feature of external debt driven current account financing was that it was mostly driven by the *non-financial private sector*, rather than the public sector. Within the private sector, non-financial enterprises explain 60% of the aggregate increase of private external debt over the post-2001 period and accounts for 70.9% of the total stock of private debt by 2008. I document the relevant data in Figure 5.

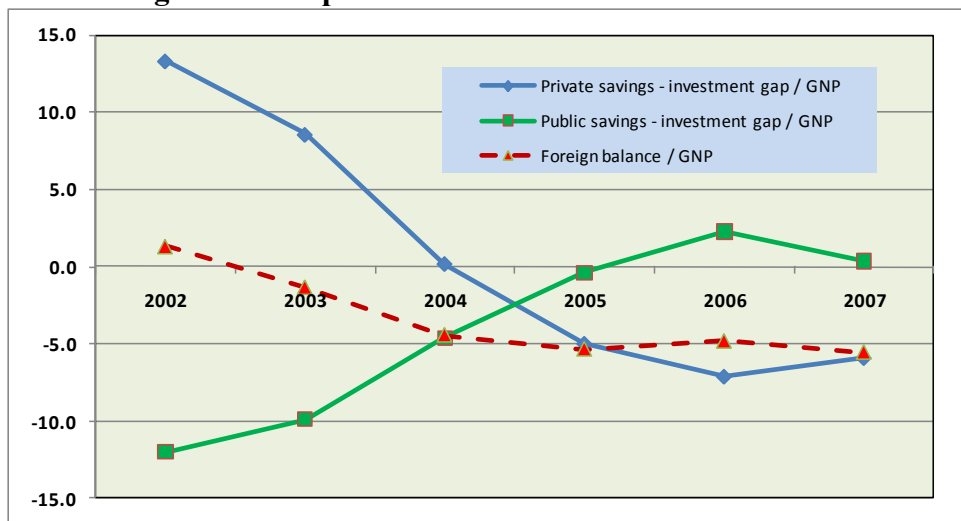
Figure 5. Composition of external debt stock (million US\$).



Source: TR Central Bank, www.tcmb.gov.tr.

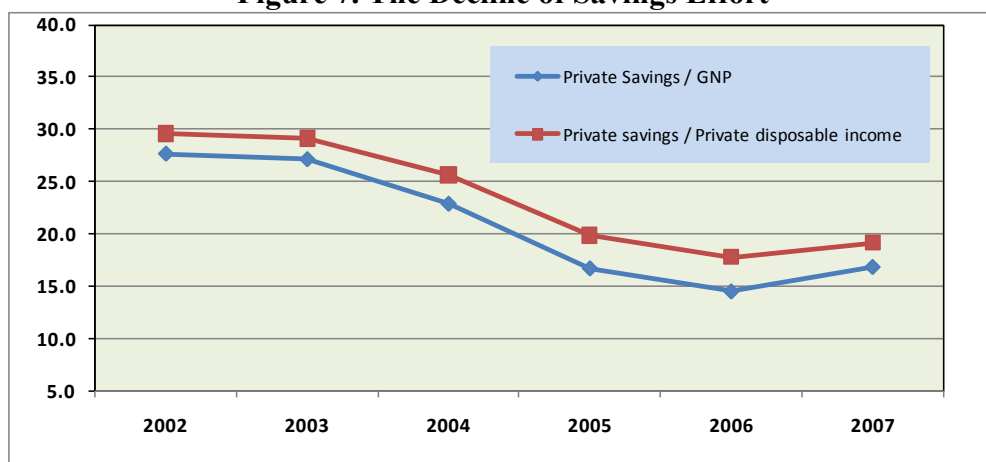
The sources of the current account deficit varied, with the deficit on merchandise trade generating the largest contribution. As for the internal component of the current account deficit, we witness that the main source had been the widening of the *private* saving-investment gap in contrast to the relative equilibrium of the *public* saving-investment balance. As the public sector balances were maintained, private sectors savings deficit deepened. In short, Turkish adjustments after 2001 into the 2008 global recession entailed substitution of the private against the public deficit. Figure 6 below narrates this observation, while Figure 7 traces this adjustment to the overall deceleration of the savings effort as a ratio to the GNP.

Figure 6. Components of the Current Account Deficit



Source: State Planning Organization, www.spo.gov.tr

Figure 7. The Decline of Savings Effort



Source: State Planning Organization, www.spo.gov.tr

The behavior of savings seems to be directly influenced by foreign exchange movements. The Lira appreciated in real terms almost by 60% since 2002 (see Figure 3 above). This appreciation led a consumption boom based on cheaper imports and widening foreign deficits. Thus, Turkey was following the downward path of savings as was observed for the case of the main OECD economies over to the road to the global recession, with a high private consumption boom, speculative financing of the external deficits, and heavy external debt burden.

Here an important issue is the decline in domestic savings effort against high domestic real interest rates. One would expect rising savings if interest rates were high. Part of the explanation lies with the observation that even though the Turkish rates of interest was high from the point of view of the foreign financial investors, they were on a declining trend for the domestic households. The decline of the real rate of interest of the public bonds, for instance, from 30% on average to less than 15%, was a strong reduction. Coupled with an obsessive hunger for credit fuelled via depreciated cost of foreign currencies, Turkey fell into a trap of high consumption with high import content.

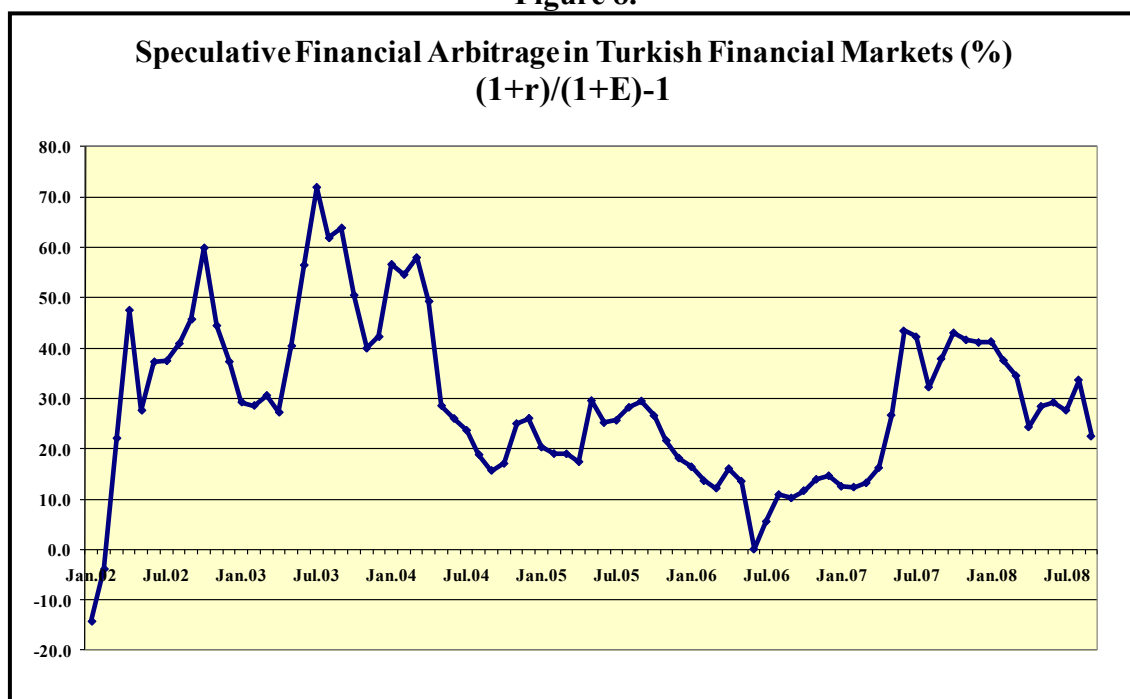
From the viewpoint of the foreign financial arbitrageurs, on the other hand, what is more important is not the *real value* of the interest rate, but its *nominal value deflated by the currency depreciation*. This is an important point and let's dwell on it.

As a “new emerging market”, Turkey was able to attract such capital inflows with the aid of very high rates of *financial arbitrage* that it offered in the international capital markets. This financial arbitrage can be calculated as the end result of an operation that converts initially the foreign exchange into Turkish Liras at the initial rate of exchange, and after earning the (nominal) rate of interest R offered in the domestic asset markets, is re-converted back to the foreign currency at the then prevailing foreign exchange rate. Algebraically, this net arbitrage gain is calculated as

$$\frac{1 + R}{1 + \varepsilon} - 1$$

Thus, during the course of this operation, financial speculators would gain domestic rate of R , and lose at the rate of depreciation of the Lira, ϵ . The net difference between the two prices would give us the net financial arbitrage gain. I calculate the evolution of such gains over the 2000s in Figure 8. Here, the main hypothesis is that the financial *arbitrageurs* would financially invest their foreign monies at the domestic instrument that would bring the highest rate of return in the domestic asset markets (most of the case the public bonds).

Figure 8.



Source: Author's calculations based on Central bank data.

According to the calculations portrayed in Figure 8, Turkey has offered arbitrage rates of 80% during the February crisis of 2001; 60% in December 2002; 75% in the summer of 2003; and became one of the leading emerging markets in the world of financial speculation! While the US and the OECD interest rates were at 2.5 – 4 % levels, Turkey continued to offer arbitrage gains over dollar-denominated assets reaching 30%. Such returns enabled Turkey to attract huge sums of speculative finance capital with a significant “hot” component during especially 2005 and 2007.

It would definitely be unrealistic to expect fixed investments to be allocated to the industrial activities within an economy offering such rates of return to the speculative financial transactions. As a matter of fact, in the aftermath of the 2001 crisis, fixed investments destined to the manufacturing industries did not exceed their real 1998 levels until late 2005.

In sum, contrary to the traditional stabilization packages that aimed at increasing interest rates *to constrain the domestic demand*, the new orthodoxy aimed at maintaining high interest rates for the purpose of *attracting speculative foreign capital* from the international financial markets. The end result in the Turkish context was the shrinkage of the public sector in a

speculative-led growth environment; and the consequent deterioration of education and health infrastructure which necessitate increased public funds urgently. Furthermore, as the domestic industry intensified its import dependence, it was forced toward adaptation of increasingly capital-intensive, foreign technologies with adverse consequences on domestic employment. It is to this issue we now turn.

III. Patterns of Employment

III-1. Labour Market Indicators

During the 2000s, despite rapid growth and a significant surge in exports, Turkish economy could not generate jobs at the desired rate. Open unemployment rate which stood at 6.5% in 2000 has jumped to 10.3% in 2002 in the aftermath of the February 2001 financial crisis. Since then the Turkish gross domestic product has increased by a cumulative 30% in real terms. Yet, employment generation capacity of this rapid growth had been dismal, and the open unemployment rate could not be brought down below 9% by the end-of 2007, just before the eruption of the current global economic crisis. Despite rapid expansion of production in many sectors, civilian employment increased sluggishly at best, and labor participation remained below its levels as observed during the 1990s. Currently (as of June 2010) open unemployment rate stands at 10.5%, one of the highest among the OECD countries. Table 3 tabulates pertinent data on the Turkish labor market.

Table 3.

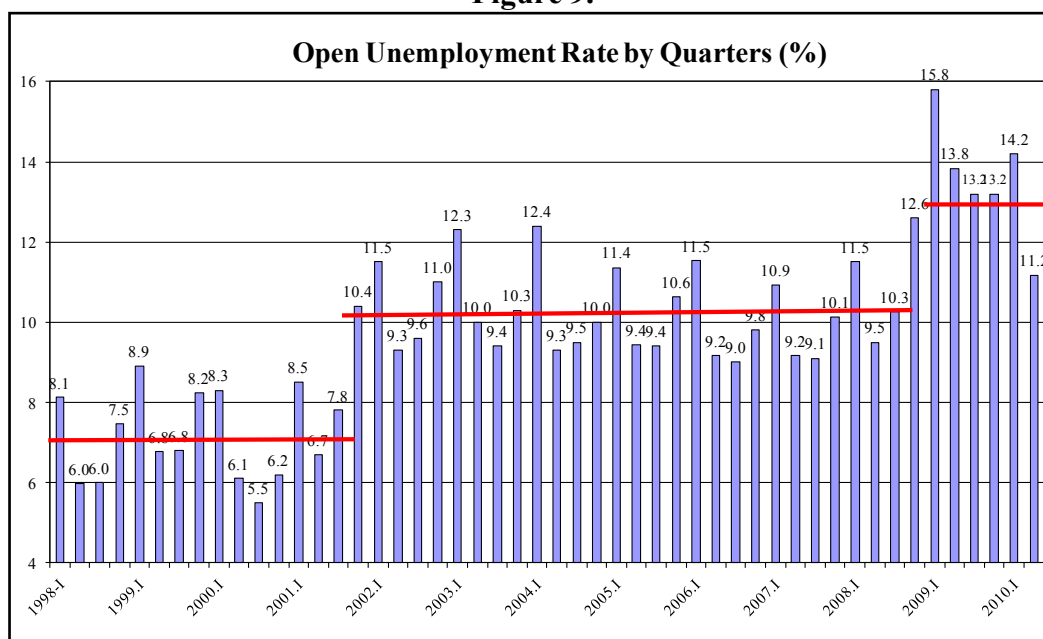
Table 3.

Developments in the Turkish Labor Market (1,000 persons)												
	New Series											
	2000	2001	2002	2003	2004	2005	2006	2006	2007	2008	2009	2010 June
15+ Age Population	46,209	47,158	48,041	48,912	49,906	50,826	51,668	48,485	49,994	50,772	51,686	52,503
Civilian Labor Force	23,078	23,491	23,818	23,640	24,289	24,565	24,776	23,250	23,114	23,805	24,748	26,239
Civilian Employment	21,581	21,524	21,354	21,147	21,791	22,046	22,330	20,954	20,738	21,194	21,277	23,488
Unemployed (Open)	1,497	1,967	2,464	2,493	2,498	2,520	2,446	2,295	2,376	2,611	3,471	2,751
Open Unemployment Ratio (%)	6.5	8.4	10.3	10.5	10.3	9.9	9.9	9.9	10.3	11.0	14.0	10.5
Disguised Unemployment ^a	1,139	1,060	1,020	945	1,223	1,714	2,087	1,959	1,805	1,850	2,061	1,857
Total Unemployment Ratio ^b (%)	10.9	12.3	14.0	14.0	14.6	16.1	16.9	16.9	16.8	17.4	20.6	16.4
<i>Civilian Employment by Sectors</i>												
Agriculture	7,769	8,089	7,458	7,165	7,400	6,493	6,088	5,713	4,867	5,016	5,240	6,233
Industry	3,810	3,774	3,954	3,846	3,987	4,284	4,407	4,136	4,314	4,441	4,079	4,536
Construction	1,364	1,110	958	965	1,030	1,173	1,267	1,189	1,231	1,241	1,306	1,580
Services	8,637	8,551	8,984	9,171	9,374	10,096	10,569	9,918	10,327	10,495	10,650	11,139
Source: Turkish Statistical Institute (TURKSTAT), Household Labor Force Surveys.												
a. Persons not looking for a job yet ready to work if offered a job: (i) Seeking employment and ready to work within 15 days, and yet did not use any of the job search channels in the last 3 months; plus (ii) discouraged workers.												
b. Total (open + disguised) unemployment accounting for the persons "not in labor force"												

The civilian labour force (ages 15+) is observed to reach 52.5 million people as of June, 2010. Total employment reached to 23.488 million. The number of *openly* unemployed people is reportedly 2.751 million, bringing the open unemployment ratio to 10.5%. The rate of open unemployment was 6.5% in 2000; increased to 10.3% in 2002, and remained at that plateau despite the rapid surges in GDP and exports. In fact, over the post-2001 adjustment path into the global recession of 2008/2010, we witness a jump of the trend open

unemployment at almost regular intervals. Based on a quarterly version of the data tabulated in Table 3, one can highlight the evolution of the unemployment rate in Figure 9.

