A Tale of Two Crises: Turkey of the Early Aughts and Today's Lebanon

Altug, Sumru and Dagher, Leila

2023

A Tale of Two Crises: Turkey of the Early Aughts and Today's Lebanon

By Sumru Altug and Leila Dagher

Crises in emerging economies often involve capital flow reversals, devaluations, and large drops in real activity, and are typically caused by unsustainable fiscal positions, financial sector fragility, and political instability. All these factors were present in the crises endured by Turkey and Lebanon, albeit with a 20-year difference.

Turkey and Lebanon's similar paths to financial and economic crisis

After gaining independence in 1923, Turkey transitioned from a model of state-led industrialization to a more liberal economy in the 1980s and suffered two major financial crises following this period—in 1994 and 2000-2001, respectively. Ozatay and Sak[i] provided one of the most influential accounts of the 2000-2001 crisis in Turkey, which erupted during the implementation of an IMF-supported stabilization plan.[ii] Following an apparent crisis of government on February 19, 2001 between President Ahmet Necdet Sezer and Prime Minister Bülent Ecevit over the process of corruption investigations[iii], overnight interest rates rose to 6,200% (in uncompounded terms) and the exchange rate system collapsed. Ozatay and Sak persuasively argue that the precipitating factor in this financial crisis was the fragility of the banking sector, which relied on earnings from high-yielding Treasury securities and hence, was vulnerable to disinflation.[iv] The risk accumulated in the banking sector arose from the need to finance a very high rate of borrowing in the public sector. Despite the existence of an IMF-supported stabilization plan[v], such risks were compounded by extraneous political events, which led to a full-blown crisis causing massive capital outflows, a 40% depreciation of the Turkish lira, and an 8.5% decline in real GDP.[vi]

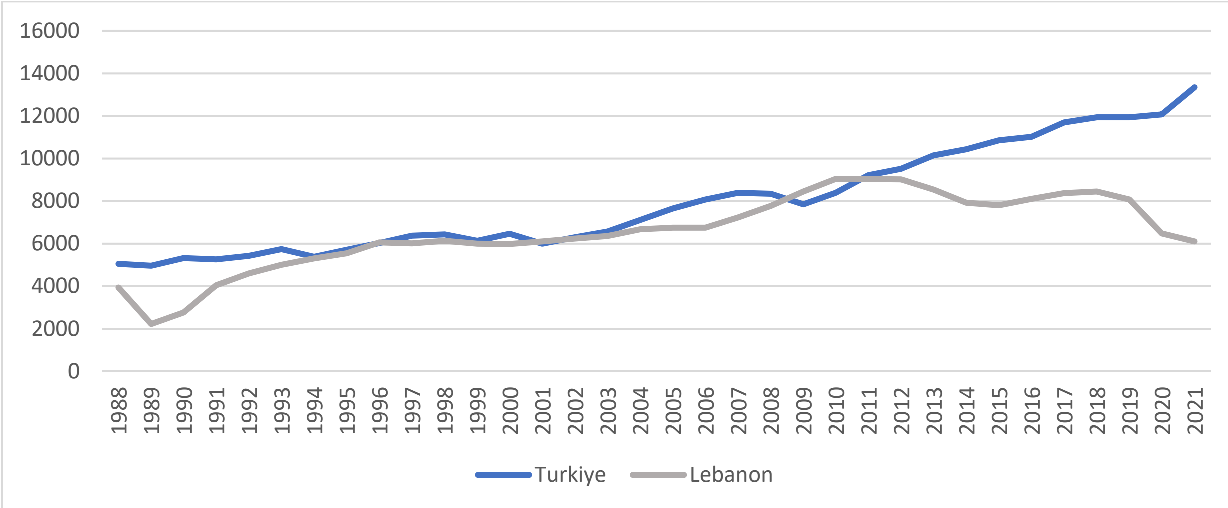
Since its independence in 1943, Lebanon's economy endured multiple periods of boom in the early 1970s and after the 1975-1990 civil war[vii] and experienced high growth rates based on the country's financial services, real estate, and tourism sectors. However, high fiscal deficits, surging public debt, and rampant corruption and mismanagement eventually led to the financial crisis that began in 2019, and which continues unabated to this day. The precursors to the financial crisis in Lebanon have been well documented.[viii] There is consensus among scholars that one of the primary causes was unchecked government borrowing to finance the operations of the public sector, a trend that has continued without interruption since the end of the civil war in 1990. The war in Syria that broke out in 2011 led to the loss of trade opportunities, which was further exacerbated by the rise of geopolitical tensions with former partners such as Saudi Arabia.[ix] Combined with the decline in oil prices between 2014 and 2016[x], remittances from Lebanese nationals residing in Gulf states sharply declined. To counteract these negative developments, Lebanon's central bank, the Banque du Liban, began its practice of "financial engineering" in 2016, whereby foreign currency flows were attracted to Lebanon by offering high interest rates on foreign currency-denominated deposits. The proceeds were subsequently lent to the government to finance its general expenditures.

