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On capital flows and macroeconomic performance: Evidence before and after the financial crisis in Turkey ☆

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Abstract

The paper sheds light on the Turkish experience of capital account liberalization and its effect on key macroeconomic variables, using quarterly data in a multivariate VAR model. We also take into consideration the crisis breakpoint in 2001 and estimate the effect of shocks attributed to capital flows, using quarterly data during the sub-periods 1989:01−2001:01 and 2001:02−2009:03. The findings indicate that capital flows have varying effects on the Turkish economy before and after the crisis in 2001 and the evidence supports significant effects of liberalizing financial flows on macroeconomic performance, especially during the post-crisis period (2001:02−2009:03). Moreover, this latter period exhibited evidence of sterilization policy that has helped mopping up excess liquidity and containing inflationary pressures. These factors seem to signal deliberate efforts by the Central Bank of Turkey to stem the risk of appreciation of the real exchange rate and preserve export competitiveness during periods of high financial inflows, a trend that has been reversed recently by the surge in outflows and currency depreciation in many emerging markets in anticipation of imminent normalization of monetary policy in the United States.

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1. Introduction

Over the past two decades, many countries in the developing world have taken measures to liberalize their capital and financial accounts in order to capitalize on a larger pool of global liquidity that seeks opportunities for higher return across the globe against the backdrop of easing monetary policy in many advanced economies in the wake of the global financial crisis that has left the world awash of liquidity searching for competitive returns across borders. There is a widespread belief that more financial and capital inflows could play a fundamental role in boosting growth and welfare by improving the allocation of capital based on productivity and rate of return across recipient countries. However, in the aftermath of the global financial crisis, concerns have risen about the risk of speedy financial integration in developing countries, in the absence of necessary reforms to ensure prudence and mitigate potential risk. To substantiate these arguments, we cite some cases where previous experiences of financial liberalization may have turned to be disastrous and contributed to wide-spread financial crises in Mexico (1994), South East Asia (1997), Russia (1998), Brazil (1999), Turkey (2001) and in Argentina in late 2001 and early 2002. More recently, there has been a surge in the literature on the consequences of the waves of capital flows on the macroeconomic

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performance as a result of the extremely loose monetary policy of the FED and monetary authorities in many advanced countries and the corresponding swelling of global liquidity spilled over to emerging markets.[1]

Turkey was among the first group of countries in the MENA region to liberalize its capital and financial account, a task which was completed as early as 1989. However, the post-liberalization experience for Turkey in the 1990s was not as successful as expected. Financial integration was implemented before undertaking the necessary reforms to ensure a strong and efficient financial system that would facilitate mobilizing the additional resources which has become available post-liberalization. As a result, the country underwent two serious crises in 1994 and 2001, both of which had financial roots underpinned by serious mismatches between the structure of liabilities and assets in terms of currency and maturity. Subsequently, Turkey embarked on serious structural and financial reforms in 2001. The banking sector reform proved to be an important catalyst of the broader reform agenda, resulting in a structural break that deserves a special treatment in the time-series analysis of the Turkish economic history.

The literature on the effects of capital mobility under financial account liberalization follows two theoretical tracks. The first approach draws heavily on the predictions of the neoclassical model where financial liberalization is expected to facilitate the efficient allocation of resources at an international level (Fischer, 1998; Obstfeld and Rogoff, 1996; Obstfeld, 1998; Rogoff, 1999). The second view, presented by Rodrik (1998), raises much doubt of the wisdom of liberalizing financial flows as a strategic public choice. The concerns were further substantiated in Eichengreen (2001, 2004) and Prasad, Rogoff, Wei, and Kose (2003) who questioned the wisdom of liberalization in the absence of defined measures to ensure the productive usage of inflows and the right institutional setting—including financial channels—to facilitate the efficient intermediation of these inflows.

So, does liberalization of financial flows necessarily increase the risk of crises or is it possible that it could be beneficial to growth by allowing for higher levels of capital accumulation? This question carries significant policy implications for many developing countries that are in the process of contemplating the speed and the degree of financial liberalization. To shed additional light on the underlying issues, it is necessary to understand how financial liberalization affects the dynamics of domestic macroeconomic variables in countries that have embarked on a higher degree of liberalization. Despite its importance, this issue has not been thoroughly explored (for a survey see Edwards, 2001; Eichengreen, 2001; Grilli and Milesi-Ferretti, 1995; Henry, 2003; Stiglitz, 2000).

In this paper, we shed light on the Turkish experience of financial liberalization and its effect on domestic macroeconomic variables, using quarterly data in a multivariate VAR model. The proposed methodology analyzes the dynamics of the interaction between financial flows and macroeconomic performance, and provides the necessary evidence to study the macroeconomic effects of financial liberalization. Among MENA countries, the Turkish economy provides a unique example in terms of domestic and external financial reforms throughout the 1980s; yet it experienced a financial crisis in 2001. Hence, the analysis will draw lessons that could prove informative for other countries in the region that have lagged behind in the process of financial liberalization.

Accordingly, we examine the macroeconomic effects of financial liberalization where we study many variables including a set of macroeconomic variables in the VAR (real interest rates, real effective exchange rates, real GDP, the inflation rate and crises dummies) to better assess the simultaneous effects of capital flows on economic performance during the period 1989—2009. We also take into consideration the crisis point in 2001 and estimate the effects of shocks, using quarterly data during the sub-periods 1989:01—2001:01 and 2001:02—2009:03. The sample period does not span the global financial crisis to avoid the structural break that is likely to have magnified capital outflows and subsequent implications, but is not entirely attributed to domestic conditions and Turkish specific policies as the recent experience of volatility of capital flows attests.

Our findings indicate that capital flows have varying effects on the Turkish economy before and after the crisis in 2001. Indeed, the evidence supports significant effects of liberalizing financial flows on macroeconomic performance, especially during the post-crisis period. Specifically, this period is featured by less inflationary pressures, which helped to stem the appreciation of the real exchange rate and preserve export competitiveness. In addition, the cost of credit was more contained, which helped to sustain credit and investment growth and contributed to real growth. Finally, there is significant evidence of sterilization policy aiming to curb the effects of capital inflows on the exchange rate and domestic liquidity in the post-crisis period. These findings are very timely to the recent experience of the Turkish economy that has slowed down on account of heightened risks of capital outflows in anticipation of normalization of monetary policy in the United States in 2015. Domestic policies should aim at countering the spillover effects of capital outflows on the domestic economy and reinforcing prudent policies and structural reforms to strengthen the underlying fundamentals of the Turkish economy and resume well managed capital inflows for robust liquidity and healthy credit growth.[2]

The rest of the paper is organized as follows. Section 2 provides the background of capital account liberalization in Turkey. Section 3 is reserved for descriptive analysis. Section 4 outlines the econometric methodology for investigation. Section 5 provides the empirical evidence, detailing the effects

[1] See, e.g., Obstfeld (2009), Prasad (2011); Jeanne, Subramanian, and Williamson (2012) and Turner (2014).

[2] In support of the findings of the paper regarding the importance of capital inflows to the growth of the Turkish economy, Morgan Stanley in 2013 identified Turkey as one of the "Fragile Five Emerging Economies", citing potential vulnerability to the widely anticipated tightening of US monetary policy.

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