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## Growth and economic crises in Turkey: leaving behind a turbulent past?

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# **Growth and economic crises in Turkey: leaving behind a turbulent past?**

## **1. Overview**

A first glance at Turkey's performance in the current crisis shows that it has managed to weather the global stormy conditions relatively well and avoid collapsing into a full-fledged currency and financial crisis. Although activity in the real sector has contracted sharply, mainly as a result of both collapsing external demand and strongly declining domestic demand - which is also a by-product of the international credit crunch and lower availability of external financing, a financial crisis similar to those in the 1990s and in 2000/2001 has been avoided. On the face of it, one could conclude economic reforms introduced since 2001 have paid off and today's performance marks a clean break with the past. But there are also indications that the Turkish economy still retains some of its old vulnerabilities. Warning signs include developments related to the timing of the economic slowdown, the fairly large correction of the exchange rate at the beginning of the crisis, concerns regarding the external indebtedness of the private sector and the numerous voices calling for policy anchors, such as the introduction of binding fiscal rules or a new IMF arrangement.

The main purpose of this paper is to assess whether the current economic crisis which affects not only Turkey, but countries around the world, has any significant similarities to the crises that engulfed Turkey in the 1990s. One immediately obvious difference is that while in the 1990s the factors triggering Turkey's economic instability were largely domestic its current crisis has paralleled the international financial and economic turmoil. But, these different trigger factors notwithstanding, it is still useful to compare how the Turkish economy has behaved in the two crisis situations in order to ascertain whether and to what extent macroeconomic and structural policy shortcomings have been corrected. It is also important to determine how resilient Turkey's economy is to domestic and international economic volatility in order to assess the sustainability of the accelerated economic convergence process on which Turkey embarked after the 2001 crisis.

The paper is organised as follows. The second chapter examines Turkey's economic performance and growth dynamics after the Second World War and identifies the main causes and features of the financial and economic crises which plagued it in the 1990s. It briefly analyses the major contributors to the unstable growth model that prevailed in past decades and what lessons the authorities drew from the 2000-01 crisis. This scene-setter leads on to a presentation of the post-crisis economic reforms and the comparative assessment with the current crisis. The third chapter focuses on the economic recovery which started in 2002 based on remarkable fiscal consolidation and improved macro-financial stability and led to uninterrupted strong growth and economic catching-up until the second half of 2008. The impressive economic rebound occurred against the background of strong external anchors – IMF programmes and an improved perspective for EU accession – and bold structural reforms. The fourth chapter looks in-depth at the ongoing economic crisis and its impact on the real economy, financial and external sectors, together with the policy responses and the challenges faced by the authorities. The last chapter asks whether the current crisis shows that Turkey has broken with its past economic instability. Improved macroeconomic stability and an implicit break with the volatile growth pattern of the recent past would represent in our view a precondition for fully utilising Turkey's potential for economic catching-up.

## 2. Causes and features of past economic crises

From the Second World War until the 2001 economic crisis, Turkey's economic catching-up with the developed economies was weak and volatile. The low productivity growth and relative stagnation through the 1970s was primarily the result of policies of import substitution, subsidisation of agriculture and economic dirigisme which resulted in a sub-optimal allocation of resources. And in spite of some steps towards reform and liberalisation in the 1980s, economic growth was plagued by recurrent crises, as a result of inadequate macro-economic policies and financial opening in a weak institutional and regulatory environment. The volatile growth pattern culminated in the 2000/2001 crisis which led to the breakdown of the currency peg to the US dollar, a sharp depreciation of the Turkish lira, and a contraction of GDP by 5.7% in real terms in 2001. But there was a silver lining: the strong incentive the crisis created for bold reforms led to five years of economic recovery during 2002-07.

### Anaemic catching-up process until the 2001 economic crisis

Turkey was largely spared the horrors and economic destruction of the Second World War, mainly because it maintained armed neutrality. However, its economy stagnated during the 1940s, in large part because of the strongly curtailed foreign trade and increased military expenditure. After the war, it was nevertheless well positioned to engage in a robust process of economic convergence with the United States, like the Western European economies, but it failed to take advantage of the effervescent post-war economic reconstruction (table 1).

The period 1950-1973 is regarded as a "Golden Age" in modern European economic history as it combined very high rates of growth with relatively mild cyclical fluctuations and moderate inflation.

**Table 1: Changes in real GDP per capita, 1950-1998**  
(Average annual growth rates)

	1950- 1960	1960- 1973	1973- 1990	1990- 1998	1950- 1998
<b>France</b>	3.6	4.4	1.9	1.1	<b>2.8</b>
<b>Germany *</b>	7.1	3.4	2.1	1.3	<b>3.3</b>
<b>Italy</b>	5.4	4.5	2.5	1.1	<b>3.4</b>
<b>United Kingdom</b>	2.3	2.6	1.8	1.6	<b>2.1</b>
<b>Greece</b>	5.1	7.1	1.5	1.5	<b>3.7</b>
<b>Ireland</b>	2.2	3.7	3.3	6.6	<b>3.7</b>
<b>Portugal</b>	3.8	6.7	2.6	2.4	<b>3.9</b>
<b>Spain</b>	3.7	6.2	1.9	2.0	<b>3.4</b>
<b>Turkey</b>	<b>3.3</b>	<b>3.0</b>	<b>2.2</b>	<b>2.4</b>	<b>2.7</b>
<b>United States</b>	1.6	3.1	1.7	1.7	<b>2.1</b>
<b>European Union **</b>	4.1	4.0	2.0	1.1	<b>2.8</b>

\* 1950-1990 and 1950-1998: West Germany, 1990-1998: unified Germany.

\*\* 1950-1998, 1950-1960 and 1950-1973: Luxembourg is excluded.

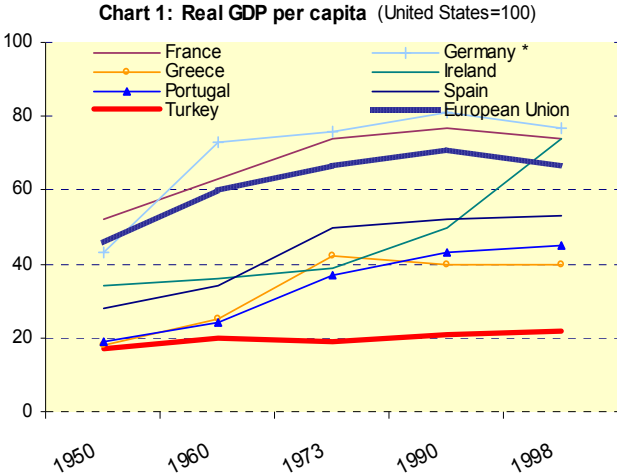
Source: UN Economic Commission for Europe

It saw Western Europe's fastest rate of output expansion since the beginning of "modern growth" in 1870. According to the United Nations Economic Commission for Europe<sup>1</sup>, real GDP per capita increased by almost 4% annually between 1950 and 1973, well above the

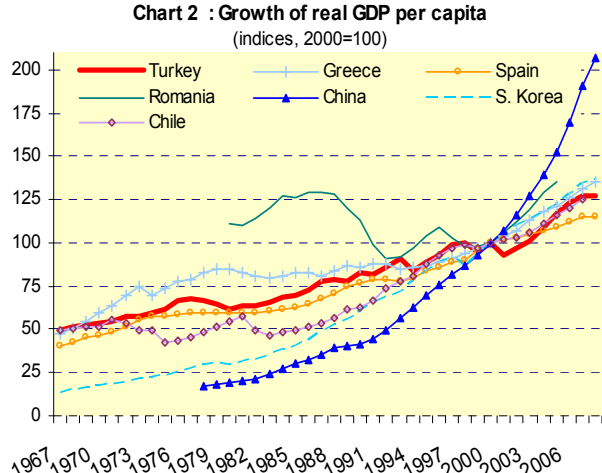
<sup>1</sup> See the "Economic Survey of Europe", 2000 No. 1.