However, government revenues were effectively squandered by subsidizing an inefficient energy sector, maintaining an oversized public sector, as well as due to rampant corruption.[xi] Events came to a head with widespread civil protests against corruption and poverty in 2019[xii] and the abrupt reversal of capital flows in the face of an unsustainable financial position. The Lebanese government defaulted on 1.2 billion US dollars of interest payments on public debt in March 2020[xiii] and banks began imposing capital controls on their customers by curtailing the withdrawal of their deposits[xiv] in the face of a sudden shortfall in foreign currency reserves. Based on recent figures, net financial losses exceed $72 billion in Lebanon[xv], while the Lebanese lira had lost over 98% of its value by 2023. How these losses should be apportioned among the different stakeholders has become one of the most contentious issues in formulating a rescue and reform plan with the IMF.[xvi]

Turkey and Lebanon's diverging strategies for crisis management

While circumstances leading up to the 2000-2001 crisis in Turkey resemble the financial and economic policy problems that Lebanon was facing in 2019, the methods of addressing the core of the issue in the two countries were starkly different. In response to its crisis of 2000-2001, Turkey swiftly signed a new letter of intent with the IMF[xvii], which subsequently helped to mitigate the direst consequences of its financial downturn, improving a number of its macroeconomic indicators as a direct result. In contrast, Lebanon has been negotiating intermittently with the IMF since May 2020, but it has yet to formally implement an agreement with the fund.[xviii] Importantly, the conditions set out by the IMF in its ongoing negotiations with Lebanon are indeed very similar to the ones Turkey ended up signing up for in May 2002. While one cannot ignore the crisis of governance, which interacts with Lebanon's economic meltdown in a mutually reinforcing cycle[xix], what follows is an economic assessment of the potential positive impact an IMF agreement could have on Lebanon's prospects illustrated by key macroeconomic indicators.

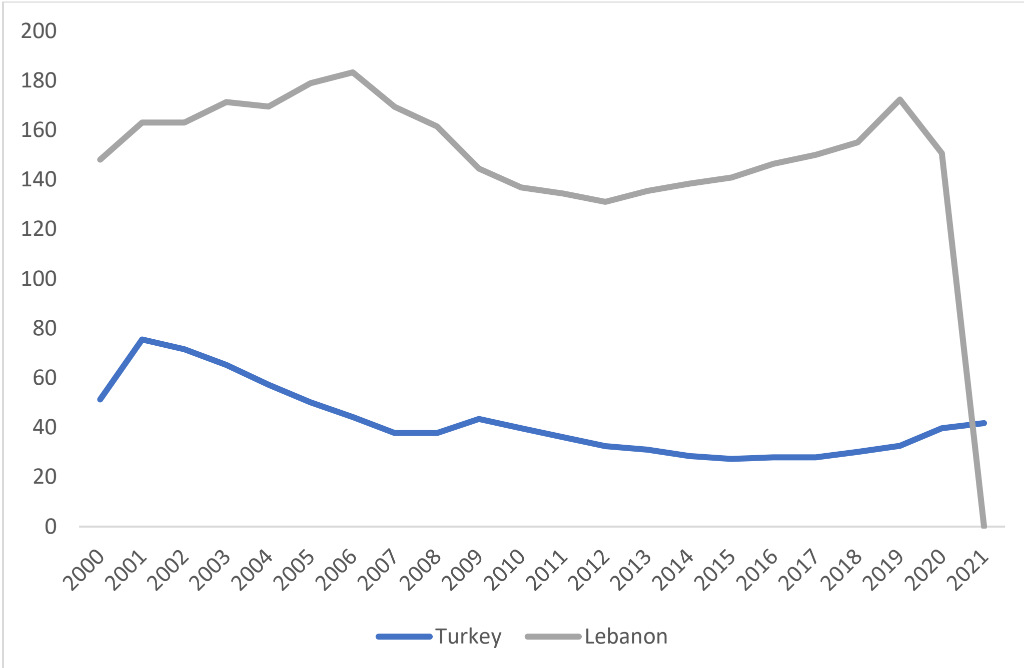
Figure 1. GDP per capita for Lebanon and Turkey in 2015 USD (1988-2021)



