Economic and Political Disarray in the US: Implications for the Turkish Economy

by Murat Aslan

Introduction
After World War II, the U.S.A. replaced Great Britain as the global hegemon in the world. The US’s economic supremacy was one of the most important factors in this leadership. American economy expanded during the 1950s and 1960s and this era was called as the golden age of capitalism. However, in the late 1960s and throughout the 1970s American economy started to decline gradually. The combined effects of the Vietnam War, OPEC crises and some other excess burdens over the American economy were early signals of the negative course that has still believed to be in effect.

Since the 1980s and particularly after the mid 1990s, global economic conditions have changed. Competition in trade, technology, telecommunication, finance and many other areas has gained momentum with the arrival of the new players (BRICS and EU). The recent global financial crisis is an important development that affects both economic and political course of the global system. In the late 2007, a financial crisis with a distressing economic nature erupted in the US and rapidly spread to other parts of the world.

Over the past six years the USA administration took fiscal and monetary measures in order to stabilize national economy. These policies have moderately helped to revitalize the economy. However, starting from May 2013 up until now, economic problems coupled with structural political setbacks and America experienced government shutdown. These developments were related to prior events including Fed’s announcements over monetary policy shifts, debt ceiling, and deficit reduction. Government shutdown might be the most attention grabbing due to the extensive media coverage.

In the summer of 2013, several hotly debated economic events and problems came up not only in the US but also in Europe and Asia. These developments have been carefully watched by Turkish experts since they might affect Turkish economy. However, this analysis limits itself with: American mortgage crisis, debt ceiling and government shutdown.

A Brief about the US Economy and Mortgage Crisis
American economy was in a headstart position in early 1950s. During the golden age, the outstanding economic performance strengthened the leading position of the USA. Figure 1 shows the American real GDP growth rates for the period covering 1950-2012. The average yearly growth rate for this 62 years period
Economic and Political Disarray in the US: Implications for the Turkish Economy

is about 3.1 percent. The linear trend line has a negative slope indicating that economic growth performance is a deteriorating tendency.

In the most recent American political history we can see three major armed conflicts (the first Gulf crisis after the Iraqi invasion of Kuwait, the wars in Afghanistan and in Iraq after 9/11) that have affected American politics and economy. Needless to say, 9/11 terrorist attack was a traumatic experience for Americans. All of these events have proved to be costly effects on the US economy. However, the US economic performance between 1994 and 2006 was exceptionally well (See Figure-2). In this period, global economy was also in good shape. In this period, improvements in computer hardware and software, mobile phones, low oil prices, availability of cheap and large amount of external financial funds were among the top stimulating factors behind the global economic expansion. The US economy generated an average yearly growth rate of 3.4 percent during 1994-2006. Huge amounts of foreign funds entered into the US financial system and this caused the escalation of risk appetite for the American financial institutions.

The financial institutions (e.g. mortgage companies and commercial banks) had issued excessively risky financial instruments. Ultimately, the mortgage crisis erupted in the late 2007 in the US and it has rapidly spread to other parts of the world. During the 2007-2012, the US economy performed annual average growth rate of less than 1 percent which was drastically lower than its historical averages.

Although the mortgage crisis was caused by the financial troubles of a few financial actors in the U.S.A, it has created serious impacts all over the world. In terms of its depth, the total size of insolvent institutions, and its speed of the worldwide contagion, this crisis is extremely unique. And it was the worst crisis after the great depression of 1929.

After the onset of this crisis, the real GDP shrank for the one and half years. According to the Congressional Budget Office’s (CBO) estimations, in February 2013, the actual real GDP of the US is %5.5 less than its potential and the dollar value of this gap is estimated to be about 850 billion US$. Furthermore, according to the CBO’s projection of the US economy it is not expected that American economy would return to its potential level until 2017.

In the mid 2000s, the unemployment rate for the US economy remained between 5 to 6 percent interval. However, the unemployment rate reached to its peak level in 2009 with more than 10 percent. Although this rate reduced to 7.6 percent in the first half of 2013, the full recovery (back to its pre-crisis rate) seems to be still far away.
The Fiscal Measures in Dealing with Crisis

In the macroeconomic system, there are automatic (or natural) stabilizers that work without the need of proactive policies. In the national economy without active governmental measures these mechanisms act so as to restrain big fluctuations in real GDP. Two of the most important automatic mechanisms are unemployment insurance and income taxes. Although these mechanisms help to dump fluctuations in economy, they also cause higher spending and lower income in government budget or would lead to induce in budget deficits.

In addition to self-activating mechanisms, during economic downturns, governments initiate active policy measures. In the most recent economic crisis, the US administration implemented three major macroeconomic packages: The Troubled Asset Relief Program (TARP), Economic Stimulus Act and American Recovery and Reinvestment Act (ARRA).