2.4% growth recorded in the United States. Real GDP per capita increased in Western Europe to 62% of the United States level in 1973, up from 45% in 1950. These were years of buoyant growth also for the "peripheral" economies – Greece, Portugal and Spain, except for Turkey and Ireland which made only limited progress in terms of real convergence with the United States. As a matter of fact, Turkey remained stuck at a level of around 20% of the real GDP per capita of the United States throughout this period.

In the quarter century following 1973 there was a general slowdown in the rate of economic expansion in the industrialised countries, strongly influenced by the two oil shocks. The earlier dynamism at the periphery also waned, except in Ireland, which by the end of the period had achieved the highest per capita GDP growth in the EU. Although Turkey's growth rates of real GDP per capita outperformed those of Greece, Portugal and Spain, they slowed in tandem with the other economies, and its advancement in terms of catching-up with the United States' real GDP per capita level was rather modest.



Source: UN Economic Commission for Europe



Source: Thomson - Reuters

The main reason why Turkey failed to close the large economic gap with the developed countries (charts 1 and 2) appears to have been the strong state-interventionist and inward-oriented economic policies which it pursued from the early 1930s and which resulted in sub-optimal allocation of resources and productivity growth. Adamopoulos and Akyol (2006) consider Turkey "an interesting case study of relative stagnation" as it is the only founding member of the OECD that has not converged to the US in terms of per capita GDP since 1950. This is despite the fact that Turkey has been part of Western international organisations and has adopted Western institutions. Their growth accounting exercise suggests that the relative stagnation of Turkey's living standards has not been due to capital deepening, which was reasonably strong until the 1980s, but rather to its decline in labour force participation and low growth of total factor productivity (TFP), which has not gained any ground relative to the US. They suggest that these are the result of economic policies such as heavy subsidisation of agricultural products, high effective tax rates on labour, and labour market rigidities which kept resources too long in agriculture and when the resources were eventually shifted from the agricultural sector, they left the formal sector altogether.

Altug, Filiztekin and Pamuk (2007) arrive at fairly similar conclusions in their investigation into the sources of economic growth in Turkey during 1880-2005, with the exception of the role of labour. For the post-1950 era, the growth rate of output has been primarily due to capital accumulation and labour force growth, while TFP growth has been very low (table 2). In particular in the non-agricultural sector, TFP growth was either very low or negative until 1980. Although output growth in Turkey derives primarily from capital growth, the rate of

capital accumulation has been relatively low compared with faster growing economies like South Korea or Portugal, which goes some way to explaining Turkey's inability to close the income gap with the developed economies.

**Table 2: Contribution to Annual Growth Rates**

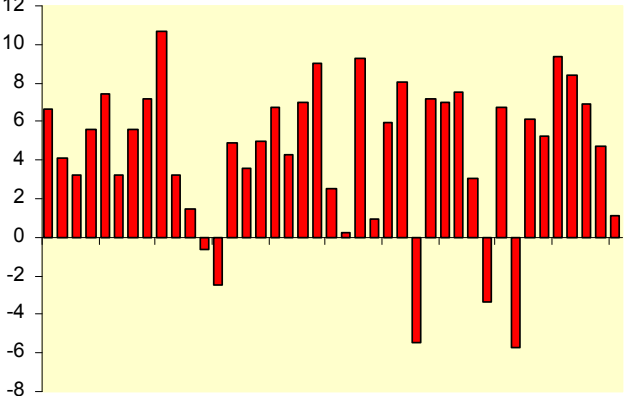
	Capital	Labor	Total factor productivity
<b>1950-1980</b>	2.13	2.26	0.58
<b>1980-2005</b>	1.52	1.39	1.14
<b>1950-2005</b>	1.88	1.92	0.83

Source: Altug, Filiztekin and Pamuk (2006), 2-sector model

After a brief experiment with agriculture-led growth in the 1950s, Turkey settled for import-substituting industrialisation, which was based on the protection of its nascent industrial sector from external competition mainly through high tariffs and other barriers to foreign trade, capital controls and subsidies. The policy prevented both a meaningful integration into the international division of labour and an optimal allocation of the factors of production. This is best reflected in the very low TFP growth rates recorded in this period and growth of the informal labour market.

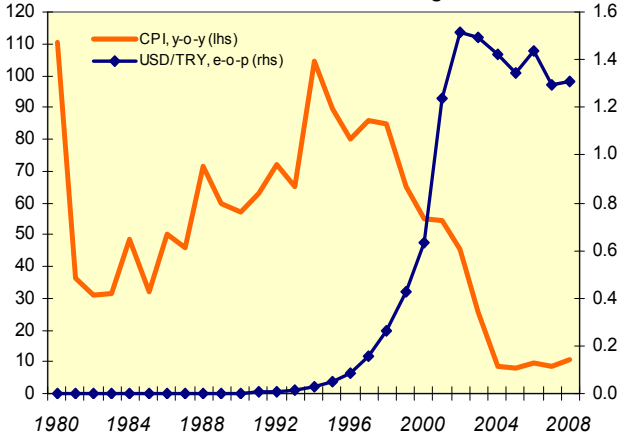
After 1980, Turkey embarked on a process of economic liberalisation. Although this proceeded in fits and starts it made good progress towards removing price controls, subsidies and interest ceilings, freeing foreign trade, relaxing capital controls, encouraging FDI and expanding the private sector. As a result, foreign trade and FDI increased significantly – albeit from low levels, in particular the FDI. TFP in industry (though not in agriculture) also picked up from this point and Turkey started displaying non-negligible TFP growth. Indeed, the contribution from TFP to output growth more than doubled compared to the previous time span, reflecting a better allocation of resources in the economy. However, growth performance was increasingly hampered by boom-and-bust cycles characterised by periods of industry-led rapid expansion, followed by balance of payments crises, devaluations of the Turkish lira and austerity programmes to dampen domestic demand for foreign goods, making possible the resumption of foreign indebtedness and yet another cycle. As seen in charts 3 and 4, growth of real GDP was extremely volatile and macroeconomic stability was plagued by high inflation and a weak currency.

**Chart 3: Real GDP growth**



Source: Thomson - Reuters

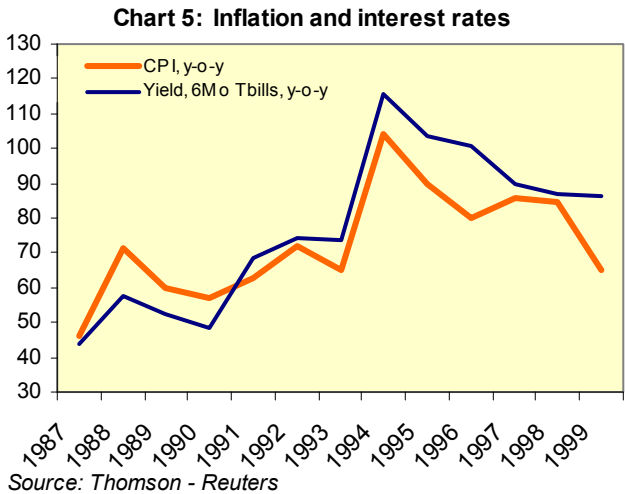
**Chart 4: Inflation and the exchange rate**



Source: Thomson - Reuters

As the liberalisation process of the 1980s was not sufficiently supported by sound macroeconomic policies and regulatory and institutional reforms, the economy suffered repeated crises in the 1990s<sup>2</sup>. The four episodes, in 1991, 1994, 1998 and 1999 – the last resulting partially from a severe earthquake – reflected a number of major weaknesses in the Turkish economy. Lack of fiscal discipline, with sustained primary deficits since the 1970s and heavy reliance on monetary financing, had led to entrenched high inflation. In turn, the high inflation had boosted the risk premium and pushed up real interest rates, reinforcing the public debt burden and dampening Turkey's growth performance vis-à-vis other emerging economies (chart 5).

