POLICY BRIEFS

The crisis of the Turkish lira: Toward economic collapse or a new economic model?

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Erdogan and his economic advisors believe that high interest rates have spurred inflation. [Al Jazeera]

When the Istanbul exchange closed on 20 December 2021, the Turkish lira stood at 18.5 to the US dollar, the lowest level since the Justice and Development Party (AKP) took power nearly two decades ago. This was the culmination of a year-long slide that saw the lira lose 60 percent of its value from early January to late December 2021.

President Recep Tayyip Erdogan took immediate action, pledging compensation for losses to lira-based deposits, increasing pension subsidies, and cutting duties on exports. By the next day, the value of the lira had climbed to 13 on the dollar.

The current crisis has been building since 2013–14, in part due to the type of rapid development pursued by the AKP in its first decade in government. Massive infrastructure projects were mostly carried out by the private sector, funded by foreign borrowing; when loan repayments began, it put increasing pressure on the Turkish lira and the exchange rate. In addition, since the Arab revolutions of 2011, Turkey has faced mounting external criticism and pressure due to what some see as its expansionist foreign policy as well as domestic unrest, which has had an adverse impact on foreign investments in Turkey.

For the last two years, the Turkish Central Bank and treasury have attempted to contain the burgeoning crisis by propping up the lira with foreign reserves and raising interest rates, particularly after the Covid-19 pandemic put increasing pressure on the lira. By early 2021, the interest rate stood at 21 percent—by far the highest level in the G20. But this policy has been overly burdensome for small and medium businesses, as well as millions of ordinary Turks who may need to borrow. Most importantly, Erdogan and his economic advisors believe that high interest rates have spurred inflation, which stood at 21 percent as of 1 October.

All of this has prompted Erdogan and his economic team to consider a new economic path. In their view, since the liberalisation of the Turkish economy, it has been held hostage to external pressures and crises, political and otherwise, that impact tourism flows, foreign direct investment, and other major sources of revenue. They are thus championing a new model that would make the Turkish economy more independent by relying on the country's productive capacities and dynamic market potential. Their approach is similar to the Chinese model, based on low interest rates, an attractive currency exchange rate, and high exports. Proponents of this model argue that it would attract Western corporations looking for cheap, professional labour and generate more income than the service and tourism sectors.

In pursuit of this vision, the Central Bank cut interest rates from 19 percent in September to 14 percent in December, precipitating a rapid deterioration of the lira that exceeded the government's expectations and raised fears of runaway inflation. Responding to his critics, Erdogan said that fall of the lira over the last month did not reflect the real state of the Turkish economy. Pointing to strong exports and growth, and a declining trade deficit and unemployment throughout 2021, Erdogan argued that the real economy is in solid shape and inflation would begin to decline in the early months of 2022.

As with any economic or fiscal policy, Erdogan is taking a risk, betting that his vision can turn the Turkish economy around. The only problem is that with presidential and parliamentary elections scheduled for June 2023, he has just 18 months to prove the efficacy of his policies. While the AKP government has taken economic mitigation measures—raising the minimum wage, increasing pension support, and cutting export duties—if the gamble fails and ordinary Turks do not see tangible improvements in their economic conditions, it could boost the electoral chances of any Erdogan rival. If, on the other hand, Erdogan's expectations pan out, the economy stabilises, and inflation begins to recede, it will make both Erdogan and his party harder to beat at the polls.
*This is a summary of a policy brief originally written in Arabic, available here.

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