Figure 9.



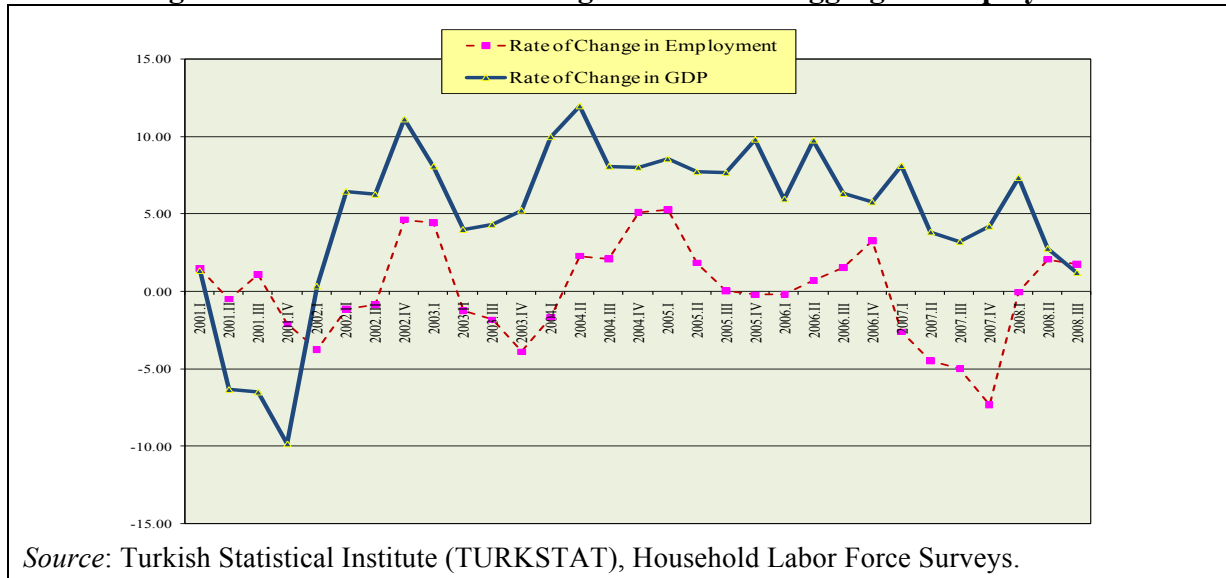
Source: Turkstat, www.tuik.gov.tr

An important group of people not covered in those numbers is the group of “discouraged” workers. As distinguished in the TURKSTAT surveys, this group is identified as: “Persons not looking for a job yet ready to work if offered a job: (i) Seeking employment and ready to work within 15 days, and yet did not use any of the job search channels in the last 3 months; plus (ii) discouraged workers”. This group of people is not counted as part of the civilian labor force and is regarded out of the openly unemployed. This number had been consistently rising over the course of 2000s and, according to the Turkstat’s Household Survey results in June 2010, had reached to 1.857 million. If we add the TURKSTAT data on the *disguised unemployment* defined as such, the excess labor supply (unemployed + disguised) is observed to reach 16.4% of the labor force.

Open unemployment is acute among the youth. As of June 2010 youth unemployment (ages 15-24) stands at 19.1%; in the urban centers this number reaches to 23.1%. Labor participation ratio is also significantly low with a current average of 49%. This ratio is especially low among urban women with 24.9%.

Yet, the most striking observation on the Turkish labor markets over the post-2001 crisis era had been the sluggishly slow performance of employment generation capacity of the economy. Despite the very rapid growth performance across industry and services, employment growth was meager. To make this assessment clearer we plot the quarterly growth rates in real gross domestic product in Figure 10, and contrast the *y-o-y* annualized rates of change in labor employment. In order to make comparisons meaningful, the changes in labor employment is calculated relative to the same quarter of the previous year.

Figure 10. Annual Rate of Change in GDP and Aggregate Employment



The figure discloses that **over 27 quarters** of data points between 2002.Q1 and 2008.QIII, the average rate of growth in real GDP had been 6.5%. In contrast the rate of change of employment averaged *only 0.8%* over the same period. Over the twenty seven quarters portrayed in the figure, GDP growth was *positive* in all periods. Yet, labor employment growth was *negative* in 14 of those 27 quarters. Another reflection of this phenomenon was the significantly *low elasticity of employment*; that is percentage gain in employment due to percentage changes in GDP growth had been relatively low (see table 4). Compared over broad period averages, employment generation capacity of the domestic economy seems to have been relatively poor in the post-2000s. There had been labor shedding in agriculture, while the non-agricultural sectors had significantly lower employment elasticities. All of these phenomena had been succinctly phrased as *jobless growth* for Turkey. (see, *e.g.* Telli, Voyvoda, Yeldan, 2006; Taymaz, 2007).

Table 4
Output Elasticities of Employment By Sectors (Annual averages)

	1989-2008	1989-2000	2002-2008
Total	0.25	0.39	0.14
Agriculture	-1.19	-0.42	-1.66
Non-Agricultural Sectors	0.54	0.68	0.48
Industry	0.43	0.49	0.39
Services	0.55	0.76	0.47
Source: Author's calculations based on Turkstat and SPO data			

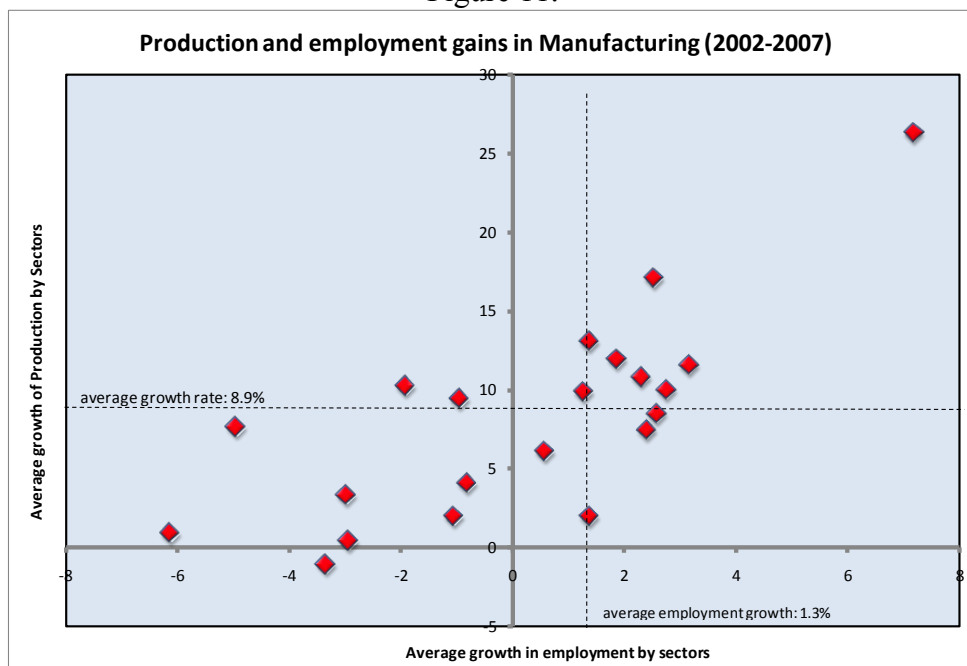
The sectoral breakdown of the post-crisis employment patterns reveals, in fact, a massive de-population in the rural economy. Agricultural employment has been reduced by 3,073 thousand workers from 2001 to 2008. Against this fall, there had been a total increase of employment in the services sectors by 1.944 thousand, and by only 667 thousand in industry.

Simultaneous to this was the overall expansion of the aggregate labor supply from 47.158 million in 2001 to 50.772 million in 2008, adding to the acuteness of the joblessness problem. Thus, it is clear that the structure of the work force has been changing with population moving out of rural areas into urban areas, and yet this shift out of agriculture has not been converted into an expansion of the industrial labor force, and got translated mostly as “*marginalized/informal labor*” into services.

Regarding the productivity patterns and employment incidences across the non-agricultural sectors, recent data are scarce and studies are limited. Focusing on the manufacturing industries, we report available figures from Taymaz and Voyvoda (2009) who studied growth in manufacturing output and in employment as distinguished by sectors.

Figure 11 summarizes Taymaz and Voyvoda’s findings in a nutshell. Over 2002 – 2007, manufacturing industry as a whole grew at an annual rate of 8.9%. In contrast, rate of manufacturing employment was a meager 1.3%. Across sectors, all of the 21 subsectors except one, achieved positive growth rates over this period. Yet their employment performance had been quite mixed and nine out of those 21 had actually reported labour shedding. Decline in employment were especially pronounced in the traditional sectors such as food processing, textiles and mining and quarrying.

Figure 11.



Source: Taymaz and Voyvoda (2009)

To complete this picture, there is ample evidence that agricultural labor surplus has been moving into small scale, family-owned services with low-quality, low-pay, and insecure “jobs”, intensifying the informalization of the urban labor markets (see also, Ercan and Tansel, 2006; Taymaz and Ozler, 2005; Agénor *et.al*, 2007).

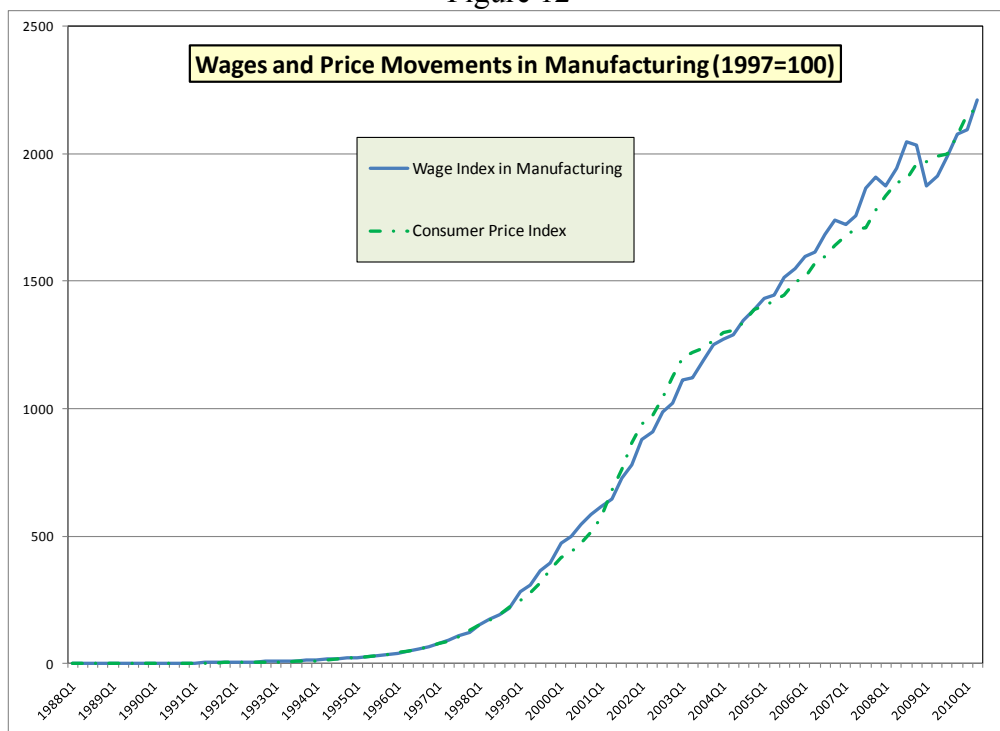
Our interviews with the social partners indicated that there was a general agreement towards the disruptive effects of the widening foreign deficit and the volatility of the capital flows in

general. For instance, The Central Bank view stressed that “Current account deficit is one of the delicate issues concerning the Turkish economy. Looking at the past, it can be observed that due to structural characteristics of the Turkish economy, current account deficit rises faster with increasing rates of growth. On the flipside, the periods during which the current account deficit declines or turns into a surplus coincide with the periods of lower growth rates or crisis. Such a structure reveals that the current account deficit has a structural character as well as a cyclical one. There is a need for a transformation on this fragility and risk creating structure of current account. Current account should be kept under control through supply side macro and microeconomic policies with medium to long-run perspective.”

Similarly, an *anonymous economist* indicated that “With the inflation targeting policy, which has been de facto in implementation since 2006, there raised a system of a downward pressure on wages. Therefore, it is not possible to say that the monetary policy aims at reducing poverty and unemployment. How the monetary policy should be formulated? A dynamic welfare function should underlay the monetary policy and the price levels for different income groups should be defined and monitored.”

In fact, data reveals that the post 2001 period had also witnessed a pattern of contraction first, and then stabilization of the manufacturing wages. Such a transfer of the financial returns through very high real interest rates offered to the financial system would, no doubt, call for repercussions on the primary categories of income distribution. It is clear that creation of such a financial surplus would directly necessitate a squeeze of the wage fund and a transfer of the surplus away from wage-labor towards capital incomes, in general. It is possible to find evidence to the extent of this surplus transfer from the path of the manufacturing wages. Figure 12 portrays the dynamics of the manufacturing (nominal) wages and offer contrasts against inflation in consumer prices.

Figure 12



Source: Turkstat, www.tuik.gov.tr

But there is another important observation one can deduce from the Figure 12. This is the realized stability of the *real* wage path following somewhat around 2005. The real wage rate in manufacturing was typically following the business cycle with a lag all over the post 1990 reform age, and yet its fluctuations seem all of a sudden to be curtailed. See in particular the post-1990 historical path of the wage rate as depicted in Figure 13 below. What could be the explanation of this relative stability after 2005?

Figure 13.



Source: State Planning Organization, www.dpt.gov.tr

I will argue that this observation pertains mostly due to the switch to first *implicit* (2002-2005), and then to *explicit* inflation targeting regime starting 2006. With the advent of explicit inflation targets, almost all contracts started to being offered against the inflation target set by the central bank. Thus, the objective of *price stability* in practice meant *wage stability*. Under absence of a nominal anchor elsewhere, the inflation targeting regime enabled the real cost of labour to serve such an anchor. Searching for price stability under conditions of *great moderation* had also meant in the Turkish labor markets *de facto* wage stability and diversion of the real wage numerations away from gains in the productivity of labour.