Macroeconomic instability was intertwined with structural weaknesses, in particular an inadequate regulatory and supervisory framework for the banking system. After the widespread monetisation of budget deficits was interrupted in 1997, the banking sector became the main instrument of government financing, funnelling short-term borrowing from depositors and investors into government debt. Several insolvent private banks were allowed to operate under a blanket public guarantee, while public banks accumulated large losses from subsidised lending. At the end of 2000, publicly-owned banks held almost 40% of total assets in the banking sector. State enterprises, generally operating at low levels of efficiency and representing a burden on the government budget, still dominated several economic sectors. Several attempts to stabilise the economy were undermined by political instability. Populist measures such as tax amnesties and repeated reductions in the retirement age further weakened the sustainability of public finances. The boom-bust cycle culminated in the 2000/2001 financial and economic crisis, which was the severest to date, so much so that it at last triggered a wave of reforms.



**The 2000/2001 crisis**

In an attempt to stabilise the economy, Turkey entered into an IMF stand-by arrangement (SBA) in December 1999. Its main pillars were an exchange rate anchor, i.e. a crawling peg with a preannounced exit strategy that would mitigate the typical risks of real appreciation for exchange-rate based stabilisations, "currency-board rules" which excluded the possibility of sterilised foreign exchange intervention, fiscal consolidation through a large upfront adjustment in the primary fiscal deficit and a comprehensive agenda of structural reforms. Initially, the programme was successful. Inflation started to fall, though more slowly than anticipated. Interest rates meanwhile came down much further than projected. This, together with the steady real exchange rate appreciation, fuelled a boom in domestic demand and led to a widening of the current account deficit. Meanwhile, fiscal consolidation and structural reforms (the only policy levers available under the quasi-currency-board rules) lagged behind, fuelling market unease about the SBA programme.

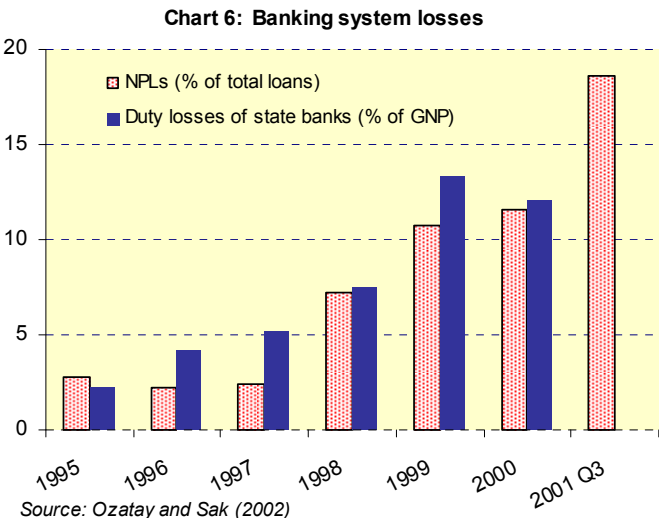
<sup>2</sup> See also Koch and Chaudry (2001).



In October 2000, Demirbank – a major primary dealer and investor in government securities heavily dependent on overnight funds, reached the point where it could no longer refinance itself on the market. Restrained by its ceilings on net domestic assets (part of the quasi-currency-board rules), the Central Bank refused to lend to Demirbank, forcing it to sell part of its government securities portfolio and triggering a significant increase in secondary market interest rates and further sale waves on the secondary market. Faced with a negative impact on other problematic banks and the Treasury's borrowing capacity, the Central Bank eventually injected liquidity in the system in November 2000. This helped prevent interest rates skyrocketing, but increased the drain on official reserves. The IMF pledged to support the programme and replenished the stock of official reserves, thus calming down the markets. Not for long though, because the lira continued to be overvalued as a result of the slow decline in inflation. In January and February 2001 the debt roll-over capacity of the Treasury was seriously tested by the very high interest rates on the market at around 60-70% compared with an annual ceiling of 12% for the depreciation of the lira. In this unsustainable situation, a public disagreement between the Prime Minister and the President on the measures to be taken was followed by a massive attack on the Turkish lira on February 21, 2001. The authorities decided to let the lira float, which led to a depreciation of around 40% against the dollar immediately after the announcement.

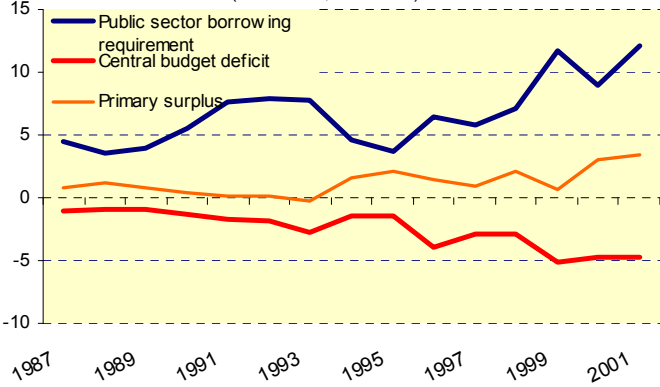
The financial turmoil and the breakdown of the peg had dire consequences for the real economy. In 2001, real GDP declined by 5.7% and investments collapsed in volume terms by 30%, while industrial output dropped by 8.7% annually. Activity in the manufacturing sector was hit harder and declined by 9.4%, the automotive sector recording a 26% decline. Exports of goods and services diminished marginally – by around 1% – compared to 2000, but imports slumped by almost 8% in volume terms, as a result of depressed domestic demand and sharp depreciation of the currency. In tandem with the shrinking economic activity, the unemployment rate surged to 8.4% in 2001 and 10.4% in 2002 from 6.5% in 2000. At the same time, wages in the manufacturing sector suffered a correction of about 15% in real terms. The increase in public debt following the depreciation of the lira and the recapitalisation of banks was staggering: it almost doubled from 38.2% of GDP at the end of 2000 to 74.1% of GDP at the end of 2001. The banking crisis had affected about one quarter of Turkey's 81 banks, causing a loss to the budget of about 30% of GDP. The lira continued to decline during most of the year, depreciating by about 60% against the USD from February to October.

A detailed assessment of the factors that triggered the crisis by Ozatay and Sak (2002) shows the root cause to have been the combination of a fragile banking sector (chart 6) together with a high public sector borrowing requirement (chart 7). Public debt monetisation having been absent since 1997, was not the cause of the speculative attack on the currency (chart 8). The public sector borrowing requirements, which included not only the general government budget, but also state-owned enterprises and other quasi-fiscal deficits, were quite large, hovering above 10% of GDP during



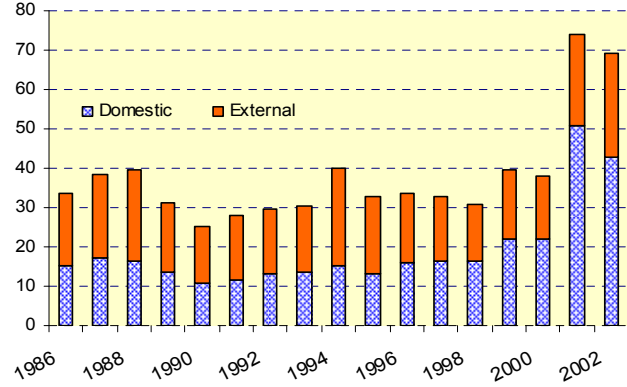
1999-2002.<sup>3</sup> Moreover, several banks were taken over by the authorities (six banks in November 1999 and an additional two banks in September 2000) and criminal investigations were initiated against owners and executives of five of these banks on suspicion of fraud and stashing away the financial resources of the banks through offshore operations. This strengthened the impression that the private banking industry had significant problems, and that large costs were imminent which would endanger the sustainability of public debt. In addition, the financing of the budget deficits by the banking sector led to the accumulation of currency and maturity mismatches on the balance sheets of commercial banks, which could not borrow long-term in domestic currency. On the other hand, state-owned banks had accumulated significant "duty" losses<sup>4</sup> and were also engaged in unsound lending practices. Although both the private and the state banks had mismanaged risks before the crisis, the nature of the problem was different. The private banks were more exposed to the exchange rate risk due to a higher and decreasing ratio of foreign currency to lira liabilities, while state banks were more subject to the interest rate risk, due to their inability to extend financing beyond short-term domestic instruments. As a result, the prudential indicators of the banking system had deteriorated to the point where the sector could no longer ensure a smooth financing of the public debt and was actually undermining its sustainability.