The large banks and other firms have faced significant amount of financial distress at the beginning of 2008. The crisis damaged the balance sheet of firms. During these traumatic times, some firms faced the risk of bankruptcy due to their excessive amount of debts. However, some firms with large amount of debt may be solvent in the sense that the value of their assets exceeds the value of their liabilities, and in order to maintain their operations these firms need external funds. The condition is known as “debt overhang” and it has been one of the most important complications of the crisis. Should government intervene and help these firms? This question is still debated by scholars, but the US government gave a green light to this operation. The government had to engage the rescue operation by enacting The Troubled Asset Relief Program (TARP) which involves 700 billion US$ for this purpose. Similar rescue operations were also carried in some major European countries (e.g. UK, Belgium, France, Germany, Ireland and Netherland). Economic Stimulus Act was the second package enacted in early 2008. The package contains measures concentrating on supply side of the economy.

Elected in November 2008 Obama took American Presidency in January 2009. The American Recovery and Reinvestment Act (ARRA) was enacted in his term. The package covers 2009-2019 period and the cost of the package is estimated to be approximately 800 billion US$. The package aims at increasing public investment expenditure, including infrastructure, education, health, and renewable energy.

One of the most considerable problems stemmed from the American subprime crisis has been the escalation of the federal government debt stock. From 2008 to 2012, both the federal government debt stock and budget deficit have increased dramatically. Figure 3-A and 3B show the trends of debt-stock-to-GDP ratio and deficit-to-GDP ratio, respectively for 1995-2012. The debt-to-GDP ratio was relatively stable till 2006. After the onset of mortgage crisis, American debt stock accumulation has accelerated and climbed to an unprecedented level and reached to %103 at the end of 2012.

On Figure 3-B, the trend for deficit-to-GDP ratio is displayed for 1995-2012. Since 2008, the ratio remained above %5 level and reached to maximum level close to %10 in 2009. The stimulus packages have put significant pressure on US government budget and higher deficit led to higher government debts.
The Fed’s Policies during the Crisis

Since the beginning of the crisis, Fed has pursued an easy monetary policy. In the US, the inflation has stayed well below the Fed’s %2 target and the inflation expectations have been low and stable. Central Banks have several interest rates or monetary policy tools that they can set to influence both financial and real sectors. In general, the central banks, during recession, can purchase financial instruments to pour money into the financial system so that the market interest rates would be reduced. The first line of action is generally over the short-term interest rate. However, in some cases, short-term interest rates are already close to zero (known as liquidity trap). When the economy is confined into the liquidity trap zone, central banks can switch to purchase the long term financial instruments so as to reduce long term interest rates. If central banks concentrates on reducing the long term interest rates by purchasing financial assets with long maturity, this policy is known as “quantitative easing” or QE.

QE regime has three phases: QE1, QE2 and QE3. Before the onset of crisis, the value of long term instruments in the Fed balance sheet was less than 1 trillion US$. By June 2010, the amount of long term securities (mortgage-backed securities and Treasury bonds) in Fed’s balance sheet was reached to 2.1 trillion US$. In November 2010, Fed decided to engage another round of quantity easing scheme (QE2). TheQE2 continued from 2010-Q4 to 2011-Q2. The QE2 scheme involves purchase of long term government securities amounting 600 billion US$. The final round of quantitative easing scheme was announced on September of 2012 and known as QE3 and the scheme initially proposed to purchase of long term treasury papers amounting 40 billion US$ per month. On December of 2012, Fed announced an increase in the amount of long-term security purchases from 40$ billion to 85$ billion per month.

In the press conferences and in the reports issued by Fed, it is underlined that Fed will continue to follow the QE3 scheme until the job market is definitely improving, just as long as inflation remains near the Fed’s target. At the end of spring 2013, Federal Reserve Chairman Ben Bernanke announced that “if the labor market condition was strong, Fed will probably slow the $85 billion a month pace of asset purchases later in this year.” In mid September of this year, however, Fed announced that “the evidence regarding economic health is not adequate to trim the QE3 scheme.” In other words, according to Fed, the US economy is still in fragile condition and it is too early to slow down the monetary stimulus before seeing more robust signals present.

Balance Between Today and Tomorrow

The size of government, generally measured as the ratio between total spending of government to GDP, has been increasing for more than hundred years for almost all countries. The increase in the government size does not follow a smooth pattern, however. The growth generally follows a discrete (or jumping) pattern. That is the size of government generally significantly increases during the years of wars and economic crisis and follow relatively smooth pattern in normal times. Another important point is that once the government spending expands during the years of political or economic tension, it does not return back to old (lower) level. In the early 1900s, the size of government for almost all countries in the world was less than %10, but today for large number of countries this number is close to %50.

The other important point we have to explain is about the tradeoff between the short term and long term objectives in designing economic policy. In the economic literature, the negative relation between the level of government debt (or government debt-to-GDP ratio) and the long-term economic growth is well established. On the other hand, there are also ample evidences that during the recession, the recovery is faster if expansionary fiscal measures are implemented. In other words, there is a trade-off between putting off tough problems for tomorrow because we are worried about short-term effects.1

The debt ceiling is a limit set by Congress on the stock of debt amount that the government can borrow and the ceiling was raised to 16.7$ trillion on May of 2013. On mid of August, Treasury Secretary Jacob Lew announced that “Unless the Congress raises the debt ceiling, it expected the Treasury to lose the ability to pay all of the government’s bills in mid-October.” After the onset of crisis, the debt ceiling was reinstated few times. In the recent US economic history, in addition to this recent tension over debt ceiling issue, there have been two more episodes: in 1995 and in 2011.