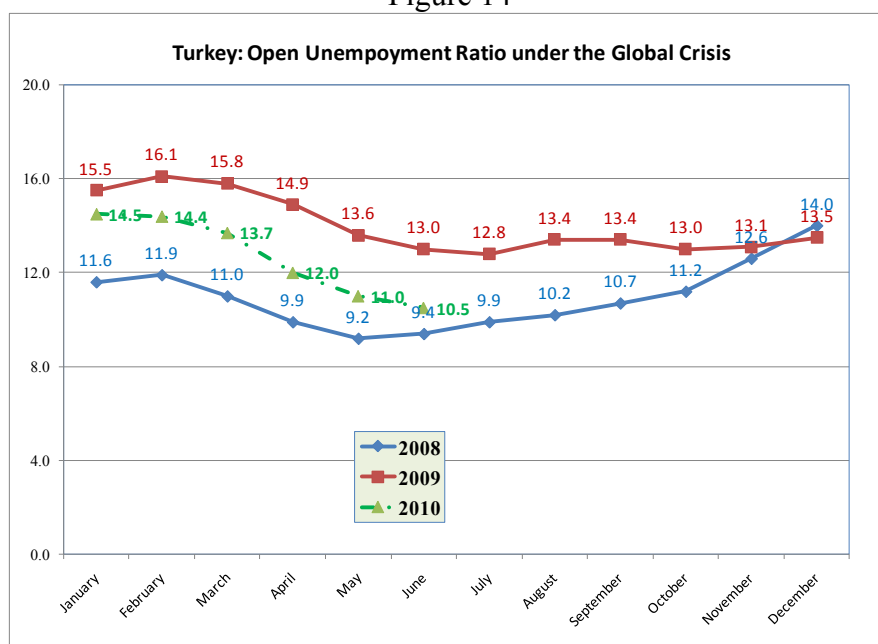
In sum, the great recession hit the Turkish labour markets under such conditions of faltering wage remunerations, persistent unemployment, and over-dependence to external financing. There was wide spread anecdotal evidence on the issue of low wage growth and opening up of the gap between wage remunerations and productivity gains. Murat Özveri from the Labor And Society Journal, for instance, indicates that “The productivity gains are attained not though

new investments but through increasing the degree of exploitation of the employees. There has not been a new industrial investment taken place and employment numbers are severely decreasing.” Dr Özveri also complemented that “The productivity gains are attained not though new investments but through increasing the degree of exploitation of the employees. There has not been a new industrial investment taken place and employment numbers are severely decreasing.”

IV-2. The great recession and the Turkish labour markets

The effects of the global crisis on the Turkish economy were increasingly felt starting the third quarter of 2008. As the growth rate in GDP decelerated to 0.9% as an average for the whole of 2008, it registered a further decline of 6.8% over the first half of 2009. The burden of adjustment increasingly fell on the real economy, in particular the industrial sectors and the labor market. Industrial output fell by 24% by the January of 2009 and could have reached to the pre-crisis levels only as late as July 2010. Open unemployment rate rose secularly towards the second half of 2008 and jumped to a new plateau in 2009; and finally receded to its pre-crisis levels, albeit at significant wage losses and extended informalization of the work place. (Figure 14).

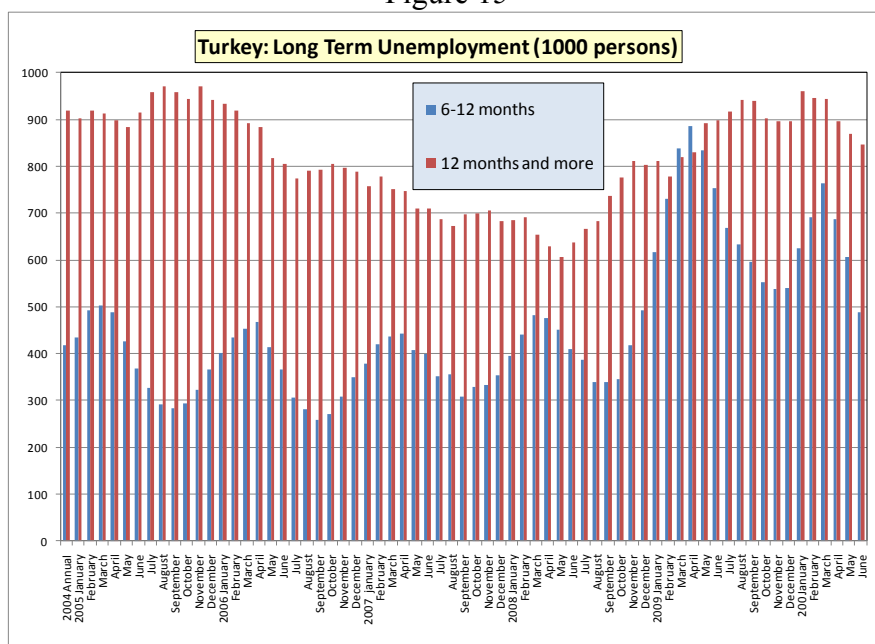
Figure 14



Source: TURKSTAT, Household Labor Surveys.

A significant characteristic of the unemployment problem over this period was the rapid rise of *long term* unemployed—that is those who had been unemployed for 6 months and more. In 2008, the annual average of long term unemployed for six months and more duration was 1,112 thousand persons, or 42% of the total openly unemployed. In 2009 the share of long term unemployed to total increased to 45%, or 1,560 persons. As of June 2010 the share of long term unemployed stood at 49%. Figure 15 below gives the evolution of long term unemployed across months.

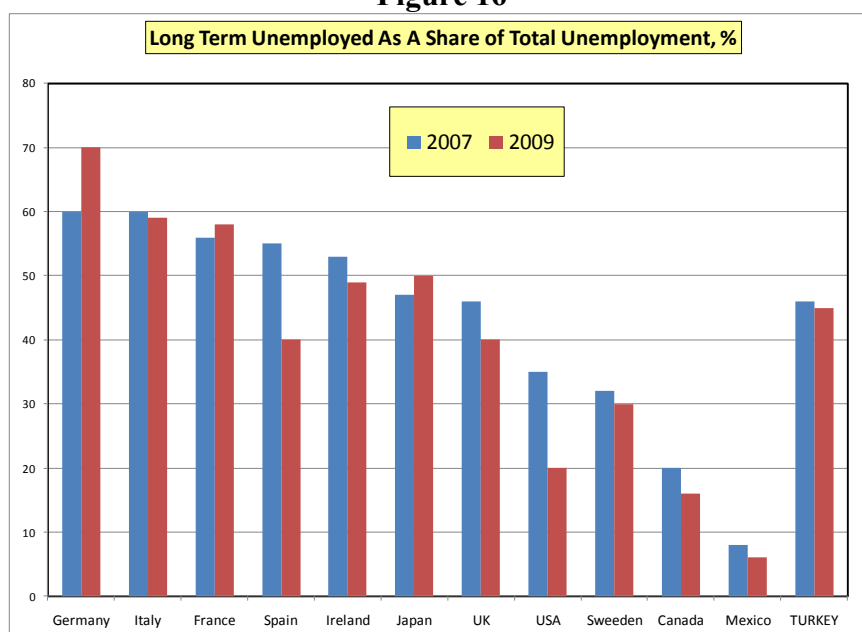
Figure 15



Source: TURKSTAT, Household Labor Surveys.

When contrasted against selected major OECD economies, Turkey fares midway in terms of its long term unemployment status. As data from the joint IMF-ILO study indicate, long term unemployment seems especially acute in Germany and Italy with rates close to 60% (Figure 16). The IMF-ILO document argues that, “although there are obvious cyclical patterns, it is clear that there has been a secular upward trend in the duration of unemployment.” This indicates that there are structural factors hindering the re-employment prospects in these countries that were present before the global crisis.

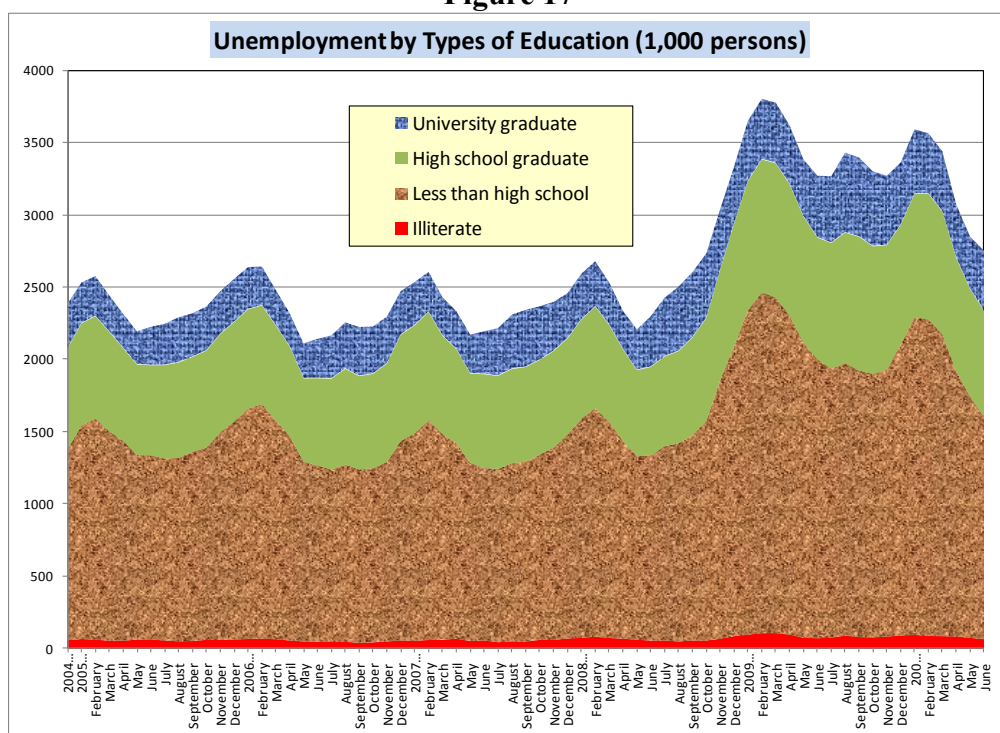
Figure 16



Source: IMF and ILO (2010); Turkey: Turkstat Household Labour Surveys

Another important structural breakdown is the composition of the unemployed with respect to education status. The global crisis hit all education levels almost proportionately, with a slightly more pronounced effect over the university graduates in relative terms. As of 2009 average, 59 percent of total unemployment has less than high schooling (1,670 thousand persons), 26 percent was high school graduates (744 thousand persons), and 13 percent held university degrees (360 thousand persons).

Figure 17



Source: TURKSTAT, Household Labor Surveys.

III-3. The Macroeconomics of the Stimulus Package and Its Employment Impact

The government had enacted a series of stimulus packages to combat aggravating unemployment and output losses. Turkish response to the global crisis has mainly relied on tax reductions and subsidies to promote investment and employment. It is estimated that as a ratio to the GDP, the fiscal costs of the overall stimulus package were on the order of 0.91% in 2008, 3.15% in 2009, and 1.56% in 2010.

Pertaining to the labor markets, the first package was announced in October 2008. With the October package the government has taken the following measures:

- Five percent reduction in social security premiums,
- Further reductions were granted in the social security premiums for the young (18-29 age group) and women workers,
- Payments for the unemployed were increased by 11%

- Increased subsidies were granted out of the Treasury for the disabled and impaired,
- Administrative requirements of the private enterprises such as to provide sport facilities, infirmary, and to employ convicts were lifted.

These measures were complemented in February 2009 by a further set where the short term employment programme (reduced working time fund) was extended from 3 to 6 months and the payments were increased by 50%.

In May 2009, a new package was enacted. With this package, the employers' share of the social security premiums of any extra employment following April 2009 were to be covered from the unemployment insurance fund. Furthermore, to support investment costs of the Southern Anatolia Project, a pre-determined sum would be allocated to the Treasury from the unemployment insurance funds.

In addition to above, a newly enacted *temporary public employment programme* through public infrastructure investment came into effect in July, 2009. The package was initially announced to command a total of 1 billion Turkish liras (646 million USD) and was launched in June with two major components: one was direct creation of temporary public employment (renovating schools and hospitals, refurbishing public parks, etc.) and the other was support for vocational schools, apprenticeship schemes, and job training with a view to boost employment. The program was initially announced as a uniform package of these two components; however, its practical application has taken rather two independent programs loosely connected to each other, with the job-training activities gaining more attention.

A further element of the package addressed the exporter SMEs. The government offered credit with no interest to these enterprises and gave them the possibility to pay back their debt in 2 years instead of 1 year. Other packages included economic measures to stimulate demand and prevent lay-offs. One of these measures was a cut in consumer and other forms of excise taxes from 18% to 8% in the automotive sector, electronics, and household appliances until the end of September 2009.

Comprehensive as it is, a major deficiency of the program is voiced over its short term structure. A major shortcoming of the package was that these jobs were actually created for a maximum of 6 months only, and lacked formal channels for further follow-up towards formal employment.

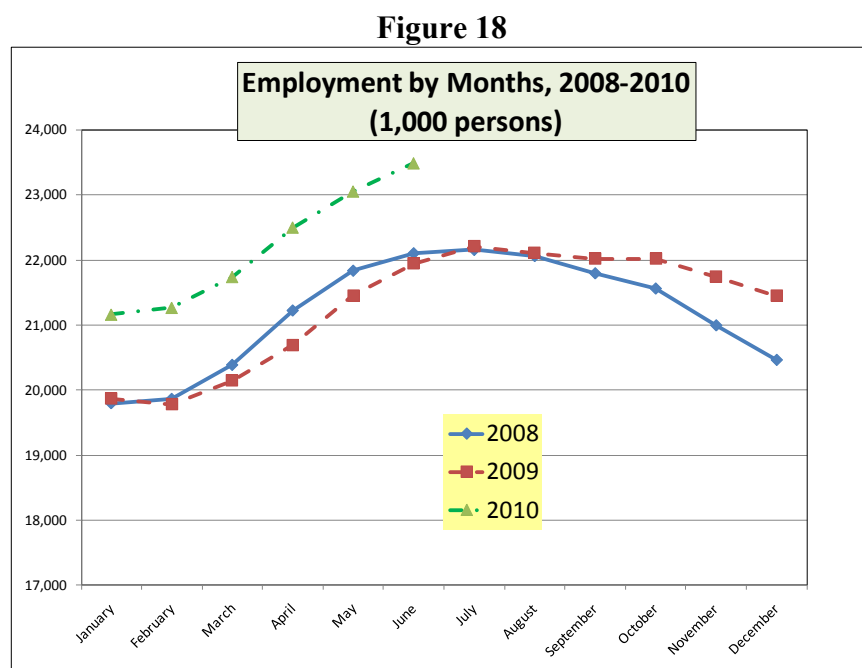
Among the "*passive*" employment programmes, one of the most visible designs was the *wage guarantee fund (WGF)*. Its main aim was to protect those employees who had been adversely affected from their employers' declaration of bankruptcy and/or revelation of inability to pay. Under those conditions the *fund* meets up to three months of unpaid wages of the affected workers. To be eligible for the *fund*, the employee has to be continuously employed by the firm a minimum of one year before the declaration of inability to pay.

Since August 2003, 1% of the employers' share of unemployment insurance fund contributions was allocated to the WGF. Total assets of the *fund* reached to 104.4 million TL as of September 2009. It has disbursed a total sum of 1.1 million TL for 827 workers in 2008; and a total of 19.8 million TL for 10,463 workers in the first nine months of 2009.

Another important *passive* measure was the reduction of employers' social security premium payments by five percentage points. The measure was initially drafted in May 2008 and was

put into effect in October of the same year. SPO estimates that total cost of this program has reached to 3,358 million TL (2,200 million \$) or to about 0.40% of the 2009 GDP estimate.

Data reveal that employment levels had recovered by July of 2009, and by June 2010 employment level exceeds the comparable *y-o-y* figure by a total of 1,541 thousand persons (Figure 18). However, the composition of such employment suggests that it is mostly centered at informal/small scale services, rather than decent paying, high quality productive jobs.



Source: TURKSTAT, Household Labor Surveys.