**Chart 7: Fiscal execution**  
(1987-2001, % of GDP)



Source: National authorities, State Planning Organisation

**Chart 8: Central government gross debt**  
(% of GDP)

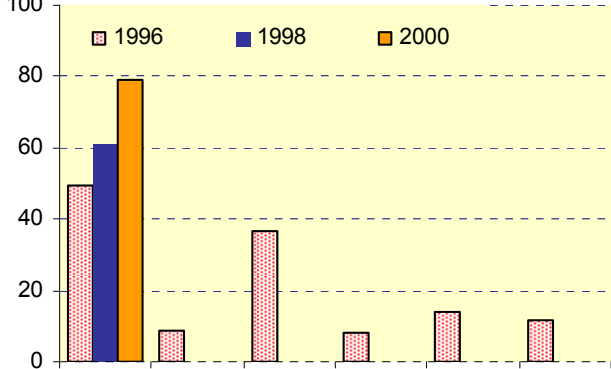


Source: National authorities, Undersecretariat of the Treasury

In a similar attempt to explore the roots of the financial and currency crisis experienced by Turkey, against the background of the various crisis models developed in the literature, Ozkan (2005) points to three sets of vulnerabilities that prepared the ground for the collapse of the Turkish lira.

First, the external position weakened as foreign debt levels rose from around USD 3 billion in 1971 to over USD 100 billion or nearly 60% of GDP in 2000. This was exacerbated by a sharp rise in short-term borrowing since 1996, when commercial banks adopted a very aggressive borrowing strategy at the short end of the maturity scale. Arguably, the worsening of Turkey's external balance and debt-servicing

**Chart 9: External debt service**  
(% of exports, 1996-2000)



<sup>3</sup> Although the central government budget deficit has not been excessively high in Turkey  
<sup>4</sup> "Duty" losses represented the losses incurred by state-owned banks from the subsidisation of various economic sectors.  
 Source: Ozkan (2005)

ability in the pre-crisis period was much worse than in the troubled Asian countries prior to their respective crises, as the cost of servicing external debt reached almost 80% of export values in 2000 (chart 9). In addition, the already mentioned inability to reduce inflation below levels consistent with the targeted exchange rate obviously led to a loss of external competitiveness.

The second vulnerable area was the considerable burden placed on the Treasury's financing capacity by the weak fiscal position resulting from record levels of interest payments and an unfavourable maturity structure of the outstanding public debt. This, in turn, had undesirable consequences for the functioning of the already fragile banking system.

The third problem was that the weak financial and banking sector adopted a risky and unsound strategy for financing the growing public sector needs, which paved the way for the liquidity squeeze in November 2000. Overall, the findings that fiscal stress and financial sector fragility played a major role in triggering the twin crises experienced by Turkey in 2000/2001 are in line with the paper by Ozatay and Sak.

In contrast, there is disagreement as to the role played by the IMF in the crisis – unsurprisingly given that the crisis occurred barely a year after the adoption of the IMF-supported stabilisation programme in December 1999. Several economists<sup>5</sup> deplore serious shortcomings in both the design of the IMF programme and in its crisis intervention. They argue that the use of the exchange rate as a credible anchor for inflation led to currency appreciation, thus attracting "hot" capital inflows because of arbitrage opportunities, in order to finance growing external deficits stemming primarily from the public sector's financing needs. The subsequent build-up of external financial vulnerability eventually raised expectations of a currency-depreciation and led to capital outflows which pushed up interest rates. This occurred also in other emerging economies where the financial system was made fragile by an overreliance on speculative short-term capital inflows as a generator of liquidity. The IMF<sup>6</sup> recently acknowledged that the ambitious exchange-rate-based stabilisation programme did not leave any margin for error, but notes that the unfavourable combination of implementation slippages by the authorities and adverse external developments did not help either. Ultimately, the 1999 SBA was undermined by the absence of sufficient fiscal policy and banking sector reform and a stable political environment. The success of the 2002 and 2005 programmes, in contrast, shows the importance of a sound but flexible programme design and the crucial role of strong programme ownership and the political will to implement reforms.

In conclusion, Turkey's experience in the 1990s and beyond confirms the theories<sup>7</sup> which state that financial liberalisation needs to occur in a strong institutional and regulatory environment, characterised by sound bank regulation and supervision, effective law enforcement and good governance in the private and public sectors. Turkey did not meet these conditions. Its macroeconomic policy shortcomings were evident in the entrenched high inflation and large public sector borrowing requirements, and the situation was not helped by the delays in setting up an adequate Banking Regulation and Supervision Agency (BRSA) and in implementing other structural measures and privatisation plans.

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<sup>5</sup> Including Akyuz and Boratav (2003), Voyvoda and Yeldan (2006), Dufour and Orhangazi (2008).

<sup>6</sup> IMF (2008), "Executive Board Concludes Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access for Turkey".

<sup>7</sup> See also Demirguc-Kunt and Detragiache (1998), "Financial Liberalization and Financial Fragility".

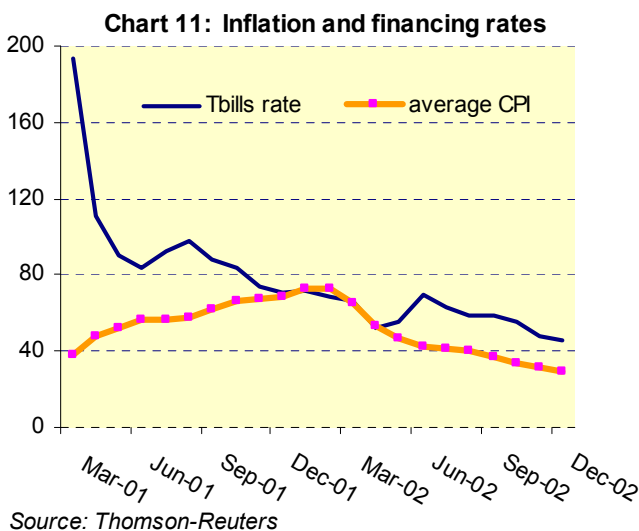
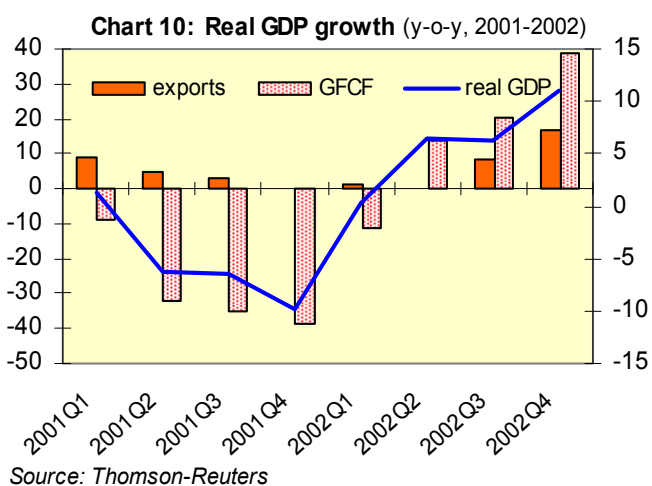
### 3. Economic catching-up accelerates during 2002-2007

The Turkish economy recovered swiftly from the 2001 crisis as a result of a clear medium-term roadmap, strong external anchors in the form of IMF programmes and the prospect of EU accession, and bold domestic reforms. Macroeconomic stability was attained first and foremost by means of tight fiscal and monetary policies. It was complemented by structural reforms in the area of enterprise restructuring and privatisation, business environment, trade liberalisation, labour market and in particular by a thorough reform of the banking sector. As a result, foreign and domestic investments shot up, increasing labour productivity and the sectoral transformation of the economy and spurring real convergence.