Source: World Bank national accounts data, and OECD National Accounts data files.

Turkey's GDP per capita showed a slight decline prior to and during the financial crisis of 2000-2001, however, it started growing strongly during the implementation of the IMF program after 2002. This upward trajectory was only halted momentarily by the Global Financial Crisis of 2008. With the end of the civil war in 1990, Lebanon's GDP per capita increased rapidly and attained a value equal to that of Turkey's—Lebanon was a country of four million people while Turkey's population stood at 60 million at the time.[xx,xxi] A few years prior to the 2019 crisis, however, cracks in the system already started to show and Lebanon's GDP per capita noticeably decreased. Part of this decline can be explained by circumstances external to Lebanon. This includes the disrupting effect of the Syrian civil war on trade relations between Syria and Lebanon[xxii] as well as the costs of absorbing an outsized number of refugees[xxiii], now making up approximately 27% of the country's population.[xxiv] In addition to this, the dramatic decline in international oil prices after 2014 affected Lebanon disproportionately, as c. 16% of its GDP was made up of remittances mostly originating from Gulf countries.[xxv] Notwithstanding these significant external challenges, Lebanon's GDP per capita appeared to bounce back from 2015 onward before going on a sharp decline in 2019. An additional decline of 32.5% in GDP per capita since the onset of the crisis illustrates the costs that Lebanon is paying for the ongoing mismanagement of its economy and financial system.

Figure 2. Government Debt as a % of GDP for Lebanon and Turkey (2000-2021)

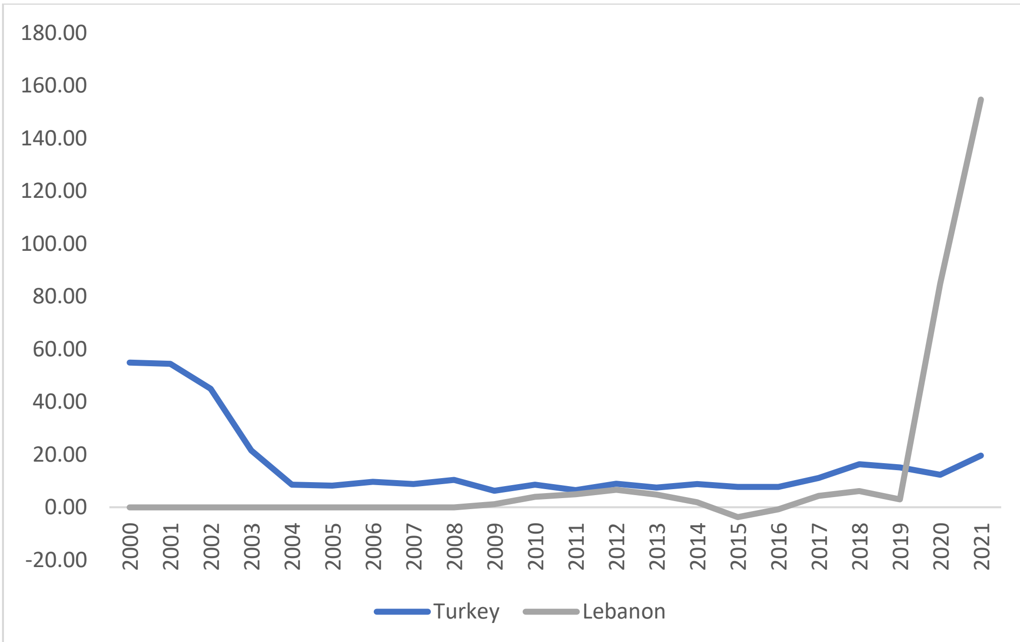


Source: World Bank, Central government debt, total (% of GDP), Turkey; IMF, Country Data, Lebanon