An overall comparison of the aggregate level of fiscal stimuli across Turkey and other G20 emerging market economies reveal that the size of the Turkish packages had been relatively small (See Table 5). Part of this problem stems from the fact that the Turkish fiscal balances were relatively more fragile at the onset of the crisis. Thus the government seems to have been severely constrained and had relatively less room for maneuver towards intervention.

A comparison of the Turkish fiscal stimuli as estimated by the IMF staff reveals that Turkish fiscal stimulus measures had fared significantly dismal as compared to the global average of the emerging market economies. Turkey had relatively high fiscal deficits, where the sources of employment-generating fiscal measures had been significantly at the low end.

Table 5

G-20 Countries: Fiscal Expansion as % of GDP

	2009			2010		
	of which			of which		
	overall balance	crisis related discretionary measures	other factors	overall balance	crisis related discretionary measures	other factors
GDP weighted average	-5.5	-2.0	-3.5	-5.5	-1.6	-3.8
Advanced G-20	-5.9	-1.9	-4.0	-6.2	-1.6	-4.5
UK	-8.9	-1.6	-7.4	-10.6	0.0	-10.7
USA	-5.6	-2.0	-3.6	-5.6	-1.8	-3.9
Emerging Market G-20	-5.0	-2.2	-2.8	-4.4	-1.6	-2.8
Argentina	-1.1	-1.6	0.4	0.7	0.0	0.7
Brasil	-0.7	-0.6	0.0	1.2	-0.6	1.8
Korea	-6.7	-3.6	-3.0	-7.8	-4.7	-3.1
Mexico	-2.8	-1.5	-1.0	-2.6	-1.0	-1.6
Turkey	-3.7	-0.8	-2.9	-3.3	-0.3	-3.0
Weighted average incl financial support	-7.0	-2.0	-4.9	-5.8	-1.6	-4.2

Figures reflect the budgetary cost of crisis-related discretionary measures in each year compared to 2007, based on measures announced through mid-July. They do not include (i) acquisition of assets (including financial sector support) or (ii) measures that were planned before the crisis.

Source: IMF Staff Position Note 30 July 2009, SPN/09/21

The relative inefficiency and the ineffectiveness of the stimulus measures and crisis management of the government were shared by most of our respondents. The İstanbul Chamber of commerce, for instance argued that “The measures taken by the government were more related with protecting and increasing employment in the short run, which needed urgent intervention during the crisis period. In combination with these measures what is needed is a forward looking strategy designed in cooperation with the social partners in a participatory manner.” Similarly the Istanbul chamber of Industry indicated that “Measures which are planned to be taken before the crisis but implemented after the crisis and therefore have not created the desired effects.” It was also mentioned that “short-time allowance, which is a crisis specific policy measure, has had a positive effect on both the enterprises and the workers, has become widespread as a form of flexible working arrangement and has set a good example of a “flexicure” employment system. Of the 200.000 people who have benefited from this arrangement most are employed by big companies, indicating that due to information and administration deficiencies SMEs are out of the scope of this system. Short-time allowances and other flexible working schemes would be further beneficial for both the enterprises and the workers if they are to be permanent, rather than just a temporary arrangement only specific to crisis.”

In contrast, DISK (Confederation of Revolutionary Trade Unions of Turkey), argues that “The measures taken in the face of the recent crisis are all in favor of the employers, disregarding the demands of the workers. While, with the announced fiscal stimulus packages, different incentive mechanisms are put into force in order to increase production, wages were pressured downwards and flexible working schemes became active.” DISK view was that “the most prominent effect of the crisis is the increase in the structural unemployment and expansion of a lasting poverty. Loss of jobs resulting in loss of income, being excluded from the social security fund, loss in production, closing of the firms are the things that we have experienced so far and will be experiencing in the near future. Facing this hard fact, the economic measures that the government has employed was only functional at delaying the problems temporarily but not successful at bringing about permanent solutions.”

Another Labor Union Confederation, Turk-Is underlined that “the adverse effects of the crisis could not be realized by the government in time, therefore the measures are belated” and that “Most of the measures are employer focused. Reductions in social security premiums have not reached its

desired outcome on creating employment and this fact has been also recognized by the government officials”.

Turk-Is administration has further indicated that “An economic policy addressing the adverse effects of the current crisis should ensure the effective functioning of the financial system, while increasing the domestic demand. Increasing the aggregate demand is important for the efficient performance of the credit mechanism and, vice versa, a better performance of the financial system is important for increasing the domestic demand. The main role of the fiscal policy, when evaluated in this framework, should be increasing the aggregate demand. But, while being devised to increase the demand, the diagnostics of the sources of falling demand should be done carefully”.

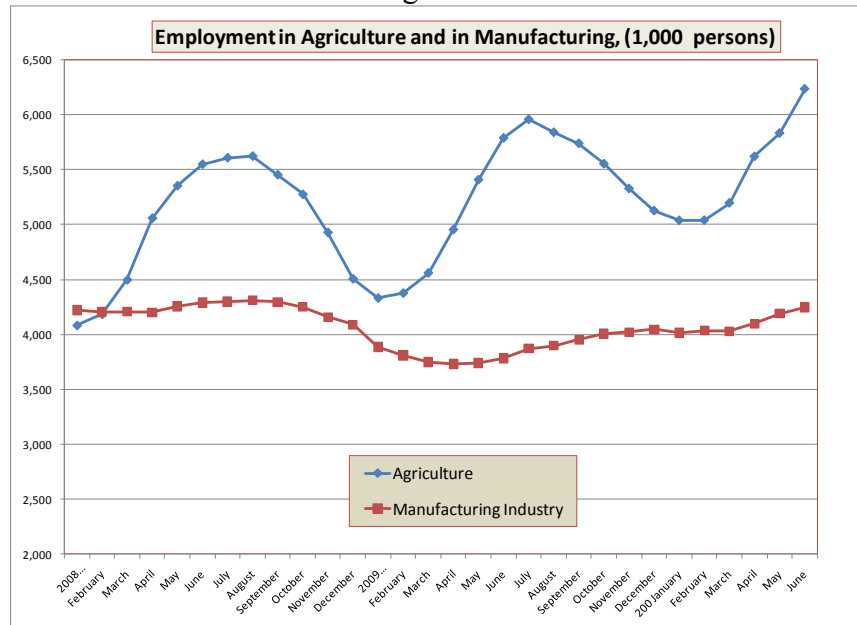
The employers’ also raise similar concerns. For instance TİSK (Turkish Confederation of Employer Associations) mentioned that “although the measures taken by the government are appreciated, they are perceived to be inadequate. Only a couple of these measures are seen to be effective, such as reduced working-time allowance and sales tax reductions. But, the effect of another important measure, which is the reductions in the employers’ share of social security premium payments, has been offset by other regulations.” TİSK’s vision towards longer term macro policy was shared with the following remarks: “most of the measures taken regarding employment are focused on creating additional employment. However, today’s priority should be maintaining the present employment level. For this reason, the main burdens on employment, such as employers’ share of social security premiums and severance payments must be reduced. There are no indications of this sort in the medium term economic program. In order to have a progress in employment, it is a necessity to increase the real sector production and exports. Although, the situation has been correctly reflected and a target of a development path through the private sector has been set in the medium term economic program, there are so strategies mentioned in the program as to the realization of this target.”

III-4. Informalization of the Labor Markets

A closer look at the details of these employment gains disclose important traits of the adjustment process experienced within the domestic economy. Composition of employment by sectors is portrayed in Figure 19. The trends of employment in the agricultural versus manufacturing industry reveal that the burden of adjustment in the labour markets was absorbed by the rural economy. Agricultural employment was about 4 million 200 thousand people in early 2008. During the evolution of the effects of the great recession on Turkey throughout 2008 and 2009, agricultural employment is observed to *increase* by 2 million people bringing number of workers employed in the agricultural activities to 6.2 millions. Employment in the manufacturing industries, on the other hand, contracted sharply during 2009 and could not recover its pre-crisis levels as of June 2010 (see Figure 19).

These adverse trends in favor of the agricultural activities raise doubts about the quality of the employment gains generated thus far. The fact agricultural output had expanded at a cumulative of only 2.3 % over the course of the last two years, the source of this observed expansion in agricultural employment reaching to 30% is hard to explain. Clearly this had occurred at the expense of significant informalization and widening of the employment slack in the rural economy.

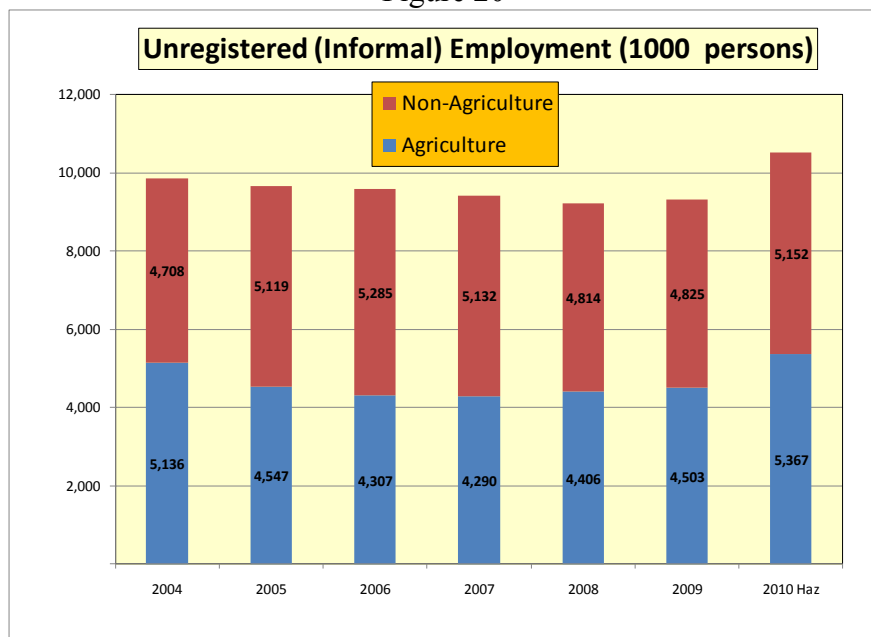
Figure 19



Source: TURKSTAT, Household Labor Surveys.

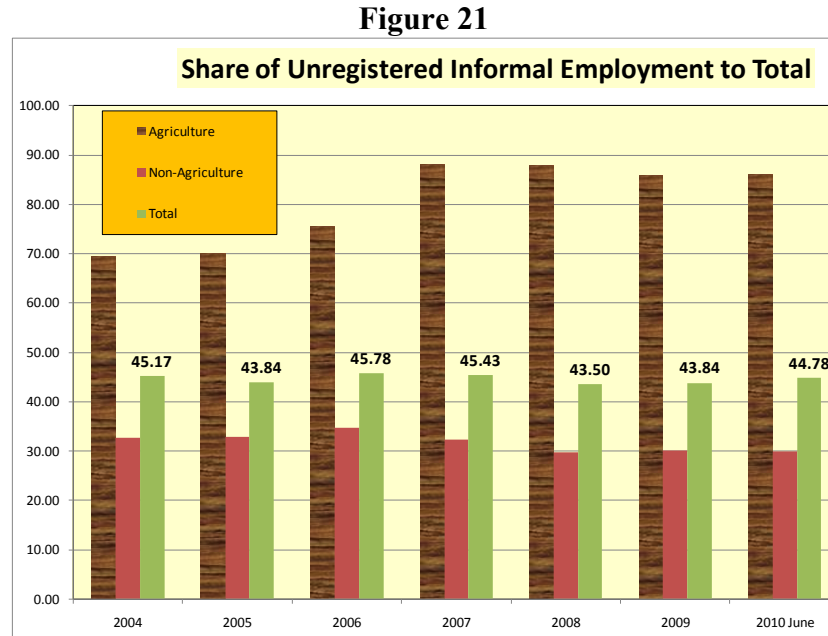
As a follow up of these observations, in Figure 20 we report on the available data from Turkstat data base on the extend of informalization and duality in the Turkish labour markets. Data reveal that as of June 2010, unregistered workers in agriculture was 5 million 152 thousand persons. With an addition of 5 million 367 thousand workers employed under unregistered conditions, this brings total unregistered employment to 10.5 million people. This is 44.78% of total employment. (See data in Figure 20).

Figure 20



Source: TURKSTAT, Household Labor Surveys.

Informal, unregistered employment without any social securitization coverage has been an indispensable trait of the Turkish labour markets over the 2000s. The ratio of the unregistered employment to total employment had fluctuated between 45 – 50 percent over the decade, and as it seems, had constituted one of the major (arguably *the main*) mechanism of adjustment. As informal labour bore the burden of adjustment, wage remunerations fell and quality of jobs unavoidably got worsened. See Figure 21 for the historical trend in the informalization of the labour markets over the 2000s.



Source: TURKSTAT, Household Labor Surveys.

In fact, unregistered informal employment gains mostly explain gains in total employment in the first half of 2010. As Table 6 attests, one can read a rapid expansion in total employment over the first half of 2010. Yet a close inspection of the status of these data reveals that of the 2 million 324 thousand newly employed workers, 1 million 570 thousand were “employed” without any social security coverage, as “unregistered” employees. This phenomenon had been particularly acute in agriculture, where of the total 1 million 194 thousand new employment, 1 million 45 thousand were unregistered as informal workers. This is a ratio of 98%!

Table 6:

Employment and Unregistered Informal Employment over January-June 2010						
		Total	Agriculture	Industry	Construction	Services
Employed						
	January 2010	21,164	5,039	4,281	1,161	10,683
	June 2010	23,488	6,233	4,536	1,580	11,139
	January-June Difference	2,324	1,194	255	419	456
		Total	Agriculture	Non-Agriculture		
Unregistered Informal Employed						
	January 2010	8,949	4322		4627	
	June 2010	10,519	5367		5152	
	January-June Difference	1,570	1,045		525	

Source: TURKSTAT, Household Labor Surveys.

Thus far, the expansions of the fiscal stimuli seem to have deepened the informalization of the labour force, with insufficient gains in decent work. This is a key attribute that we come across again and again in the country experiences since the onset of the global recession.

III-5. The Medium Term Outlook

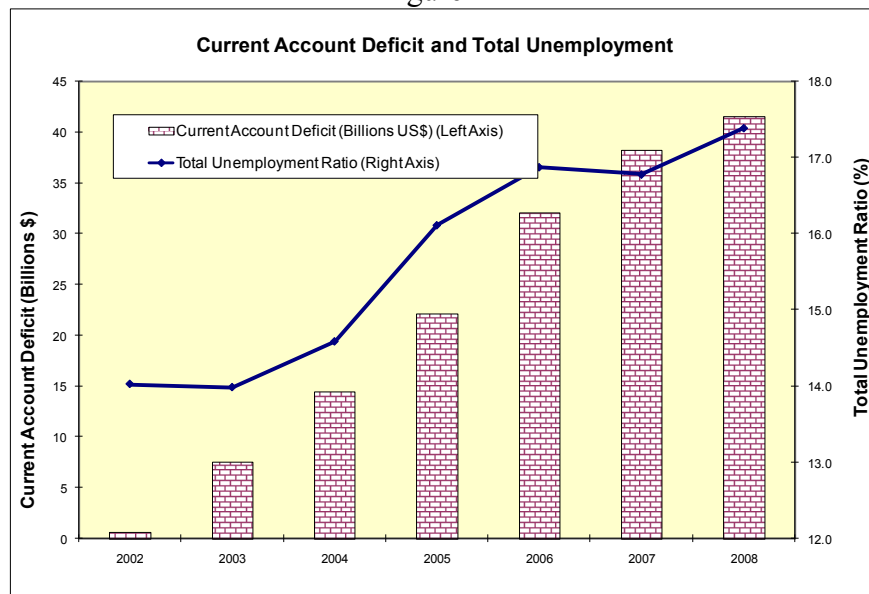
To be certain, the effectiveness of the labor promoting policy measures cannot be separated from the overall macroeconomic environment the domestic economy had been situated in, and none of these outcomes were of course independent from the overall macro performance of the Turkish economy. Unfortunately, the character of macroeconomic policies that were effective in Turkey following the 2001 crisis had generally been quite unfriendly for employment generation.