#### Emerging out of the 2001 crisis

The 2000/2001 crisis resulted in a substantial output loss: real GDP dropped by 5.7%, representing Turkey's most severe recession since the Second World War. Year-end inflation reached 69% as the sharp depreciation of the Turkish lira fuelled inflationary pressures, despite the sharp contraction in economic activity. Moreover, the external environment became less supportive for a quick recovery after the September 11 terrorist attacks in the US.

In response to the crisis, the government embarked on a set of structural reforms and sound macroeconomic policies under the new Economic Programme launched in the spring of 2001. The clear medium-term policy perspective supported the recovery and real GDP started to grow again vigorously from the second quarter of 2002 (chart 10). The main contributor was the recovery of domestic demand, in particular of investment, after the large contraction recorded in 2001. Political uncertainties greatly receded once a single-party majority government emerged from the November 2002 elections, which boded well for the future stability of the economy. The government took over the new 2002 SBA with the IMF negotiated by the out-going government and implemented a series of reforms, the most important of which was the adoption of a target for the public sector primary surplus of 6.5% of GNP for 2003 and beyond. Also in 2001 and 2002, substantial primary surpluses in excess of 5% of GNP were recorded.



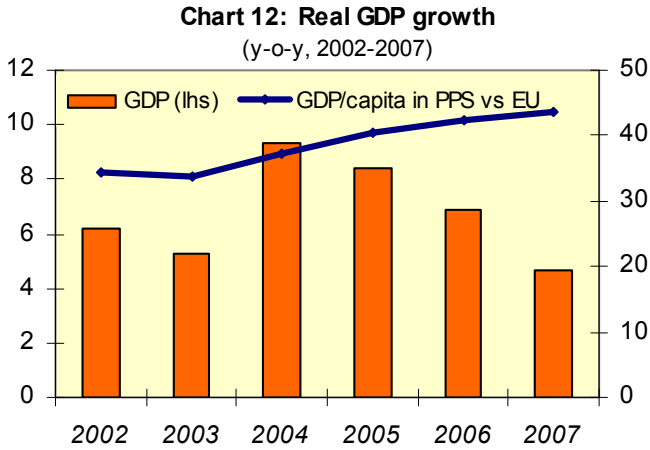
Hence, fiscal and monetary consolidation succeeded in restoring short-term confidence on the markets and taming inflation, without preventing a strong recovery in output (chart 11).

The strong recovery witnessed in 2002 and 2003, when real GDP grew again by 6.2% and 5.3% respectively, also reflects the natural rebound after a severe recession<sup>8</sup>. Similar rebounds have been observed also in the case of other emerging economies, such as Russia after the 1998 financial crisis. But there were still some early indications of an improvement in the long-term growth prospects, such as the continuation of strong growth post-2004, the double-digit real increase in private investment in 2002 and 2003 and the rapid increase in labour productivity. The external financing side also improved as portfolio flows became positive again and together with other investments, including the IMF loans, led to an increase of the gross foreign reserves of the Central Bank. The swift response of domestic production to the external adjustments was undoubtedly a contributory factor in Turkey's swift recovery. Following the significant depreciation of the Turkish lira and the improved external competitiveness, exports of goods and services rose in volume terms by around 7% y-o-y in both 2002 and 2003.

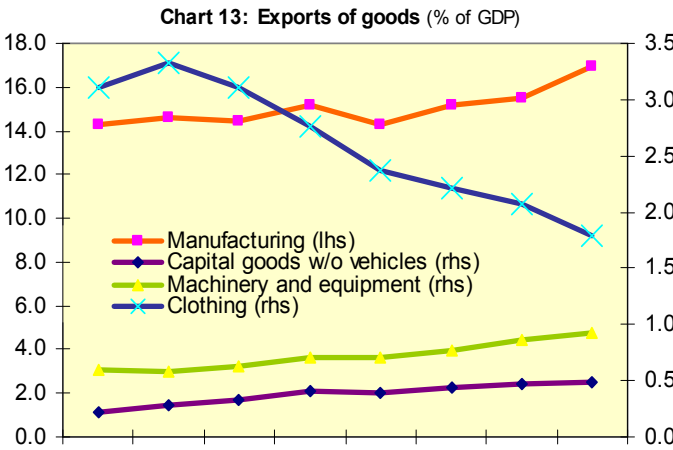
**Outstanding growth performance**

The catching-up process of the Turkish economy accelerated markedly during 2002-2007, when real GDP grew on average by 6.8% annually, more than double the average posted during the boom-bust decade of the 1990s (chart 12). This facilitated real convergence with the EU, as demonstrated by the increase in the GDP per capita level (in Purchasing Power Standards) by almost 10 percentage points over the period<sup>9</sup>. This was an unprecedented dynamic given Turkey's past experience with a relative stagnation of its catching-up with the developed economies. Driven also by the real appreciation of the lira, nominal GDP, which had slumped to USD 210 bn immediately after the crisis, reached around USD 660 bn by 2007. Thus, the economy became the 17<sup>th</sup> largest in the world, while per capita GDP grew from the depressed post-crisis 2001 level of USD 3 250 to close to USD 9 000 by 2007.

The strongest growth performance took place in 2004/2005, followed by a certain slowdown as of 2007, as a result of reform fatigue, political uncertainties and the tightening of monetary policy after the exchange rate



Source: Thomson-Reuters



Source: Thomson - Reuters

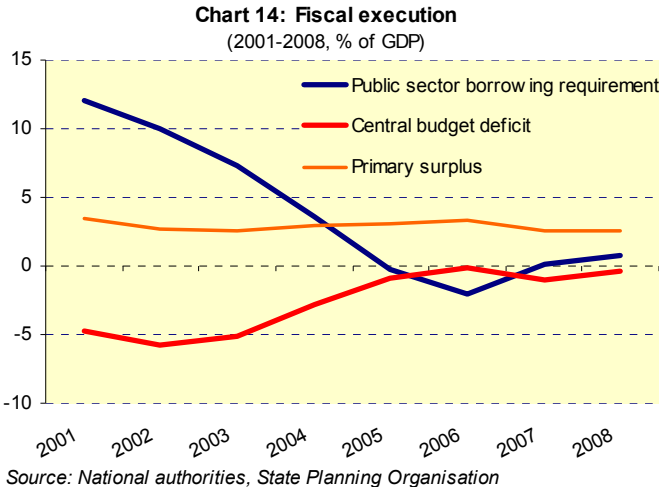
<sup>8</sup> See also Airaudo, Dervis, Gros, Oztrak, Bayar and Isik (2004) "Stabilising Stabilisation".

<sup>9</sup> According to data provided by Eurostat.

volatility in mid-2006. Growth was driven by increasing private consumption, and in particular by a boom in investment which grew on average by 15% in real terms during 2002-2007. The impressive pick-up in investment reflected not only the weak basis after the drop in the 2001 crisis, but also the sustained efforts of the government to improve the business environment and attract FDI. As a result, the investment ratio climbed from about 22.5% of GDP in 2002 to a respectable 29.5% of GDP in 2007. The high growth recorded in certain sectors such as motor vehicles, machinery, metals and appliances signalled a shift from traditional, lower value-added sectors such as textiles, wearing apparel and leather products. In the automotive sector, more than one million cars and light vehicles were produced in Turkey in 2007, which shows its strong integration in the global division of labour, but also reveals how exposed it was to the risk of falling external demand in the current crisis. Equally important, economic growth was relatively broad-based and income inequality, although still high, declined. The latest available data shows that Turkey's Gini coefficient<sup>10</sup> fell from 0.44 in 2002 to 0.38 in 2005, having already declined from its mid-1990s level of 0.49. In addition to inter-personal inequality, regional inequality is also relatively high.