Turkey's debt-to-GDP ratio was around 75% in 2001 but reached 40% by 2009 after gradually falling for eight years. This decline is one of the achievements of the IMF Standby Agreement, which stipulated the maintenance of primary surpluses of 6% of GDP to control government spending. The IMF Standby agreement also stipulated a restructuring of the banking sector to strengthen bank capital ratios and eliminate duty losses of state banks. [xxvi] During the crisis of 2000-2001, the losses incurred due to the takeover of private banks together with the duty losses of state banks added to the fiscal burden of the government. The takeover of private banks and the disposal of their assets was accomplished by the the Savings Deposit Insurance Fund (SDIF) of Turkey and the strengtening of the regulatory environment facing banks and financial markets was implemented through the activities of the Banking Resolution and Supervision Authority (BRSA). While the BRSA was originally established in 1999, its independence, effciency and overall functions were enhanced by a law passed in 2005."[xxvii] These reforms directly led to the steady improvement in Turkey's debt-to-GDP ratio.

At the onset of the crisis in 2019, Lebanon's debt-to-GDP ratio peaked at 172%, a burden that eventually led to its sovereign default in 2020. As a general observation, while Turkey's debt-to-GDP ratio equaled 42.23% across the entire sample period of the crisis as well as crisis management, it stood at 154.47% in Lebanon. Lebanon's debt situation is inextricably linked to the financial engineering practices of its central bank, which eventually led to a collapse of the country's banking sector.

Figure 3. Inflation Rates (%) for Lebanon and Turkey (2000-2021)

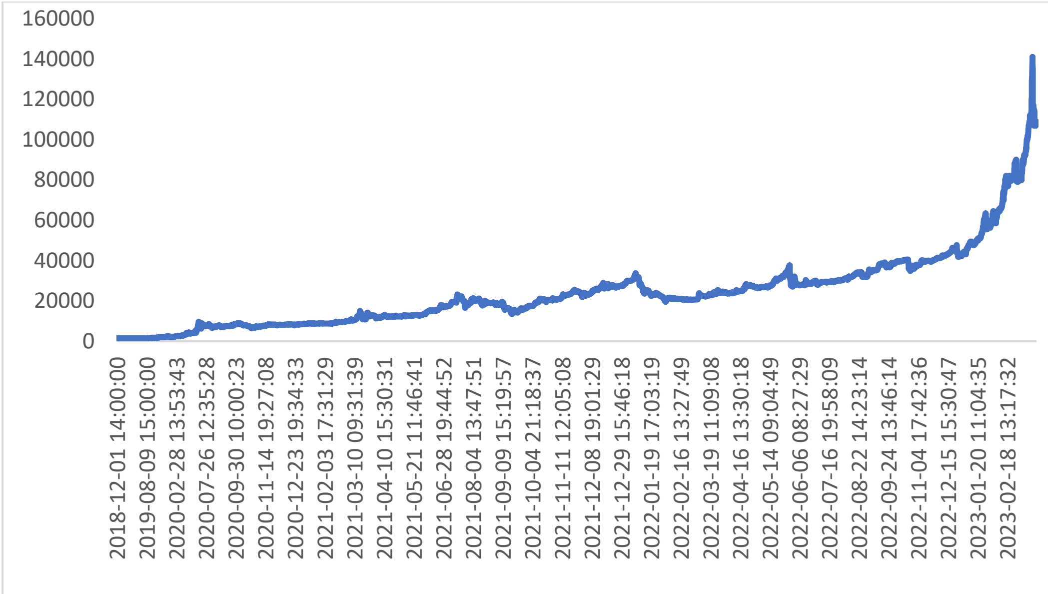


Source: World Bank, Inflation, consumer prices (annual %), Lebanon and Turkey

Turkey's inflation rate fell from a value of around 55% in 2000 to less than 6.5% by 2009. Here again, the credit goes to the IMF's Standby Agreement, which instituted fiscal discipline and stipulated a transition to an inflation-targeting regime, an event which occurred formally in 2006.[xxviii]

Lebanon's inflation rate, which was under control prior to the crisis, climbed to 84.86% in 2020 and 154.76% in 2021 from a value of merely 3.01% in 2019 as the fixed exchange rate regime collapsed in the face of a multifaceted governing, economic and financial crisis.