A major distinct feature of the Turkish economic scene in the post-2001 crisis era was its relatively high interest rates and high costs of credit. Operating under an environment of global financial expansion, this fact has led to a rapid expansion of foreign capital inflows, especially in the form of short term speculative “hot” finance. The underlying speculative nature of such flows was a witness to the fact that they were not necessarily part of “green field investments” that could expand labor demand by creating new jobs and bringing new advanced technologies. The “hot” character of speculative finance resulted in mainly currency *appreciation* and loss of competitiveness for the traditional Turkish exportables. “Modern” manufacturing sectors, on the other hand, gained from this appreciation. These were mostly sectors such automobiles, auto parts, and consumer durables. They typically display high import content, and the fact that imports got cheaper meant significant cost savings for such sectors. Thus, Turkish exports of automotives and consumer durables expanded during this period. However, being import dependent, such sectors displayed relatively low domestic value added content and had relatively low elasticities of labor

employment. In what follows, the appreciation of the exchange rate led to a loss of competitiveness and stagnation of the labor intensive traditional Turkish exportables, such as textiles, clothing, small scale glass and ceramics. As labor employment demand dwindle in these sectors, the rising “modern” manufactures had low elasticities of labor and could not maintain high employment gains. The end result had been a rise of unemployment.

Figure 22 summarizes all these assessments succinctly. The figure depicts *total* (open plus disguised) unemployment ratio as a line graph with respect to the right axis. This ratio is borrowed from data in Table 4 above. It is contrasted against the *current account deficit* displayed with respect to the left axis. The portrayal of the rising unemployment along with an expanding current account deficit is no surprise to students of development economics. As Turkey consumed more and more of value added produced *abroad*, and found it profitable with an appreciated currency financed by speculative financial inflows, external deficit widened and foreign debt accumulated. The costs of this *speculative-led growth*, however, were realized as loss in jobs, and decline of real wage income.

Figure 22



Source: TR Central Bank and Turkstat.

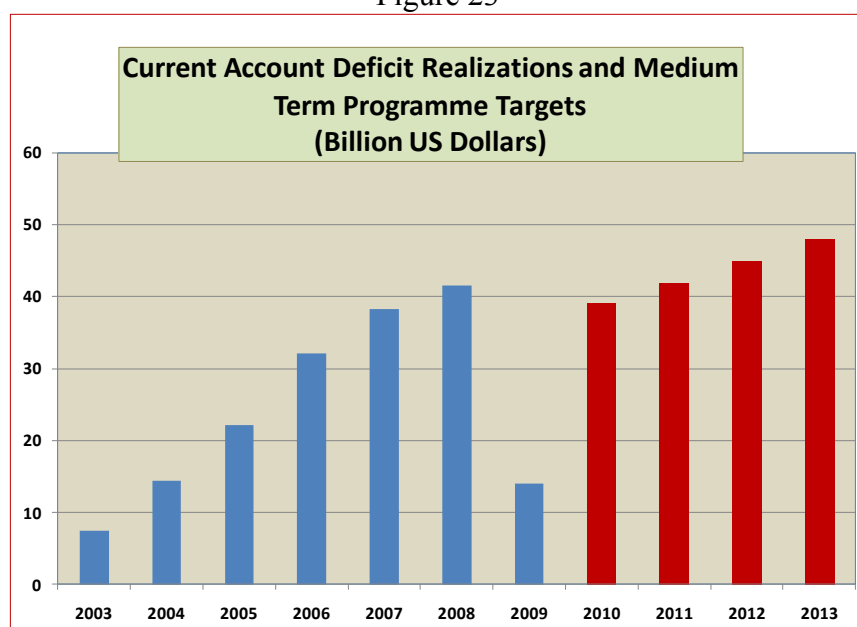
On the other hand, the recently released⁷ *medium term economic program* estimates reveal that the Turkish economy will likely to re-enter a new path of relatively large current account deficits over the years ahead (see Figure 23 below). The program forecasts that the GDP would expand at a rate of 6.8% in 2010 and at rates of 4.5%, 5% and 5.5% over 2011, 2012 and 2013, respectively. It is expected that the unemployment rate will be 12.2% in 2010 to recede to 11.4% by the end of 2013.

The MTE program's main assumptions seem to rely on the strategy of continued external deficit financing with an expected re-emergence of current account deficits over 2011-2013. It is expected that as a ratio to the GDP, the external deficit will rise from 3.5% in 2009 to

⁷ State Planning Organization, medium Term Economic program, 2011-2013. Dated 11 October 2010, Ankara

5.3% over 2011-2013 (Figure 23). Leaving the general question of whether such external deficits could at all be feasible in the period ahead, the desirability and appropriateness of this strategy for employment is desperately questionable given the historical experience of the early 2000s. Continued adherence to external deficit-led growth will, no doubt, result in undue strain in the labour markets.

Figure 23



Source: State Planning Organization (2010) *Medium Term Economic Program*, 2011-2013, October, Ankara

These observations were also resonated in Rodrik (2009) who writes that “... a financially open economy has many sources of vulnerability. Even when a country does its homework, it remains at the mercy of developments in external financial markets. Crises and contagion are endemic to financial globalization. The world of finance does not always operate in a benign fashion. So lesson number one is that policy needs to guard not just against domestic shocks, but also shocks that emanate from (external) financial instability. Writing in particular over the Turkish experience with the global recession, Rodrik further comments that “the Turkish economy grew at quite rapid rates in the years before the most recent crisis. This can be interpreted as the reward for the solid macro policies pursued since 2001. At the same time, there were too many disconcerting elements in this growth experience. In particular, domestic saving fell (instead of rising, as it should have done in an environment of increased macro stability and confidence) and unemployment remained stubbornly high. The external deficit kept on widening. Investment remained lower than required. All of these put the sustainability of the economic boom into question. Even if the sub-prime mortgage crisis had never taken place, Turkey’s prevailing pattern of growth would have run into problems. Therefore it would be a mistake for the country to return to the status quo ante and resuscitate a model that fails to make adequate use of domestic resources. Most importantly, Turkey has to learn to live with reduced reliance on external borrowing.” (Rodrik, 2009, p.2).

All of these observations underscore the argument that labor enhancing policies will not be successful unless complemented by an *employment-friendly* vision in the overall macroeconomic policy environment, to be designed and implemented not only at a domestic,

but also at the *global* level. Excessive reliance on external finance is compelling at first sight, but its costs could be tremendous, and not necessarily limited to conjectural swings of the business cycle but typically involve strategic costs adversely affecting the future growth path and its quality.

IV. Lessons Learned from the Great Recession: Towards a New Employment Friendly Paradigm of Macroeconomics

To conclude, let's recall the main shifts that had been witnessed over the last three decades in the world economy (the so called "reform" decades):

- Lower real wage incomes and the consequent rise in inequality;
- A big jump in consumption —a drastic fall in private savings;
- A big jump in private indebtedness
- Coupled with flexibilization of the exchange rate regimes and central banks' decision to surrender their instruments to the markets, severe appreciation of the domestic currency, and deteriorating current account deficits;

We have summarized the outcome as *financialization* and the deepening of the financial glut with the advance of sub-prime mortgages, sub-prime credit, and lax supervision, etc., — all of which had been collected under the term *toxic assets*.

IV-1. Theoretical Matters

Could economic theory have predicted this outcome? Not really, under the disguise of "micro-foundations" driven models of perfect competition with perfect substitutability of finance and other forms of capital, many of the realities of the world we live in had been harnessed behind the "smooth" functional forms and the idea of "intertemporal harmonious equilibrium", *ad infinitum*. Simply put, the mainstream paradigm is constructed so carefully behind a well-protected Byzantine wall of stability assumptions that it is virtually impossible, using this apparatus, to capture *bubbles* and *asset-mania* (a la Kindleberger) that the world markets had long been suffering from.

Now, let's take the relevant areas in turn:

- *Nature of international trade*: openness and trade reform had been seen as the miraculous panacea for all evils associated with waste, inefficiency and stagnation. Based again on models of perfectly competitive markets, neoliberal economics maintained the manta of *comparative advantage* for a quick-fix remedy to pick up the "hundred dollar bills laying on the side walk". Yet, the world trade is known to be governed by principles of not comparative but *absolute* advantage with the trans-national companies (TNCs) accounting for 2/3 of the global merchandise trade. The static gains associated with revealed comparative advantage are often dwarfed with the dynamic gains that can be pursued from strategic trade policy, with a careful mix of both protectionist and export promotion policies. This is of course the crux of the Korean development strategy as documented in Amsden and more recently by Rodrik and Ha-Joon Chang. We have learned over once again that development warrants not doing more of the same thing more intensively, but diversification into producing

new things up in the ladder of industrialization. The policy recommendations based on static comparative advantage, simply put, had been misleading advice.

- *Obsession with inflation phobia.* The last two decades had also witnessed a major shift in central banking policies destined only for targeting inflation, in almost cases at the expense of other possible macroeconomic objectives. Initially adopted by New Zealand in 1990, the norms surrounding the IT regime have been so powerful that the Central Banks (CBs) of both the industrialized and the developing economies alike have declared that maintaining price stability at the lowest possible rate of inflation is their *only* mandate. It was generally believed that price stability is a pre-condition for sustained growth and employment, and that ‘high’ inflation is damaging the economy in the long run. However, the common expectation of IT promoters that price stability would ultimately lead to higher employment and sustained growth failed to materialize. Generally, the world economy had been growing too slowly to generate sufficient capital investment and reduce unemployment. Cast in a deflationary environment where there has been a significant growth in the global labor supply, the IT central banks’ almost exclusive focus on price stability fails to help address the root causes of the macroeconomic instability, including the globalization of unregulated finance in the past two decades.

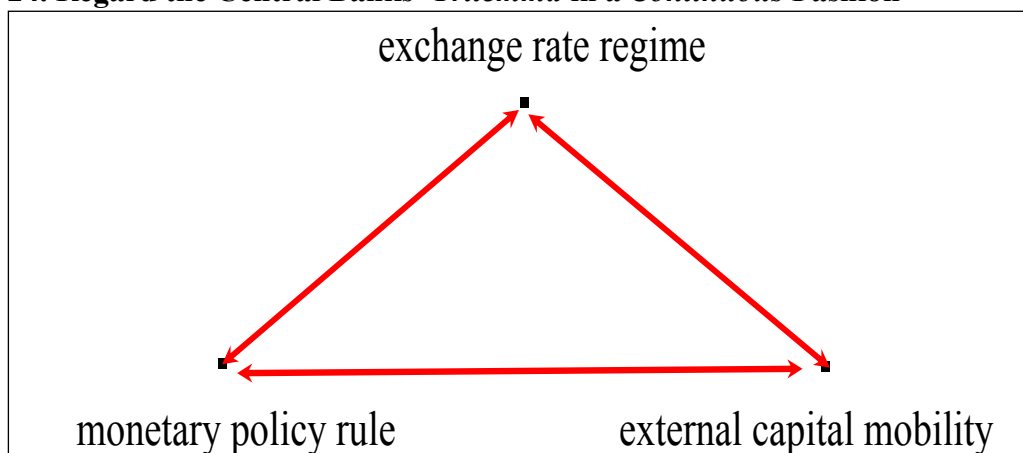
Part of the broader requirements surrounding the IT system was often argued to be the implementation of a “floating/flexible” exchange rate system in the context of free mobility of capital. Accordingly, the CBs should abandon their interventionist policies in the foreign exchange markets for all practical purposes other than pursuit for price stability. Thus, “*exchange rate flexibility and floating exchange rate administration*” became the new *motto*, and to many advocates, central bank “policy” has typically been reduced to mean merely “*setting the policy interest rate*”. The exchange rate and macroeconomic prices such as the credit and consumer rates of interest were thereby left to the unfettered workings of the global financial markets.

The mainstream case for exchange rate determination rests on the well-celebrated Mundell (1963) and Fleming (1962) model where the model rests on an assumed duality between reserves (fixed exchange rate system) *versus* flexible exchange rate adjustments. Within the mainstream orthodoxy, the major policy implication of the Mundell-Fleming duality is the so-called “trilemma”, which commands that central banks can only choose two out of three of the following: open capital markets, a fixed exchange rate system, and an autonomous monetary policy geared toward domestic goals. A “*fixed*” exchange rate regime along with “*open*” capital markets, for instance, necessitate reliance on international reserves and renders it impossible to have an autonomous monetary policy otherwise. By the same token, a central bank like that of China’s can afford to pursue relatively *more autonomous* monetary policies together with a *fixed/administered* exchange rate regime; yet it has to rely on “*controlled/regulated*” capital markets.

While this so-called “trilemma” is not strictly true as a theoretical matter, in practice it does raise serious issues of monetary management. From our perspective, the real crux of the problem turns out to be the very narrow interpretation of the constraints of the trilemma: CBs are often thought to be restricted to choose two “*points*” out of three. Yet, the constraints of the trilemma could as well be regarded as the boundaries of a *continuous* set of policies, as would emerge out of a bounded, yet continuous depiction of a “*policy triangle*”. Thus, even within the boundaries of the trilemma a menu of choices does exist, ranging from

administered exchange rate regimes to capital management/control techniques. Figure 24 attempts to provide a visual portrayal of this statement.

Figure 24. Regard the Central Banks' *Trilemma* in a *Continuous* Fashion



The conundrum is that those interpreting the trilemma in a very orthodox fashion regard one of its corners, namely the free mobility of capital, as a pre-determined choice and take for granted that virtually complete financial liberalization in the external sector is the first-best, optimal policy environment. Yet recent evidence amply shows that open capital markets can create very costly problems for developing countries⁸ and that many successful developing countries have used a variety of capital management techniques to manage these flows in order, among other things, to help them escape the rigid constraints of the so-called “trilemma” (Ocampo, 2002; Epstein, Grabel and Jomo, K.S., 2005).

In response to these concerns the heterodox/structuralist tradition asserted that irrespective of the conditionalities of foreign capital and boundaries of inflation targeting regimes, it is very important for the developing economies to maintain a *stable and competitive real exchange rate* (SCRER) (see, e.g., Epstein and Yeldan, 2009; Galindo and Ros, 2009; Frenkel and Rapetti, 2009; Frenkel and Taylor 2006; Frenkel and Ros, 2006). They argue that the real exchange rate can affect employment, and the economy more generally, through a number of channels: (1) by affecting the level of aggregate demand (*the macroeconomic channel*); (2) by affecting the cost of labor relative to other goods and thereby affecting the amount of labor hired per unit of output (*the labor intensity channel*); and (3) by affecting employment through its impact on investment and economic growth (*the development channel*) (Frenkel and Ros, 2006). While the size and even direction of these channel effects might differ from country to country, maintaining a competitive and stable real exchange rate is likely to have a positive impact on growth and employment through some combination of these effects.