**Successful macroeconomic stabilisation**

Turkey's remarkable growth performance would not have been possible without the successful macroeconomic stabilisation implemented during 2002-2007. The fiscal consolidation process was instrumental not only in lowering the public debt burden to reasonable levels by 2007, but also in anchoring investor confidence and inflationary expectations (chart 14). Turkey managed to reduce its public sector borrowing requirement<sup>11</sup> from around 12% of GDP in 2001 to almost zero in 2007. On average, Turkey achieved a central budget primary surplus of close to 3% of GDP during the period 2002-2007, which allowed it to roughly balance the central budget starting from 2006. The consolidated budget has in general achieved an even more favourable outcome than the central budget. This was mainly due to the now positive impact of public sector enterprises, once privatisation and enterprise restructuring got well under way and to the revenues obtained from privatisation and not used to pay down public debt. Measured in ESA 95 terms, the fiscal consolidation was notable, as the general government budget deficit declined from almost 10% of GDP in 2002 to only 0.2% of GDP in 2007.



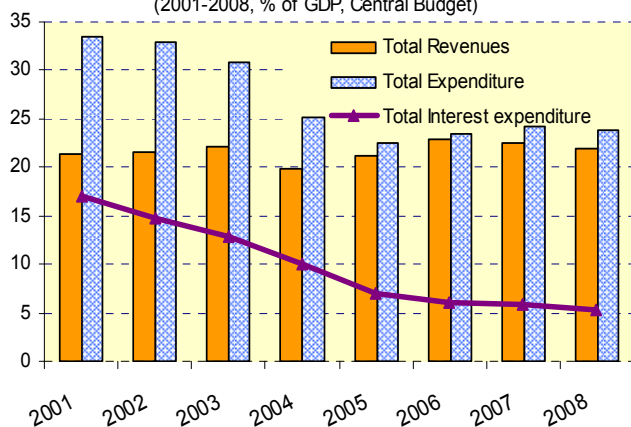
The fiscal adjustment took place primarily on the expenditure side, as revenues of the central budget varied only marginally from 2002 to 2007 (chart 15). The share of revenues in GDP did not change significantly, and their composition remained more or less the same, with the notable exception of the share of social contribution taxes, which increased. On the other

<sup>10</sup> The Gini coefficient is used to measure income inequality within a population and ranges from zero (total equality) to one (where all the income accrues to one person).

<sup>11</sup> Including the financing requirements of the general government budget, state-owned enterprises and other quasi-fiscal deficits.

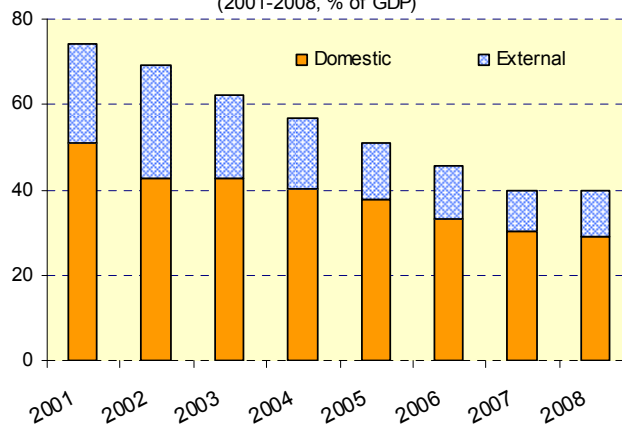
hand, savings were achieved on interest payments, as public debt declined dramatically as a share of GDP and the cost of servicing the stock of public debt fell. Interest expenditure declined from almost 15% of GDP in 2002 to less than 6% of GDP in 2007, while primary spending recorded only small fluctuations as a share of GDP over the period. Despite initial concerns that the fiscal adjustment would be achieved mainly by cutting back on public investment, the share of capital spending in fact declined only modestly as a share of GDP. At the same time, the surge in private investment fully compensated for this relative decline.

**Chart 15: Fiscal adjustment**  
(2001-2008, % of GDP, Central Budget)



Source: Thomson-Reuters

**Chart 16: Public Debt**  
(2001-2008, % of GDP)



Source: National authorities, Undersecretariat of the Treasury

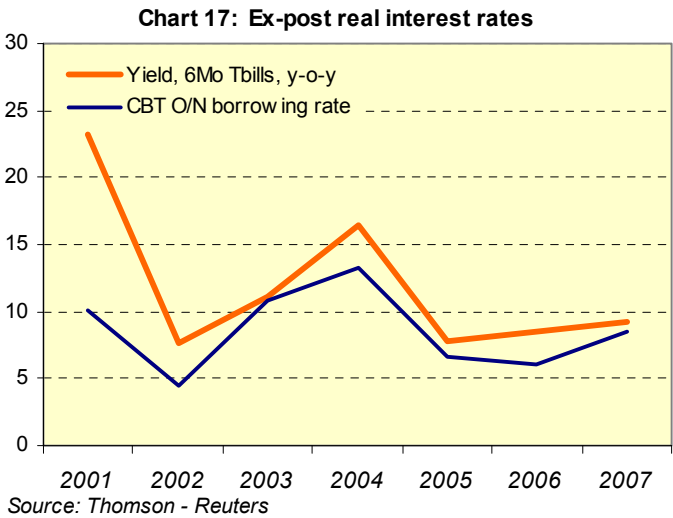
The virtuous cycle of regular sizeable primary surpluses and the decline in the stock of public debt was the main characteristic of fiscal policy during 2002-2007, which boosted growth by increasing business confidence and the access of the private sector to domestic savings. Several authors call it an expansionary fiscal consolidation<sup>12</sup>. The impressive decline in public debt from around 74% of GDP in 2001 to less than 40% of GDP in 2008 was the result not only of the strong primary surplus, but also of other favourable developments. High real GDP growth rates made a substantial contribution during 2002-2007, outpacing all other factors. The appreciation of the Turkish lira in real terms caused an immediate reduction of the debt-to-GDP ratio, as a significant part of the debt was either denominated in or indexed to foreign currency. At the end of 2007, external debt had come down to one third of the 2001 value as a share of GDP. As the privatisation process picked up speed, a large share of the privatisation revenues was used to pre-pay debt, in particular until 2006, which alleviated the public debt burden by around a further 4 percentage points of GDP. The positive contribution of real interest rates was evident only in 2002 and less so in the other years, as real interest rates remained relatively high over the period. And finally, the improved management of public debt also played an important role in optimising the cost of public debt by targeting an increased maturity of the debt issuance, primary borrowing in domestic currency at fixed rates and maintaining a certain level of cash reserves by the Treasury in order to reduce the liquidity risk. In addition, the benefits of the structural reforms in the banking and enterprise sectors impacted favourably on the stock of contingent liabilities and the accumulation of quasi-fiscal deficits that would eventually spill over into a higher public debt.

Support for macro-stabilisation came also from the monetary side. The newly independent central bank was allowed to pursue its primary objective of price stability thanks in part to the tight fiscal policy. Notwithstanding a difficult environment where the degree of dollarization was fairly high, the prudent monetary policy was effective in stabilising inflation expectations and the annual inflation rate declined from 54.2% in 2001 to 8.8% in 2007. The monetary

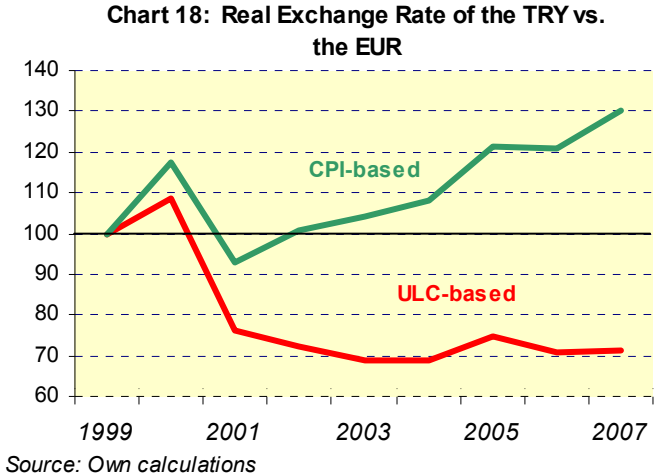
<sup>12</sup> See also Ozatay (2008), "Expansionary Fiscal Consolidations: New Evidence from Turkey".

framework included an interim stage based on a flexible exchange rate regime and the control of monetary aggregates with an explicit plan to pass to full-fledged inflation targeting as soon as the conditions allowed. With the credibility of the central bank not yet fully established, the formal adoption of the inflation-targeting regime in 2006 was less successful in bringing inflation down, and the rather ambitious official year-end targets of 5% in 2006 and 4% in 2007 and 2008 (within a 2% uncertainty band) were missed. Disinflation was particularly adversely affected by the cost-push inflation imported via soaring international commodity and oil prices in the latter part of the period.