Figure 4. USD to LBP Black Market Exchange Rate (2018-2023)



Source: www.lirarate.org

Since the 1990s the fixed exchange rate regime in Lebanon had pegged one US dollar (USD) to 1505 Lebanese pounds (LBP), which appears to have provided stability to an economy lacking any other external anchors. Since the collapse of the fixed exchange rate regime in 2020, Lebanon has experienced several different exchange rates. *Figure 4* displays the black-market exchange rate between USD and the LBP over the period 2018 to 2023. An alternative exchange rate is available from the so-called Sayrafa platform, an application that allows Lebanese people to trade currencies at an exchange rate available only to certain banks and those with pre-existing bank accounts, with specific monthly traffic quotas. The Sayrafa rate was equal to 90,000 LBP per USD on March 22, 2023, while the black-market rate reached as high as 107,500 LBP per USD. Relative to the official rate that was in effect in 2018, *Figure 4* shows that the Lebanese lira had lost over 98% of its value by 2023, showcasing the uncontrollable rate of depreciation of the Lebanese currency over this period. By contrast, Turkey transitioned to a managed floating exchange rate regime in 2001 and stabilized its exchange rate to a large extent up until 2021, when it began implementing an unorthodox monetary policy under President Recep Tayyip Erdoğan.[xxix]

Notwithstanding the reversals over the past several years, Turkey implemented a successful macroeconomic stabilization plan by lowering its inflation rate, bringing its government debt under control, and successfully restructuring its banking sector to maintain financial stability and well-functioning credit markets. Altug and Uluceviz[xxx] conducted an out-of-sampling to forecast inflation and real output growth proxied by industrial production growth and showed that policy variables such as interest rates and market-based expectational variables such as asset prices were better placed to predict real activity and inflation in the post-2001 and post-2006 forecast periods compared to the post-1993 forecast period when monetary aggregates and market sentiment were better predictors, reflecting the impact of the stabilization program that Turkey implemented in the early 2000's.

By contrast, in an environment without a credible stabilization and reform plan to anchor expectations and where increases in the price of energy and food due to the war in Ukraine are making themselves felt more acutely every day, the Lebanese economy appears to be in a freefall, with prices and exchange rates pursuing an upward spiraling path and real output declining by around 40% since 2018.[xxxi] Informal capital controls imposed by banks prevent ordinary citizens from accessing their deposits or from providing credit to finance private sector investment, deepening the downward spiral in markets.

Conclusion

Our analysis shows that a well-designed and judiciously implemented stabilization and reform program supported by the IMF can quickly revive an ailing economy. More than three and a half years after the onset of the crisis in Lebanon, and a year after the IMF's Staff Level Agreement,[xxxii] the government has been unable to make any progress on implementing the necessary reforms. This procrastination is intentional as Lebanon's leading political class have a vested interest in all economic sectors from fuel imports to banking.[xxxiii] IMF reforms calling for the lifting of banking secrecy and for more transparency and accountability are likely to expose vast corruption and mismanagement committed by Lebanese leaders. Delays caused by the government only exacerbate the crisis; for example, net financial losses in the finance and public sectors have increased from 44 billion[xxxiv] in April 2020 to more than 72 billion USD in November 2022.[xxxv] The ongoing blanket subsidies policy adopted by two consecutive governments is practically draining the country's foreign currency reserves. Lebanon is far from being on the right track for crisis management. In lieu of a comprehensive policy intervention, risks of a full-fledged collapse grow day-by-day.

Dr. Sumru Altug is Professor and Chair of the Department of Economics at the American University of Beirut and a Research Fellow at the Centre for Economic Policy Research, London, UK. She is currently active in academic, policy, consulting, and media circles internationally as well as locally.

Dr. Leila Dagher is an Associate Professor of Economics at the American University of Beirut and a Senior Fellow at the Lebanese Center for Policy Studies. She has been serving as economic advisor to several policymakers since January 2020.