The general analysis of the SCRER within the context of IT central banking is investigated in Cordero (2009). The gist of the structuralist case for SCRER rests on a recent (and

⁸ Due to space limitations I abstain here from a detailed assessment of the detrimental effects of premature openness of the capital account to short term (“hot”) capital inflows. For a thorough discussion of these issues, see, e.g., Stiglitz (2002), UNCTAD (1998), Epstein, Grabel and Jomo (2005). For an analytical assessment of the short term capital inflows see, Adelman and Yeldan (2000).

unfortunately not well understood and appreciated) paper by Taylor (2004). Basing his arguments on the system of social accounting identities, Taylor argues that the exchange rate cannot be regarded as a simple “price” determined by temporary macro equilibrium conditions. In Taylor’s (2004, p.212) words, “... *the balance of payments is at most an accumulation rule for net foreign assets and has no independent status as an equilibrium condition. The Mundell-Fleming duality is irrelevant, and in temporary equilibrium, the exchange rate does not depend on how a country operates its monetary (especially international reserve) policy*”. Accordingly, the exchange rate “*has to evolve over time subject to rules based on expectations about its values in the future.. (yet), in a world of shifting and perhaps unstable expectations, no simple dynamic theory is likely to emerge*” (Taylor, 2004, p.223).

In a practical setting, the fact that the exchange rate can be in “equilibrium” in the sense of meeting the demand for foreign exchange with a corresponding supply in the spot market, and yet its level might still be “mis-aligned” with respect to overall macro equilibrium has been recently claimed in Edwards (2001). In this view, the exchange rate is regarded as “mis-aligned” if it’s realized value exhibits a persistent departure from its long run equilibrium trend. The long-run equilibrating value, in turn, is taken to be that rate which, for a given set of “structural fundamentals”, is compatible with the simultaneous achievement of internal and external equilibrium⁹. It is clear that such an assessment has to go beyond the simple PPP calculations, which are wrought with the issues of choice of a relevant price index and a proper base year.

Leaving the exchange rate management directly to the unfettered capital inflows had led to misalignments and appreciation of the domestic currencies with a severe deterioration of the current account. And yet, over-obsession with inflation targeting and with fiscal sustainability, while neglecting current account sustainability had proven to be a dangerous game as had been witnessed by the emerging market episodes post-2008. It is very interesting to note at this juncture that the Korea meetings of the G20 had witnessed a structural shift in favor of capital controls as way to curb hot money inflows. As a recent leader in *Straight Times*¹⁰ indicate, “they were once regarded with barely disguised horror but capital controls are being touted as a way of combating the liquidity flooding the region. One unconventional suggestion made by the IMF is that such controls be coordinated across a number of nations. It signals a stark turnaround from recent conventional wisdom.” It seems even the IMF has now endorsed the idea as a measure to prevent the destabilizing effects of hot money flows.

IV-2. An Employment-Friendly Macro Paradigm for Turkey

Given our analysis thus far, it ought to be clear that the current Turkish macro economic trajectory rests mostly on speculative capital inflows to close the foreign gap. Labor markets, in turn, bear the burden of adjustments of this speculative-led growth path. Thus, an employment-friendly macro economic policy should focus first and foremost on releasing the burden of adjustment in the labor markets so as to alleviate pressures from wage-labor. To this end,

⁹ See also Fischer (2001) on the formal statement of the problem within the context of a finer classification of the exchange rate systems.

¹⁰ Straight Times, 26 October, 2010.

(i) Fiscal policy has to be re-designed to favor expenditures on *social capital*. The share of education and health expenditures has to be increased within a well-designed and targeted social program. The public sector should also be responsible in designing a labor-intensive public investment programme to expand employment especially in the backward regions of East and South Eastern provinces.

To ensure that increased costs of social expenditures/public investments will not have inflationary pressures, a re-hauling of the tax system to cover the capital incomes will be necessary. Currently, at a rate of less than 1% of the gross domestic product, Turkish tax burden on corporate capital incomes is one of the lowest in Europe. Extending this coverage will generate a higher revenue base to pursue such social expenditures.

A further revenue source is imposition of a “financial transaction tax”. Such a tax is already utilized as an instrument to reduce the volatility and destabilizing effects of hot money inflows by, for instance, Brazil (6%) and Thailand (13%). Korea has also debated invoking such a tax on capital transactions and is likely to do so in a short while. Such a levy is purposed not only for purposes of enhancing fiscal revenues, but also for slowing down the rate of movement of speculative capital flows (see further below).

(ii) On the monetary policy front, the Central Bank of the Republic of Turkey (CBRT) has to be facilitated with enhanced macro tools for intervening to the money and asset markets. The IMF program that had been in place since 1998 at the background has taken away the tools of austerity from the hands of the central bank. The post-crisis adjustment period is a conducive time to get these tools back.

Researchers at CBRT are already discussing *re*-introduction of a reserve requirement ratio to reduce the rate of expansion of credit, and to slow down inflows of finance capital. The CBRT has announced recently that the reserves will not be granted any interest income to the banks. It is estimated that such a move has increased the cost of credit by 3 percentage points.

A further intervention could be designed so as to increase the *reserve cost* of the *short term financial inflows* in contrast to *long term inflows* (with more than 6 months maturity).

(iii) Capital market policy will directly benefit from the interventions discussed above. A further complementary policy could be the introduction of a financial transaction tax/levy on the *financial flows*. The basic principle motive for such a tax is to reduce the mobility of finance capital and to introduce more power to the CBRT to intervene to the asset markets. Here the tax rate could be set at a progressive level inversely related to the maturity of financial flows.

The combination of these instruments will be helpful in strengthening the CBRT’s arsenal of austerity tools and enhance its independence from the speculative inflows. The CBRT, under this environment will be able to intervene to the foreign exchange market at a lower cost and will be able to dampen the pressures towards appreciation of the Lira, as well as its fluctuations. With increased independence the CBRT could expand its effectiveness on the exchange rate and could employ more efficient interventions to the foreign exchange market against appreciation.

(iv) Employment policies are clearly the main foci of the new macro economic policy. It ought to be proposed at the outset that the main responsibility creating an employment-friendly investment environment rests with the public sector. The state has to generate an employment intensive investment program mainly in the poor Eastern-Southern provinces. Agro-based industries will be a natural candidate for sectoral priorities. Such a public investment program will generate not only increased labor demand for the region, but is also expected to create a conducive environment for reducing regional income differences as well.

On the social protection side, it is known that the unemployment insurance fund resources in Turkey is of very limited assistance to the unemployed. As of September, 2010 total assets of the fund had reached to 45 billion TL, and yet disbursements could have reached only to 4.5 billion TL, less than 10% even at times of severe unemployment.

A final word of caution regards attempts towards increased flexibilization of the labor markets. It is already a known fact that measures to increase flexibility of the labor markets, if not accompanied by proper institutional reforms to protect the well being of the laborers, may end up in creating a dual labor market with highly productive labor being employed with unproductive temporary workers. Over time the gulf between these types of labor markets could widen, leading to increased fragmentation of the work environment with consequent efficiency losses. Such a worry was succinctly narrated in the joint ILO-IMF Conference at Oslo, September 2010. The report wrote that, “Over the past 20 years, a number of OECD countries tried to increase labour market flexibility by encouraging temporary work contracts that were not subject to the strict employment protection that applied to permanent contracts. Due to this increased flexibility, employment in countries with a pervasive dual employment system should be more responsive to output changes. Countries that have a higher share of temporary workers tend, not surprisingly, to have more disparity (in terms of wage and benefits) between the permanent and temporary workforce. These disparities risk becoming entrenched as the temporary workforce has less access to on-the-job training and thus acquires less human capital than their permanent peers, which in turn worsens their prospective employment opportunities.”

The ILO-IMF report warns that “In addition to equity concerns, there is also compelling theoretical and empirical evidence (e.g. Blanchard and Landier, 2002) that the coexistence of a flexible temporary workforce and a highly protected permanent workforce can in fact increase unemployment and thus turn out to be inefficient. This perverse effect of a two-tier system on unemployment is due to a high turnover of low-productivity jobs that, on aggregate, lower output and employment.” (pp.36-37)

Thus, proposed reforms to enhance flexibility and efficiency of the labor markets should be considered in terms of protection of labor incomes, reduction of wage inequality and ensuring increased productivity. Short term solutions to maintain profitability of the enterprises should be weighed against the long term losses in social efficiency and equity.

The great recession has surely led to a widespread impact not only on the policy sphere, but also on the macroeconomics of international relations. It ought to be our task, as development economists, to engage into fruition of the new macroeconomics that is more employment friendly and also socially responsible. Above all, it is clear that the role of active social dialogue can not be over emphasized in matters of designing an employment-friendly macro environment that will enhance not only equality, but also social efficiency.

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Appendix. Social Dialogue: Interviews With Social Partners

In order to back up the technical assessment of the current macroeconomic framework in Turkey and its reflection in the labor markets, we now supplement anecdotal evidence that was collected through interviews/consultations conducted with the key personnel of the related public-private institutions and other social partners. The questionnaires for the interviews were designed to focus on 4 main policy areas; monetary, fiscal, foreign exchange and capital market policies, and their complementarities with the labor market policies. Same questions are asked to the concerning parties from different backgrounds, in order to derive the story behind the economic policies as a whole. These questions involve how changing macroeconomic environment following the 2001 crisis has been perceived; how the reflection of macroeconomic policies on the labor market is evaluated; and how the overall policy framework should be designed to align the policies of different areas to address issues of employment, decent work, poverty, productivity and growth.

The interviews/consultations are conducted with Süreyya Serdengeçti (former Governor of Central Bank of Turkey), Erdem Başçı (Deputy Governor of Central Bank of Turkey), Emin Dedeoğlu (former Directorate General for Public Finance, Undersecretariat of Treasury), Murat Özveri (Labor and Society Journal, editor) and a number of economists who wished to remain anonymous. When asked about their institutional opinions on the above mentioned issues, the social partners (ISO, ITO, TÜRK-İŞ, HAK-İŞ, DİSK and TİSK) had returned to excerpts from their previous reports. Consequently, their views are summarized from their related reports and are presented separately. Below are the responses of the individuals to the interview questions. The synopsis from the institutional reports follows.

- 1) *Macro economic developments in Turkey and in many other emerging markets over the post-2000 period indicate that there had been important gains in narrowing the fiscal gap and reducing inflationary pressures and yet there had been a general substitution of private external deficit with the public deficit. How would you assess this observation?*

The regulations regarding the banking sector should also be included in this list, as a factor contributing to stability. In fact, the rising private foreign debt against falling public debt was an expected outcome. Because, the firms lacked the necessary capital to make investment and it was not possible to borrow from the banks, since all of their assets were invested in government bonds. In such a setting we did not see any problem with the increasing foreign debt of the firms. But, then it was realized that the firms were not capable of risk management. Since their incomes were denominated in TL and debts in \$, it has given rise to an exchange rate based problem. We had tried to attract attention to this problem but nobody had listened, necessary measures were not taken. Clearly, there is a current account deficit problem and this deficit is not sustainable unless there is a capital inflow into the economy. Where should the solution to this savings-investment gap lie? This problem does not fall into the policy area of the Central Bank. Here, the sustainability of these capital flows is an important matter. What we were experiencing before the crisis was that the effects of the “hot” money flows were decreasing. But it is now increasing again. Unfortunately, a long sighted approach to policy making has not been established yet. Even a growth rate of %7 was not successful in bringing down the unemployment

rate, let alone a rate of %3-4. This fact should be seriously considered. (Süreyya Serdengeçti, former governor of the Central Bank of the Republic of Turkey)

Current account deficit is one of the delicate issues concerning the Turkish economy. Looking at the past, it can be observed that due to structural characteristics of the Turkish economy, current account deficit rises faster with increasing rates of growth. On the flipside, the periods during which the current account deficit declines or turns into a surplus coincide with the periods of lower growth rates or crisis. Such a structure reveals that the current account deficit has a structural character as well as a cyclical one. There is a need for a transformation on this fragility and risk creating structure of current account. Current account should be kept under control through supply side macro and microeconomic policies with medium to long-run perspective. In order to explain the current account issue through simple arithmetic, we can think of it as the sum of net borrowing requirement (to close the budgetary deficit) and private sector net borrowing. During the 2002 – 2008 period, due to tight fiscal policies, public sector net borrowing has declined. Steps taken towards macroeconomic stability has lowered the level of interest rates, the falling rates has increased the investment demand while decreasing the level of domestic saving. One of the requirements for the savings gap not to become a risk factor in the long run is, creating the necessary productive capacity in order to make the repayment of the debt possible. In other words, the borrowing should be used for increasing the productive capacity through investment, rather than for consumption. Increasing share of the machinery and equipment investment in GDP by 4 percent points, following the year 2002, indicates that this requirement is satisfied in case of Turkish economy. During the same period public sector borrowing requirement to GDP ratio has decreased by 10 points. Parallel to this development, private sector savings has decreased. The transformation of demand between the private and public sector shows that the phenomenon which is known as the Ricardian equivalence in the economics literature, is also present in Turkey. Due to the perception that the recoveries in the public finance are permanent and fiscal discipline will last, private sector has lowered its saving rate which was originally kept higher in response to the concern of a possible crisis. (TCMB, Central Bank of the Republic of Turkey)

Turkey had been following an IMF led economic policy following the 2001 crisis. When this policy is evaluated, it can be seen that the IMF led policies are formulated with the aim of saving the global system from breakout of crisis. And the policies designed so far are in accordance with this aim: guarantee the repayment of the external debt. Turkey has to follow these policies, since the choice is to stay within the global system. For political reasons and lack administrative capacity, it could not afford to stay out of it. The reform agenda is meaningful when these points are considered. Micro reforms which would ensure the development of sector-specific policies and strategies, reduction of regional disparities through bottom-up planning approach should continue. But there are still problems with the administrative capacity. The design of new governance schemes is, therefore, important: new forms of doing business should be developed, a more participatory policy making process should be designed, more space should be given to local administrative bodies in the policy are etc. (Emin Dedeoğlu, former Directorate General for Public Finance at Undersecretariat of Treasury)

The truth is reflected in the external deficit statistics. Although, as a part of its public propaganda, the government is claiming that the external deficit is decreasing, the external debt keeps accumulating through private sector borrowing. The government is concealing these figures by acting as if the treasury guaranteed debts are of a separate category. I fear that its negative effects will outgrow the effects of extensive public borrowing. (Murat Özveri Labor and Society Journal, editor)

With the beginning of the 2000s the world economy has gone through a period of expansion. High growth rates coupled with high liquidity caused the capital flows to target emerging market economies in specific, where the gains are perceived to be greater. Although the capital inflows have many different effects on the host country, they have been the determining factor in the rapid price rise in the housing sector. High liquidity, on the one hand, has fostered the investments of the private sector with lower interest rates and low costs of financing. But on the other hand, with the effects of overvalued TL, has increased the imports of intermediate inputs and investment goods, and together with the private sector foreign borrowing, has contributed to widening current account deficit. On the public side, borrowing at low interest within this favorable conjuncture, increase in the tax collection with the heating of the economy and limited increase in the public sector investments due to high private sector investments, has kept the public sector deficit had been low and given rise to private sector deficits. This situation has lowered the fragilities of the public sector respectively but increased the riskiness of the private sector. Thus, probable economic downturns may result in bankruptcy of the firms, causing adverse effects on employment. (Anonymous Economist)

This result is valid for many countries. Especially the reduction of the subsidies in the agricultural sector has caused a fall in the production level in this sector and eventually the prices have risen. In the meantime the demand for agricultural products had also risen at the global level. Such a development had created an additional upward pressure on the prices. The rise in the prices of agricultural products which are used as an input in the industrial sector had resulted in falling profits and need for more financial resources. Another factor adversely affecting this set-up was the private sector firms joining the global race to seize a place, even by accepting the risk of a decrease in their profits. This fact had decreased the value added while sometimes causing the exporters to sell their products at a price that is under their costs. On the other hand, since the domestic demand was not backed up with income adjustments and with the effects of financial liberalization and the increase in the number of financial instruments, volume of institutional and private borrowing had been risen. As a matter of fact the economies which were hit the hardest by this ongoing global crisis are the ones with more sophisticated financial system and more debt. Lack of domestic savings but continuing consumption and investment pattern had increased the demand for foreign savings, thus, the level of current account deficit had risen in many countries. (TİSK, Turkish Confederation of Employer Associations)

- 2) *“Fiscal discipline”; “inflation targeting”, “floating exchange rate regimes”, and “free mobility of international finance capital” are the general headlines of the macroeconomic policy environment surrounding the 2000s. In your view, how would*

you assess the net effects of this overall structure over domestic saving - investment balance, industrial production, and employment/unemployment?