However, the monetary framework has come in for criticism regarding the persistence of high real interest rates, often viewed as linked to the inflationary target regime. Over the last decade, ex post real interest rates (benchmark government bond rates) have been around 20% on average, with a high degree of volatility. Although real interest rates declined somewhat over the period, by 2007 they were still hovering above 10%, as reflected also by the yields of the inflation-indexed bonds (chart 17). This compares unfavourably with other emerging markets, where Turkey and Brazil stand out as clear outliers in a sample distribution. Several analysts looking into this matter, including most recently Kannan (2008), have suggested that although it is normal that a country like Turkey with a high growth potential and a relatively low capital-labour ratio should have high real interest rates, they are higher than this alone might suggest. Other factors therefore appear to be at play. Kannan identifies these as the lack of credibility of the disinflation path, which required the central bank to set higher nominal interest rates, and the substantial risk premium (of around 5 percent in recent years) stemming from Turkey's volatile past.



Starting from 2002, the real exchange rate started to appreciate gradually in CPI terms, as investor confidence in the economy was gradually restored. The relatively high interest rates also played a role in the attraction of foreign capital, in particular short-term portfolio flows. This enhanced external vulnerability, but overall the external competitiveness of the economy was not impaired. Our calculations indicate that although the Turkish lira appreciated in real terms (CPI based) by around 30% from 1999 to 2007 against the euro, it has actually remained almost flat in terms of unit labour costs after the large depreciation that took place during the 2001 crisis (chart 18). Nonetheless, some labour-intensive traditional export

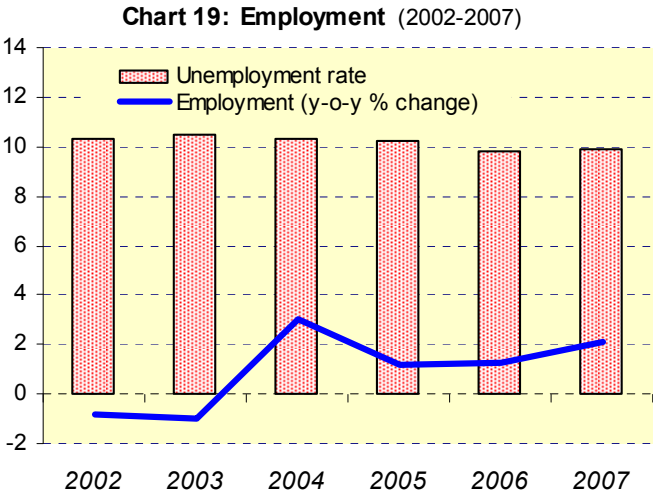




sectors such as textile, footwear or base metals have shrunk in relative terms in recent years. But overall, 2002-2007 witnessed a very robust advance in labour productivity at an average rate of around 7%, suggesting that the acceleration of structural reforms was successful in attracting domestic and foreign investments into higher-value-added sectors and in liquidating or restructuring unviable enterprises.

**Labour productivity and investment improve**

The marked increase in labour productivity during the recovery period has been viewed by some analysts as no more than the positive face of a period of jobless growth<sup>13</sup>. Certainly, the performance of labour market indicators was subdued despite the strong growth cycle. The unemployment rate remained stuck after the crisis at above or just under 10% of the labour force despite the resumption of employment growth at almost 2% on average during 2004-2007 (chart 19). This is at least partly because Turkey's young, fast-growing population increased the labour force at almost the same annual rate as employment growth. The other main reason for the relatively high unemployment rate was labour market rigidities. Despite the reforms undertaken over the period, these were not fully eliminated, and according to many analysts there are still many obstacles to employment in the formal or informal economy: a high tax wedge on labour, large severance payments, high minimum wages, worker skill mismatches and a need for further improvement in educational and vocational training achievements. The constant intra- and inter-sectoral resource reallocation in the period may have also contributed to a higher than natural rate of frictional unemployment. And finally, increasing competition from low-cost countries and real currency appreciation may have weakened cost-sensitive activities that were highly dependant on domestic inputs and low-skilled labour.



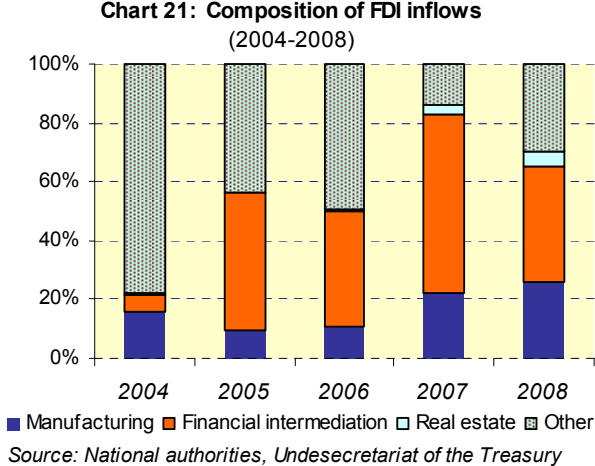
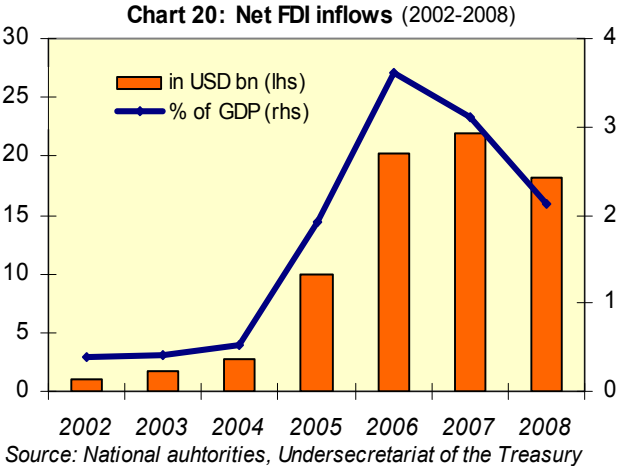
Source: Thomson-Reuters

The increase in the investment rate comes from both domestic and foreign investment. This marked a significant improvement compared to previous years. Historically, foreign direct investment into Turkey had been subdued for numerous reasons, an important one being political uncertainty<sup>14</sup>. The new AKP government managed to turn around the situation, leading the process with an ambitious privatisation programme. As a result, during 2002-2008 the cumulated net FDI reached about USD 76 bn which is almost eight times higher than the USD 10 bn received during 1995-2001. Similarly, while from 1954 to 2003 only 6 323 companies had foreign capital participation, in the five years 2004-2008 this number more than tripled.<sup>15</sup> FDI inflows also increased quite substantially as a share of GDP, from 0.4% in 2002 to 3.1% of GDP in 2007 (chart 20), though they remained much lower than in other central and eastern European countries which enjoyed an FDI boom as they joined the EU or progressed towards accession. Annual FDI inflows in 2006-2008 averaged around 5% in

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<sup>13</sup> See also Voyvoda (2006).  
<sup>14</sup> See also Hemetsberger and Quijano-Evans (2007).  
<sup>15</sup> Source: Republic of Turkey Prime Ministry (Under-secretariat of Treasury).