[i] Ozatay, F., & Sak, G. (2002). Banking Sector Fragility and Turkey's 2000-01 Financial Crisis. Brookings Trade Forum 2002, 121-160. doi:10.1353/btf.2003.0008.

[ii] International Monetary Fund. (2001). Press Release: IMF Approves Augmentation of Turkey's Stand-By Credit to US$19 Billion. Retrieved from: https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr0123.
[iii] Morris, C. (2001). Turkey suffers as leaders fight on. The Guardian. Retrieved from: https://www.theguardian.com/world/2001/feb/21/3.
[iv] Ozatay, F., & Sak, G. (2002). Banking Sector Fragility and Turkey's 2000-01 Financial Crisis.
[v] International Monetary Fund. (2000). Press Release: IMF Approves Third and Fourth Turkey Reviews and US$7.5 Billion Supplemental Reserve Facility Credit. Retrieved from: https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr0080.
[vi] Macovei, M. (2009). Growth and economic crises in Turkey: leaving behind a turbulent past? European Economy - Economic Papers 2008 – 2015, 386. Directorate General Economic and Financial Affairs (DG ECFIN), European Commission.
[vii] Kubursi, A.A. (1999). Reconstructing the Economy of Lebanon. Arab Studies Quarterly, 21(1), 69-95. Retrieved from https://www.jstor.org/stable/41858277
[viii] Blair, E. (2022). Explainer: Lebanon's financial crisis and how it happened. Reuters. Retrieved from: https://www.reuters.com/markets/rates-bonds/lebanons-financial-crisis-how-it-happened-2022-01-23/.
[ix] Abouaoun, Dr. E. (2021). What's Behind the Lebanon-Gulf Diplomatic Row? United States Institute of Peace. Retrieved from: https://www.usip.org/publications/2021/11/whats-behind-lebanon-gulf-diplomatic-row.
[x] Stocker, M., Baffes, J. & Vorisek, D. What triggered the oil price plunge of 2014-2016 and why it failed to deliver an economic impetus in eight charts. World Bank Blogs. Retrieved from: https://blogs.worldbank.org/developmenttalk/what-triggered-oil-price-plunge-2014-2016-and-why-it-failed-deliver-economic-impetus-eight-charts.
[xi] Dagher, L., and Nehme, R. (2021). Can Lebanon's Economy Be Saved? A Plan for Revival. Middle East Policy, 28(1), 123-134.
[xii] Chulov, M. (2019). Lebanon's mass revolt against corruption and poverty continues. The Guardian. Retrieved from: https://www.theguardian.com/world/2019/oct/20/lebanons-mass-revolt-against-corruption-and-poverty-continues.
[xiii] The Economist. (2020). For the first time, Lebanon defaults on its debts. Retrieved from: https://www.economist.com/middle-east-and-africa/2020/03/12/for-the-first-time-lebanon-defaults-on-its-debts.
[xiv] Geldi, M. (2021). Lebanese cannot access money in banks since late 2019. AA. Retrieved from: https://www.aa.com.tr/en/economy/lebanese-cannot-access-money-in-banks-since-late-2019/2158782.
[xv] The World Bank. (2022). Lebanon Economic Monitor, Fall 2022. Retrieved from: https://openknowledge.worldbank.org/entities/publication/147ea492-37ff-5af9-b703-8a3728d3c413.
[xvi] See Dagher, L. & Altug, S. (2023). Is There an End Game to Lebanon's Woes? Georgetown Journal of International Affairs, forthcoming.
[xvii] International Monetary Fund. (2001). Letter of Intent of the government of Turkey… Retrieved from: https://www.imf.org/external/np/loi/2001/tur/02/.
[xviii] The government signed a staff-level agreement with the IMF in April 2022. The political impasse in Lebanon and the delays it has led to in adopting and implementing a much-needed IMF Plan are documented by Dagher and Altug (2023).
[xix] IISS. (2022). Lebanon's governance crisis. Retrieved from: https://www.iiss.org/publications/strategic-comments/2022/lebanons-governance-crisis.