In order to increase the output, we had to increase the savings at the private sector but we couldn't accomplish such task. Capital account was liberalized as a result, but it had to be stabilized. It should be questioned if it was possible to increase production under a closed current account. With the liberalization of the current account we had achieved a growth rate of %7. Of course, it should be noted that the economy was operating in a favorable conjuncture globally. Even if the employment was increased through a sluggish public sector account, this increase was not efficient. Active and passive employment policies should lead to an increase in the overall employment. A consensus should be maintained with the labor unions, on the issues such as, regional minimum wage, severance payments, labor taxes. Qualification of the workforce is also another important problem. But the education is a matter of a long term vision, which the governments lack. There are no clear cut rules to policy making, monetary targeting could have replaced inflation targeting or the problem could have been solved with exchange rate policy, crawling peg was not God given. The Program has failed because of the external factors. Unless the structural regulations are in place, the policies are not sustainable and the risk premium is rising. Even if the interest rates are decreasing there is still a high risk premium on top of that increasing the costs. Another area of struggle was dollarization, which could have had impacts on many other areas. (Süreyya Serdengeçti, former governor of the Central Bank of the Republic of Turkey)

Turkish economy has grown annually at a rate of 7 percent, after 2001, until the global financial crisis of 2008.

In nominal terms, the export figure which stood at \$ 31 billion at the end of year 2001 has risen to \$ 132 billion by the end of 2008. When we look at the share of Turkish exports in the global market, it can be seen that there is also an important relative growth in our exports. The share of Turkish exports in world exports has grown from %0.5 in 2001 to %0.8 in 2008.

During this period, the private sector has been the driving force in growth and the industrial sector has contributed the most to this growth figure. The value added of the industrial sector has grown annually by %6.5 on the average, performing a better growth than that of GDP. Industrial production has also grown annually by % 6.4, on the average.

We witness macro and microeconomic policies to complementarily contributing to the progress in the arena of economics. A monetary policy which is focusing on price stability and budgetary discipline are the two factors that contribute to the formation of macroeconomic stability. On the other hand, reforms for strengthening the structure of the banking system, improvements in the investment climate, privatizations, liberalization of the basic infrastructure sectors and developments in the regulatory and supervisory functions of the public sector have contributed to the betterments in the areas of production, investment, competition and doing business in Turkey. When the labor market data are analyzed it can be observed that, due to the relocation of the agricultural labor to other sectors, employment figures have not changed much but the employment in non-agricultural sectors has grown annually at a rate which is a

little over %3 on the average, which is higher than the birth rate. It is expected that the period of structural transformation from agricultural sectors to others will continue in the coming years as well. (TCMB, Central Bank of the Republic of Turkey)

The aim of the fiscal policies is to maintain macro fiscal stability where the expenditures are being limited and income is tried to be enhanced, in order to avoid any payment crisis. With the breakout of the 2001 crisis measures in similar nature has been implemented. Another element of fiscal stability is the effective distribution and efficient use of the resources, but we can't say that these principles are very much in implementation. In order for them to be implemented, performance budget and strategic planning should be present at the institutional level, which requires developed institutional capacity. It cannot be said that the fiscal policies have an employment dimension; their main aim is to create a fiscal space for other policies. Privatization policies have creating additional income, as their priority, not efficiency. In the short-term, it could have adverse effects on employment but it can be said that the indirect effects could be positive. These policies contribute to increase private employment and to improve investment climate. The factors shaping the fiscal policies are, in fact, politics. It is the social policies which should take into account the just distribution of the resources and their consequences. The issue about the "new fiscal rule" is also the same. Although it is taking growth into account, and therefore it could be expected that the new rule would have indirect effects on employment, the expectations should not be set very high. In the end, it is not duty of fiscal policy to create employment. Yet, it does not constitute an obstacle for the design of the social policies. (Emin Dedeoğlu, former Directorate General for Public Finance at Undersecretariat of Treasury)

The productivity gains are attained not through new investments but through increasing the degree of exploitation of the employees. There has not been a new industrial investment taken place and employment numbers are severely decreasing. (Murat Özveri Labor and Society Journal, editor)

Since the national saving has two components, private and public, one should analyze both parts to get a complete picture. On the public side the identifying elements have been fiscal discipline, low budgetary deficits, high tax and privatization income, increase in public savings but rather a cautious increase in public investments. On the private saving side, the observed status was the increased imports due to overvalued TL with the high capital inflows. Looking at the rather slow increase in public investments and the trends in the private sector which can adversely affect domestic consumption, one can conclude that production and employment has been hurt on the overall. (Anonymous Economist)

With the inflation targeting policy, which has been de facto in implementation since 2006, there raised a system of a downward pressure on wages. Therefore, it is not possible to say that the monetary policy aims at reducing poverty and unemployment. How the monetary policy should be formulated? A dynamic welfare function should underlay the monetary policy and the price levels for different income groups should be defined and monitored. In the aftermath of the 2001 crisis, a "policy mix" was defined and it was consisted of fiscal and monetary policies. Back then, we were just learning how to come out of a severe crisis. We are again following the same route. But we are facing a different circumstance now, and therefore we need a different

policy set up. Is there a single receipt for this policy mix or are there other mixes available? We have to question this. There are also some other issues to be questioned about the new fiscal rule. Who is the owner of this rule? Who manages the parameters regarding the rule? Does this rule take into account the distributional issues? Although, it seems like there is a linkage in between the periods, will the rule be interrupted by a change in the government? Does this rule have the ability to nurture other strategies? (Anonymous Economist)

Inflation targeting had raised the current account deficit, especially in the countries with foreign trade deficit, while causing greater deviances from the target inflation rate, contrary to expectations. While the Taylor Rule, from which the inflation target is derived, stands upon exchange rate elasticity, had caused the inflation rates, which is the main tool for controlling the inflation, to stay at high levels in real terms, especially in emerging economies. The main reason for this is the high sensitivity (elasticity) of the domestic price levels to exchange rate movements. For this reason, Central Banks had kept the domestic interest rates comparably higher in order to promote capital inflow into the economy, for financing foreign trade deficit and controlling the overall price level. This cycle had created inflationary pressures while increasing the volume of foreign capital inflow, which in turn caused the real exchange rate to appreciate, in other words given rise to an overvalued domestic currency. According to us, previous policies such as free mobility of international finance capital – fixed exchange rate regime or free mobility of international finance capital – flexible exchange rate regime had not been successful in countries like Turkey. At times like this, during which the design of new monetary system at the global level has been discussing, Turkey should also consider new capital market arrangements, as well as fiscal and monetary policies. (TISK, Turkish Confederation of Employer Associations)

- 3) *Observations over informalization of the labor markets and an overall reduction in the availability of decent work are reflected in many studies of the global labor markets. Based on the Turkish experience, how would you assess the net effects of implementation of inflation targeting central bank policies and a floating exchange rate regime within a free mobility of capital on employment and decent work?*

Informalization has been a long standing issue. What lie behind the informal labor is the tax policies. Politics is the factor why this area of concern is still untouched; it is seen as a potential source of vote. As long as the labor costs are at this level, informalization will keep being one of the biggest issues. Capital account liberalization is seen as a factor that fosters growth, but it is also a factor that defines the position of the economy among the global division of labor. At a setting of overvalued domestic currency, unavoidably the share of imports increase hurting the domestic firms, which in turn adversely affects the employment figures (Süreyya Serdengeçti, former governor of the Central Bank of the Republic of Turkey)

There are some indicators pointing out a change in the quality of employment during the period of 2002-2008. First of these indicators is the decreasing rate of informal employment. Following the year 2001, the share of informal employment in the overall employment figure has decreased by almost 8 percent points. Another indicator is share of agricultural employment decreasing by more than 10 percent points converging to the value added of the sector. Third indicator is the decreasing

share of unpaid family worker, thus, increasing share of paid workers. From 2001 to 2008 the share of unpaid family workers has fallen by 8 percent points while the share of paid workers has increased by 13 percent point rising to a level of %60. It has been anticipated that, falling interest rates and increasing labor demand due to increasing investment expenditures promoted through lower rates of interest have contributed to these developments along with the constructed macroeconomic stability. (TCMB, Central Bank of the Republic of Turkey)

I think its most important effect is felt as the form of “Insecurity” that is being used as a control system. What I mean is that, the labor market has been broken into hierarchical levels in order to maximize its supervision power over the employees. Insecure working schemes at the lowest level becomes a tool of pressure on the nest level by giving a message that if they do not obey then they would end up as such. Through daily wage earners the subcontracted workers, through subcontracted workers the blue collar core workers, through core workers the white collar workers are disciplined. This fragmentation is not limited to the production level but also spread to the neighborhoods, to the public transportation systems and even to amusement centers, creating a hierarchy at the social relationship level, similar to the one of the production process. (Murat Özveri Labor and Society Journal, editor)

Fiscal discipline and low budget deficits had positive effects on national saving but public sector investments, production and employment had been affected negatively. High interest rates as a part of inflation targeting policy, overvalued TL have resulted in an import depended economy. The adverse effects on exports have negative reflections on employment figures as well. (Anonymous Economist)

Inflation targeting is only functional through flexible exchange rate system. For the sustainability of the system free mobility of international finance capital is required for both the functionality of the system and theoretical integrity. Applying the inflation targeting policy under these circumstances, in economies with balance of structures similar to Turkey’s, causes an increase in the growth rates, a fall in the inflation rates in the short run but also increases the current account deficit. In order to maintain this situation the Central Bank increases its foreign exchange reserves, then intervenes into the money market in order to decrease the money supply, which had increased as a result of inflation targeting policy, by increasing the interest rates. Thus, the cost of increasing foreign exchange reserves is high in Turkey. This is also a social cost, since the increase in the interest payments also means a decrease in other factor incomes or an income transfer. Eventually, this picture is translated into a decline in the growth rates and an increase in unemployment rates. The deficiency of domestic savings forces the growth model of the economy to depend only on the foreign savings, thus on current account deficits. It is clear that, such a model is not sustainable. (TİSK, Turkish Confederation of Employer Associations)

- 4) *Generally speaking, even within a bullet-point framework, what kind of macroeconomic and institutional policies would you recommend for the Turkish economy to help boost employment and its overall quality?*

Active and passive labor policies, on which a consensus is achieved among the social partners, should be implemented. Education is the key factor here. For a sustainable growth path, structural reforms are essential. IMF wants Turkey to be its “success”

story, which is why they don't interfere with the Social Security Reform of 2005 and the new Fiscal rule, claiming that it is all good. EU cannot be an anchor for Turkey, as long as an accession date is determined. Turkey has to devise its own anchor and, through a strong communication strategy, make it operational. (Süreyya Serdengeçti, former governor of the Central Bank of the Republic of Turkey)

Structural problems concerning the labor market should be addressed through well planned, long term, supply side policies. In this regard;

- Vocational training, strengthening and planning of the interaction between education and labor markets,
- Hindering the informalities in the labor market, lowering the employment taxes to world standards,
- Improving the investment climate,
- Increasing the adaptation capacity of the labor force and the business enterprises to changing environment

are steps to be taken as a solution to the related labor market problems.

On the other hand, maintaining the macroeconomic stability in the following periods, thus, keeping the interest rates permanently at low levels would support the labor demand. (TCMB, Central Bank of the Republic of Turkey)

Social policies, economic policies and politics should be considered as a whole. A holistic approach should be accepted by all related parties, since all of these three areas are interrelated. Institutional structures are effective on many of the economic decisions and most of the complications regarding these areas can be solved through politics. While considering these areas national and international actors, threats and opportunities should also be considered carefully. Can the competitive power of the economy rely on supply of cheap labor, at the global level? Are the technological innovations being followed closely? How should the labors be directed when innovation is concerned? Such perspective and similar questions would shape the employment policy. (Emin Dedeoğlu, former Directorate General for Public Finance at Undersecretariat of Treasury)

A growth strategy which would create employment should be pursued. If necessary, state economic enterprise system might be redesigned according to current needs. The average work of 72 hours/week should be decreased, the wages should increase, informal employment should be prevented, and arrangements should be made to free the workers from the existing laws, in order to inhibit insecurity in the labor market. Today's problem is not about a need for a legal framework but rather freeing oneself from the restrictions of the existing laws. Obeying the laws means ditching today's workers into insecure working conditions, loaded working hours and cruelty. The barriers that prevent the collective agreement should be abolished. Workers, in a working environment where they can freely use their right to strike, would provide a shield built up with their own power against insecurity. Increasing wages would both inhibit informal employment and increase employment. In sum, an employment creating growth and a working environment where the laws which enslave the workers are abolished would help to boost employment and its overall quality. (Murat Özveri, Labor and Society Journal, editor)

Under the present circumstances in Turkey, the effects of policies targeting an increase in competitive power would be limited. It is clear that, with the competitors

being China and India in the labor market, policies aiming at lowering the labor costs would be ineffective. An alternative to this policy is to initiate a change in the domestically active sectors and to shift towards sectors with high value added. For such a transformation the necessary measures, especially in the area of education, should be taken. Public sector should be leading the previously determined strategies. Otherwise, the effects of policies such as incentives and tax reductions would be temporary and in the long run, their contribution to employment would be insignificant. (Anonymous economist)

İTO (İstanbul Chamber of Commerce)

On the labor market policies

- During the economic crisis periods governments should make the necessary design for making the flexible working scheme possible and this is what the Turkish government has done. Especially the arrangement regarding the short-time allowance has been an appropriate measure for mitigating the job losses. This arrangement is expected to bring about positive outcomes even in the post-crisis period. But, even in such a favorable climate there are still some legal obstacles for the flexibility of the labor market to be realized fully. These obstacles can be listed as: the obligation of the employer of 50 or more workers to have medical and security teams present within the workplace, the obligation of the corporations to have an attorney.
- Regarding the other measures taken against the global crisis:
 - Although the cut in the employers' share of social security premium has provided a relative benefit during the crisis period, in the long run there is not much to be expected from such a measure.
 - The cuts in the value added and excise taxes have contributed much to the consumption of inventories rather than to an increase in production, so it had no reflection on creating employment.
- The measures taken by the government were more related with protecting and increasing employment in the short run, which needed urgent intervention during the crisis period. In combination with these measures what is needed is a forward looking strategy designed in cooperation with the social partners in a participatory manner.