In 2009, budget deficit was record high registering 1.4 trillion US$. However, in 2012, the deficit declined to 1.1

---

1 Hasset, Kevin (2012): “Fiscal Cliff: How to Protect the Middle Class, Sustain Long-Term Economic Growth, and Reduce the Federal Deficit”. Dr. Hasset’s Testimony before the Joint Economic Committee, December 6, 2012.
trillion US$ and for 2013 the deficit expectation is about 630 billion US$ which is very close to 4% of GDP. In other words, the US has already engaged modest fiscal austerity policy. It is estimated that in order to achieve debt sustainability, the deficit-to-GDP ratio should be around 2%.

From May to mid-October of this year, we have witnessed hotly debated economic issues, including signal about Fed’s policy shift, debt ceiling, deficit reduction and finally government shutdown. In particular, President, Congress and House fail to compromise in addressing problems over debt ceiling, long-term deficit reduction and the burden of health care costs.

The most simplistic explanation of the conflicts during the debt ceiling talks in the Congress has seemed to be about the reduction of the size of the federal government, in particular reducing the government spending. During the crisis, the proactive policies will lead to higher budget deficits and thus higher government debt but at the same time these policies will induce economic recovery. On the other hand, the higher government debt will induce macroeconomic risks and thereby can distress long term economic growth. In other words, there has to be some balance between the short-term and the long-term. The pro-side suggests that the US economy is still not fully recovered and the global economy is not in good shape. Therefore, it seems that in the short run it may cause more harm than good to change the track by switching full-scale fiscal austerity measures. The decision change of Fed (we just explained in the previous section) may be also related to this uncertainty. Both real and financial sectors in the US economy have relatively much better condition than they have few years ago but the fragility and uncertainties are still presents. On October 17, the Congress, House and President found a way to solve (or postpone) the problem until early 2014. It has to be underlined here that the trade-off between short-term and long-term economic health has not resolved in the US and it seems that the problem is swept under the carpet for few months.

**The Signals We Should Understand**

Since the 1980s Turkey has experienced many reforms toward liberalization of its national economy. The crisis also negatively affected Turkey. Turkish economy has had relatively better growth performance after onset of this global crisis, the growth performance slowed sharply relative to initial phase of Justice and Development Party (AKP). It must be emphasized that the success of AKP has been rooted in economic prosperity, which will remain one of the most important indicators for Prime Minister Tayyip Erdoğan’s popularity.

As a relatively open economy Turkey is vulnerable to global economic fluctuations. For the last ten years, although the budget discipline was strictly followed by AKP, Turkish economic growth has been mainly based on excessive spending of households. In this structure, we have large number of little fragility. We can give list them (The list is deemed to be exhaustive):

I) Low private savings
II) Investments (particularly for the production of high value added) are relatively low
III) Export concentration is mainly low or medium value added goods (or sophistication)
IV) The dependency of production on imported intermediate goods.
V) Inefficient use of “demographic dividend.”
VI) High level of foreign denominated debts of the real sector.

The first five problems have structural nature and therefore it would take absolutely long time to tackle them. The last problem fits the frame of our study. Foreign currency denominated debt for the Turkish government is relatively low and the Turkish public finance is relatively in good shape. Therefore, it seems that even if the political strain in the US intensifies, it would not have considerable direct effects over Turkish public finance. However, the private sector in Turkey has been borrowing from foreign financial markets. This foreign debt is denominated in foreign currency and the size of the debt is quite large. Different from our experience of 2001 crisis, today the firms in real sector (not banks) are in a fragile position.

What will be the worst case scenario for Turkish economy? The ambiguity of the monetary and fiscal policies in the US as well as the uncertainties in the global economy may lead to an unexpected chain of events which may result in a new and deeper crisis. Due to large amount of foreign currency denominated debt of Turkish firms, these medium and large size industrial firms may face insolvency. Therefore, it is a wise step to reduce currency risk before the end of 2013. Therefore, Turkish policy makers and private sectors have 4-5 months to clean up their houses.
Established in 2008, the Wise Men Center for Strategic Studies (BILGESAM) is one of the leading think tanks in Turkey. As a non-profit, non-partisan organization BILGESAM operates under the guidance of a group of well-respected academics from different disciplines, retired military generals and diplomats; and aims to contribute regional and global peace and prosperity. Closely following the domestic and international developments, BILGESAM conducts research on Turkey’s domestic problems, foreign policy and security strategies, and the developments in the neighbouring regions to provide the Turkish decision-makers with practical policy recommendations and policy options.

Murat Aslan is associate professor of public economics at Eskişehir Osmangazi University. He received a PhD degree in economics from George Mason University in 2004. His research areas include fiscal policies, the role of government in international political economy and applied models in economics. He has published several articles that extensively deal with public economics.