[xx] Country Economy (2023). Lebanon – Population 1996. Retrieved from: https://countryeconomy.com/demography/population/lebanon?year=1996
[xxi] Country Economy (2023). Lebanon – Population 1996. Retrieved from: https://countryeconomy.com/demography/population/turkey?year=1996.
[xxii] The World Bank. (2015). The impact of the Syrian conflict on Lebanese trade. Retrieved from: https://documents1.worldbank.org/curated/en/908431468174247241/pdf/96087-WP-P148051-PUBLIC-Box391435B-Syria-Trade-Report.pdf.
[xxiii] Brun, C., Fakih, A., Shuayb, M. & Hammoud M. (2021). The Economic Impact of the Syrian Refugee Crisis in Lebanon. Retrieved from: https://wrmcouncil.org/wp-content/uploads/2021/09/Lebanon-Syrian-Refugees-WRMC.pdf.
[xxiv] UNHCR. (2023). UNHCR Lebanon at a Glance. Retrieved from: https://www.unhcr.org/lb/at-a-glance.
[xxv] Pierre Sassine, G. (2015). Impact of Oil Price Drop on Lebanon's Economy & Petroleum Sector. Retrieved from: https://logi-lebanon.org/uploaded/2016/5/53J6AFN3_Impact%20of%20oil%20price%20drop%20on%20Lebanon%E2%80%99s%20economy%20&%20petroleum%20sector.pdf
[xxvi] See the June 2001 IMF Country Report No.01/89. Retrieved from https://www.imf.org/external/pubs/ft/scr/2001/cr0189.pdf
[xxvii] https://www.bddk.org.tr/KurumHakkinda/Detay/19 and Presidency of the Republic of Türkiye. (2023). Banking Regulation and Supervision Agency. Retrieved from: https://www.cbfo.gov.tr/en/banking-sector/banking-regulation-and-supervision-agency.
[xxviii] Kara, H. (2006). Turkish experience with implicit inflation targeting, The Central Bank of the Republic of Turkey, Research and Monetary Policy Dept Working Paper No. 06/03. Retrieved from https://www.tcmb.gov.tr/wps/wcm/connect/5cbc48e5-979d-4be3-8bae-7e5a9267ed84/WP0603.pdf?MOD=AJPERES
[xxix] Giles, C. (2021). Why Erdogan's unorthodox Turkish economic experiment is not working. Financial Times. Retrieved from: https://www.ft.com/content/4a7303dc-9bf6-4a70-8078-13f98edc30b4.
[xxx] Altug, S. & Uluceviz, E. (2013). Identifying leading indicators of real activity and inflation for Turkey, 1988-2010: A pseudo out-of-sample forecasting approach. OECD Journal: Journal of Business Cycle Measurement and Analysis, 1-37. Retrieved from: http://dx.doi.org/10.1787/jbcma-2013-5k4221j86n8v.
[xxxi] World Bank (2023a), Lebanon Economic Monitor (Spring 2023): The Normalization of Crisis Is No Road for Stabilization, Washington DC. Retrieved from: https://documents1.worldbank.org/curated/en/099027005152320346/pdf/IDU0ea0213ae0e0f804ba309c7a00638cf710a36.pdf

[xxxii] International Monetary Fund. (2022). IMF Reaches Staff-Level Agreement on Economic Policies with Lebanon for a Four-Year Extended Fund Facility. Retrieved from: https://www.imf.org/en/News/Articles/2022/04/07/pr22108-imf-reaches-agreement-on-economic-policies-with-lebanon-for-a-four-year-fund-facility.
[xxxiii] Assouad, L. (2021). Lebanon’s Political Economy: From Predatory to Self-Devouring. Carnegie Middle East Center. Retrieved from: https://carnegie-mec.org/2021/01/14/lebanon-s-political-economy-from-predatory-to-self-devouring-pub-83631.
[xxxiv] As estimated by the Government of Lebanon’s Financial Recovery Plan also known as the Lazard Plan in April 2020 https://today.lorientlejour.com/article/1225139/why-are-lebanons-negotiations-with-the-imf-deadlocked.html
[xxxv] World Bank (2022). Lebanon Economic Monitor, Fall 2022: Time for an Equitable Banking Resolution. Retrieved from: https://openknowledge.worldbank.org/server/api/core/bitstreams/167b9d8e-01f4-5aaa-8ca1-3b58318c1dd2/content