On the global crisis

- The crisis framework:

The indicators regarding production, budget deficit, exports and employment have been adversely affected due to the contraction of both foreign and domestic demand. Decrease in investment spending with the contraction in demand, decrease in exports with contraction in foreign demand and deteriorating consumer confidence had caused the domestic demand to fall. The stagnation of the economy due to decreasing domestic and foreign demand, falling rates in capacity utilization and employment, rising unemployment and especially the increasing budget deficit as a result of the decrease in tax revenues are the leading adverse effects of the crisis.

Falling current account deficit and inflation and reductions in interest rates throughout the crisis period can be counted among relatively positive effects. The fact that imports had shrunk faster than the exports have contributed to the falling current account deficit. The global reduction in the asset prices combined with the contraction of the domestic demand have paved the way to single digit inflation rates. Falling interest rates have not been reflected in real sector credits much yet. Since there does not exist a problem of current account deficit, reductions in interest rates has not created an upward pressure in exchange rate and the rates have been following a rather stable path since the mid-2009.

- In the ITO report titled “2009 Economic Outlook” the forecasts about the 2010 Turkish economy is such that:
 - Turkey is expected to display a positive growth with an average of 4%.
 - The current account deficit is expected to grow with the effect of economic recovery and structural factors yet will still be sustainable.
 - The budget deficit is expected to be at high levels as experienced during the crisis.
 - There is not much expectation for a progress in employment; even with the economic upturn employment is not expected to increase to desired levels. The uncertainties of the crisis period along with the structural problems in the labor market prevent provision of new job opportunities.

İSO (İstanbul Chamber of Industry)

On the crisis measures

- The measures taken against the global crisis can be categorized under 3 subject areas:
 - Measures such as short-time allowance arrangement, wage subsidies for trainees, social security premium cuts for the employers, development of public service works and incentives for creating additional employment are taken only to address the current crisis period.
 - Incentives aiming at increasing the domestic demand and investment. These incentives include tax cuts which have been reflected in the big firms as sale of the existing stock and as increases in production and employment in SMEs; therefore have been somewhat effective in maintaining the existing employment.
 - Measures which are planned to be taken before the crisis but implemented after the crisis and therefore have not created the desired effects. They include, easing the conditions on compulsory employment, removing the obligation to opening up a child day care and sports facilities, allowing the employers to outsource services regarding work safety in order to decrease the costs.

- Short-time allowance, which is a crisis specific policy measure, has had a positive effect on both the enterprises and the workers, has become widespread as a form of flexible working arrangement and has set a good example of a “flexicure” employment system. Of the 200.000 people who have benefited from this arrangement most are employed by big companies, indicating that due to information and administration deficiencies SMEs are out of the scope of this system. Short-time allowances and other flexible working schemes would be further beneficial for both the enterprises and the workers if they are to be permanent, rather than just a temporary arrangement only specific to crisis.

On the social dialogue

- It is for sure that countries with different socio-economic structures are affected differently from the crisis. Therefore, the policies addressing the crisis are different. The economic policies that are to be followed should also include social policies and labor law. In order to avoid social tensions, workers should be given securities while employers are granted flexible employment schemes, dialogue between the social partners should be ensured while the policies for the management of the crisis period is being designed and employed.
- The consultation mechanisms are even more important during the crisis periods. “Economic and social councils” devised at the macroeconomic level, “framework agreements with social content” among workers and employers’ confederations, adoption of “social plans” are well benefited exercises. The delayed formation of the Economic and Social Council has not reached the desired outcomes yet. The limited inclusion of the NGOs in the formation of this council is about the government’s desire to lead this council in line with their expectations. For this council to be more active, its structure has to be revised and with frequent meetings it has to contribute to social reconciliation within the crisis environment.

DiSK (Confederation of Revolutionary Trade Unions of Turkey)

- Although the prime minister of Turkey has announced that this crisis has by-passed Turkey, the high unemployment rate proves the opposite. A lot of attention should be directed to the high unemployment rate among the juvenile, since it is an important risk factor. In order to fight unemployment, most of the efforts should be put into abolishing informal labor market and decreasing working hours to normal -8 hour-periods. Also, our confederation stands for reduced working time fund and the fact that its being financed through unemployment insurance fund is not a subject of concern. But regional minimum wage is not a proper policy and regional investment incentives are irrelevant to the realities of the region by design, therefore it is not much beneficial.

- The measures taken in the face of the recent crisis are all in favor of the employers, disregarding the demands of the workers. While, with the announced fiscal stimulus packages, different incentive mechanisms are put into force in order to increase production, wages were pressured downwards and flexible working schemes became active.
- The most prominent effect of the crisis is the increase in the structural unemployment and expansion of a lasting poverty. Loss of jobs resulting in loss of income, being excluded from the social security fund, loss in production, closing of the firms are the things that we have experienced so far and will be experiencing in the near future. Facing this hard fact, the economic measures that the government has employed was only functional at delaying the problems temporarily but not successful at bringing about permanent solutions. A holistic, consistent and long term social and economic program at the macro level has become an urgent issue. Preserving the professional and skilled labor force, employing the unskilled labor by supplying necessary education, fair distribution of the created value and securing the future is important. Also, in order to lessen the effects of the crisis in the long run, the public feature of health and social security mechanisms should be made effective and domestic consumption should be increased through strengthening the purchasing power.
- Transfer of the financial sources by the public to struggling firms or easing the repayment of their credit debt should be conditional on no further firing of the employees.
- Fixed investment, when left to private sector's saving and competitive decisions, has a limited effect on employment and it is shaped with the drive of the expected private gains. Such a concern, under a fierce competition, causes labor intensive production preferences to prevail and efficiency capacity to fall. For this reason, employment enhancing policies should be led by the public, directing the private sector.
- Flexible working schemes did not affect employment much. On the contrary, the firms which had benefitted from the reduced working-time allowances started to lay off their workers by the end of the payment period, ironically. During such periods, the demand of the employer unions for flexible working schemes addresses nothing but opportunism. Demands like flexibility, flexicure labor markets and private employment offices are always said to be demands for increasing employment. But, in reality, it is known that these policies have no effect in decreasing employment.
- Informal production and employment lead to limited employment gains as working hours are increased, wages fall, and productivity and efficiency decline. That is why the regulations to prevent the informalization in production and employment should be in place the earliest and working environment and conditions should be improved.

- Unemployment insurance fund is one of the mechanisms which was put into force with social concerns. But in practice, this fund has been used in other economic areas which are out of the scope of the fund's essential functions. The use of the fund outside of its purpose and the strict conditionalities had kept the fund to fulfill its duties and it has lost its power to correct for unjust and to substitute for the wage income.

TÜRK-İŞ (Confederation of Turkish Trade Union)

- The adverse effects of the crisis could not be realized by the government in time, therefore the measures are belated. This has caused a job loss of around 400.000.
- Most of the measures are employer focused. Reductions in social security premiums have not reached its desired outcome on creating employment and this fact has been also recognized by the government officials. The reductions in premiums should be devised such that, it takes into account the rights of the employees and it is applicable only to employers whose labor force is mostly (at least %50) composed of organized labor.
- While, following the 2001 crisis, the integration of Turkey to the international economy has been through the indebtedness of the real sector, technological progress and the problems regarding industrialization have been disregarded. Turkey, during this period, could not properly manage the intense capital inflow into the economy in the era of mass liquidity at the global level.
- The policies that were developed as a cure for the crisis and were initiated by the foreign economies, should not only target at short term problem solving tasks but also imply a long term perspective. In other words, the implemented policies should be devised such that, it helps the current growth path to converge to that of economy's potential in the short term, while pushing the potential growth rates to a higher level in the long term. The short term measures, that support the long term perspective, should be implemented in a holistic approach and short term urgencies should be prioritized.
- The main elements of the IMF Program, which has been continuously followed by Turkey since 1998, were: under the cover of "structural reforms" expression, displacing the economic policies away from the processes of democratic control and rearranging the role of the government ensuring the mechanisms for the transfer of resources to the multinational capitalists are in place; under the cover of "flexible labor markets" expression, limiting the earnings of the labor force and paving the way for the capital accumulation through lessening the share of the labor in the national income; under the cover of "privatization" expression, directing the transfer of strategic public assets to domestic and foreign capitalists and handing the future of the national economy to the profit focused, private capital through limiting the areas of intervention of the government to the economy. In light of this experience, it should

be emphasized that, any similar policies claiming to restore the confidence of the foreign investors would not be a cure either for the chronic external deficit of the Turkish economy and its import depended structure or for the growing problems of the labors.

- There are only three ways to increase the production potential of the economy: increasing the quality and quantity of the workforce, increasing the capital stock and increasing the innovation capacity of the economy. These three points lead to the design of an industrialization policy. In this regard, fighting the crisis could not be done through monetary and fiscal policies but a thorough micro reform agenda, which would increase the potential for the value added produced within the national industry, is needed.
- An economic policy addressing the adverse effects of the current crisis should ensure the effective functioning of the financial system, while increasing the domestic demand. Increasing the aggregate demand is important for the efficient performance of the credit mechanism and, vice versa, a better performance of the financial system is important for increasing the domestic demand. The main role of the fiscal policy, when evaluated in this framework, should be increasing the aggregate demand. But, while being devised to increase the demand, the diagnostics of the sources of falling demand should be done carefully. Here, the core question is: While increasing the aggregate demand, should the fiscal policy favor measures that increases the public spending or the measures that would increase the disposable income of the economic agents within the economy? It is clear that the measures which would create a one-time increase in the disposable income cannot bring about the desired outcomes. For this reason, the main aim should be securing the continuity of the permanent income of the economic agents.
- During the financial crisis, maintaining and even increasing employment should be a priority. Use of economic crisis as a justification to layoff the workers should be prevented. The incentives, exceptions and exemptions should be granted to the firms which keeps its employees.
- In order to diminish the adverse effects of the crisis and also as a requirement of the social state, a better security mechanism should be devised immediately from scratch. The deficiencies of the labor law concerning the security, working time, limitations of the number of employees should be enhanced in favor of the labors. Since the layoff is the easy way out, it is seen as the most applicable alternative by the employers. But it decreases the purchasing power, as an indirect effect, which in turn deepens the adverse affects of the economic crisis. Therefore, the decision of layoff should be a joint decision of a committee of labors' and employers' delegations, formed at each province/sector.

- Another important aspect of the policies designed to overcome the crisis is the necessity to formalization of the economy. Informalization has many adverse effects in different areas such as, decrease in the tax and security premium collection, unfair competition conditions among the firms and worsening of working conditions and loss of social security on the labor side. Therefore, fighting against informalization should not be discarded especially in the time of the crisis.

HAK-İŞ (Hak-İş Trade Union Confederation)

- The economic crisis has become a well-known pattern of the Turkish economy with an interval of five years. Therefore, Turkey has to learn how to live with the crisis environment. Through policies and regulations a strong and a stable structure should be sustained.
- What we have experienced during the recent crises was that, the greater the degree of integration of the Turkish economy with the global economy, the greater was the damage. With the contraction in global economies the volume of the world trade has shrunk, by which the crisis has become more widespread. And it was obvious that the measures taken by the government in the face of the crisis was not enough.
- Even before the crisis the workers were already excluded from security, without hope and in fear of losing their jobs. The break out of the crisis has enhanced this picture spreading the insecure working schemes and leaving more and more workers without hope. During the crisis the first measure concerning the savings, which is taken by the employers, is the layoffs. But there could be other alternatives to consider.
- Traditional labor intensive policies, with the effects of the external developments, do not seem to be applicable for decreasing unemployment. For this reason, as a measure which could decrease unemployment and also contribute to the external balance, the employment and export incentives should be given to the firms which uses domestically produced intermediate goods.
- The key to success during the crisis period is harmonization of production, consumption and employment. Policy instruments, which would positively affect the purchasing power and help to raise the level of domestic demand, should be utilized. Employers should be aware of the importance of the permanence of employment, therefore should act sensibly. The dynamics of the economy is sustained through the synergy created by the qualified labors and entrepreneurs, together. If labor is disregarded while measures are taken to save the firms, not only the dynamics of the economy would be hurt seriously but also the growth of the economy would be hampered as well.
- The measures taken as a reaction to the crisis should be complemented with employment focused policies, economic and social policies should be implemented

simultaneously. If not, the consequences on the labor market, which is severely distorted already, would be devastating. Therefore, a social dialogue mechanism devised among the social partners on the egalitarian grounds and sustaining the flow of information is important in formation of the common mind and common attitude.

- In addition to the rearrangements of the unemployment insurance fund, reduced-time working schemes and severance payments, passive policy measures which could eliminate the adverse effect of the crisis on the most vulnerable group. This group is mainly consists of low income groups or the ones who are living in poverty. For this reason, especially during the era of the crisis, “positive discrimination” principle should be adopted in social protection policies. In order to minimize the damage of the crisis on the most vulnerable, measures such as direct income support and family support should be planned and activated. Planning of these policies is not only important for addressing the adverse effects of the crisis but also for the overall design of the social policies, since poverty is a fact that has been part of our daily lives even before the crisis.

TİSK (Turkish Confederation of Employer Associations)

- Although the measures taken by the government are appreciated, they are perceived to be inadequate. Only a couple of these measures are seen to be effective, such as reduced working-time allowance and sales tax reductions. But, the effect of another important measure, which is the reductions in the employers’ share of social security premium payments, has been offset by other regulations.
- Most of the measures taken regarding employment are focused on creating additional employment. However, today’s priority should be maintaining the present employment level. For this reason, the main burdens on employment, such as employers’ share of social security premiums and severance payments must be reduced. There are no indications of this sort in the medium term economic program.
- In order to have a progress in employment, it is a necessity to increase the real sector production and exports. Although, the situation has been correctly reflected and a target of a development path through the private sector has been set in the medium term economic program, there are so strategies mentioned in the program as to the realization of this target.
- The program estimates a creation of new employment at a level of 1.250 thousand during the related time frame. But, there are no clear explanations of an employment policy which is assumed to be decreasing unemployment rates while it is expected to rise at the global level during the period 2010-2012. During the great repression, the number of jobs lost equals to the number of employment planned to be created during the program period. But in the mean time, it is expected that another 1.8-2.1 million new labors will be joining the current labor force, demanding jobs. Therefore, the

newly created jobs would not be enough to decrease the unemployment level. Even for keeping the unemployment level constant, the growth rate should be at least %5-5.5, which is not very likely for the coming years.

- Analyzing the country examples, the tools to support employment can be listed as; wage subsidies, unemployment security, subsidies related with reduced working-time, subsidies related with non-wage employment costs, flexible working scheme subsidies and active workforce programs.
- In order to give a boost to the economy the policies should be designed to increase demand; monetary and fiscal policy targets should be revised, if necessary. Industrial sectors should be supported for the production and employment to be sustainable. In such a context, the public sector has been in deficiency of resources due to the fall in its tax revenues, where as the informal sector constitutes about a half of the economy and keeps growing. The funds needed for supporting the industrial sector should be financed by the derivation of resources through formalization of the economy.