Poland, Hungary and the Czech Republic and were well above this figure in the Baltic countries, Romania and Bulgaria. Nonetheless, the increased FDI flows to the Turkish economy were significant, not only because of the shift from short-term and more volatile capital inflows (portfolio and external borrowing) towards sources of funding that were more stable and richer in know-how, but also because of their composition (chart 21). In Turkey, FDI inflows have been less skewed towards real estate or financial intermediation and more oriented towards upgrading and expanding the productive capacity of the economy, at least until 2006. This has had an insulating effect over the domestic financial sector in the current crisis, as it did not expand as aggressively in the boom years. At the same time, it leaves the real economy more exposed to the negative impact of disrupted international trade flows and external demand. This is because the buoyant FDI and other capital flows in Turkey since the 2001 crisis were partly a direct result of the ample liquidity available on a global scale<sup>16</sup> after interest rates had been kept too low and for too long by major central banks and the financial sector on both sides of the Atlantic expanded too aggressively. According to several analysts<sup>17</sup> the low interest rates fuelled a credit and economic boom that has most likely led to worldwide mal-investments and over-consumption, which now need to be unwound in the corrective phase of the business cycle. This has had a negative impact also on Turkey, where deeper integration into the world economy has led to sharply declining economic activity in the current economic down-turn.

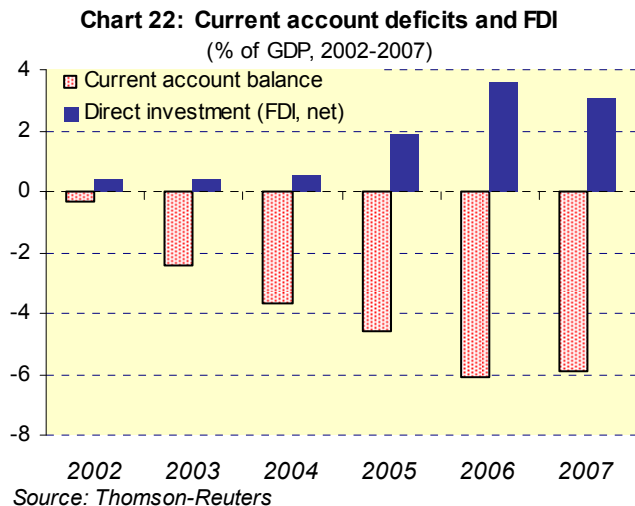


**External imbalances widen again**

Towards the end of this period of overall notable reforms and economic progress, vulnerabilities started to emerge again, in particular as the external imbalances widened. A relatively large current account deficit surfaced in tandem with the robust economic recovery, hefty capital inflows and rising oil and commodities prices. Unlike in the past, the process was driven by the financing needs of the private sector and not by a large saving–investment gap in the public sector. However, the fact that capital flows were poorer in terms of FDI has left the economy more exposed than other emerging markets to reversals in investor

<sup>16</sup> According to data published by the IMF Global Financial Stability Report (April 2009), global capital flows increased 4.5 times from less than two trillion USD in 1999 to more than nine trillion USD in 2007. During the same period, FDI flows increased less, but still significantly from around USD 850 bn to USD 1,550 bn. The highest increase was recorded by cross-border lending, which is not surprising, given the loose monetary policy.  
<sup>17</sup> Including, the IMF World Economic Outlook (April, 2009) or modern proponents of the "Austrian School Business Cycle Theory". For a brief overview of the theory, see Garrison (2002) <http://www.auburn.edu/~garriro/c6abc.htm>

confidence and changes in global credit conditions (chart 22). This, together with the re-emergence of political uncertainties and the slowdown of economic and political reforms, led once again to pressures on the exchange rate in mid-2006 when volatility on the international financial markets increased. As explained in more detail in the next chapter, this was the beginning of a period of economic deceleration which was reinforced by the current global economic crisis.



### External anchors

Turkey's economic revival during 2002-2007 benefited from two robust external anchors which improved domestic and international confidence, namely the successful implementation of a reform programme supported by the IMF and the opening up of accession negotiations with the EU. The two anchors were underpinned by Turkey's determination to leave its turbulent economic past behind, and complemented each other very well. On the domestic front, the detailed economic reform roadmap provided clear guidance for the implementation of reforms that pulled the economy out of the 2001 crisis. On the international side, the beginning of accession negotiations with the EU in 2005 was the catalyst for long-term political, social and economic reforms and a signal for investors that Turkey's nominal and real convergence is on firm ground. The IMF has acted as a guarantor against renewed financial turmoil, while the EU has been mainly perceived as a driving force for consensus-based reforms with strong domestic ownership. Over time, the EU is expected to gradually step in more and anchor Turkey's economic transformation during the accession process, as it did in the case of the central and east European countries which are now Member States<sup>18</sup>.

The IMF's involvement in Turkey's economic stabilisation and revival was reflected in the successful conclusion of two SBAs initiated in 2002 and 2005, the second of which expired in May 2008. The first programme was based on three main pillars: strict fiscal consolidation, significant structural reforms in the banking sector and in particular in banking supervision and central bank independence, with monetary policy anchored in the short run by monetary targets, but aiming towards full-fledged inflation targeting. The programme succeeded thanks to consistent implementation by a reform-minded government team and strong political support from the single party majority in the Parliament. In the fiscal area, the primary surplus target of 6.5% of GNP became a transparent and easy-to-follow benchmark, which was key in restoring confidence and allowing the expansion of private sector activities through the reduction of public debt and the contraction of the public sector. The 2005 SBA maintained the primary surplus target of 6.5% of GNP and the planned shift to formal inflation targeting. In addition, the structural conditionality covered many reform areas – including fiscal issues, the pension system and the financial sector. Both the programme's macroeconomic objectives and structural conditions were broadly met.

Turkey's relations with the European Union started as early as the 1960s, but have only gradually grown stronger. This process certainly looks protracted compared with other waves

<sup>18</sup> See also Barysch (2005), "The economics of Turkish accession".

of EU enlargement, particularly the fifth wave which reunified Europe after the fall of the communist regimes in the east. Turkey applied for associate membership in the European Economic Community in 1959 and was granted it in 1963. Political and economic factors delayed its formal application to join the European Union until 1987 and its acceptance was deferred until the emergence of more favourable conditions in both the EU and Turkey. However, the process continued with the signature of a customs union agreement in 1995 and the official recognition of Turkey as a candidate for full membership in 1999. In 2005, negotiations for accession started and so far 11 out of the 35 chapters of the EU's *acquis* have been opened.

Although both the candidate status and the customs union represent important landmarks in deepening political and economic cooperation between Turkey and the EU, it was not until the opening of accession talks in 2005 economic and financial integration got a significant boost. Achieving EU candidacy status significantly strengthened the political commitment to reforms. In particular, as the customs union has been implemented rather gradually. Under the customs union agreement, Turkey and EU have now removed all barriers to trade in industrial goods, and Turkey has adopted the EU's external tariff for trade with non-EU countries. It has also implemented certain EU rules, such as intellectual property protection and some competition policy rules, which are needed for creating a level playing field for bilateral trade. The trade volume between the two partners has almost doubled since the introduction of the customs union and Turkey has also benefited from reducing its trade barriers vis-à-vis non-EU countries. This opening up of the economy has made Turkey more attractive to foreign direct investment and thus further integrated it into the international division of labour.

But the customs union remains incomplete: services and agricultural products for example are not included. And other domestic obstacles still hamper the establishment of foreign productive capacities in Turkey, preventing the full benefits of trade liberalisation from materialising. Until 1996, Turkey did not have a competition policy and even though some aspects of the competition regime, such as the control of mergers and cartels, work well today, others do not. Turkey still does not have an effective system of state aid control, even though this was a condition agreed with the EU already during the customs union negotiations (it is reportedly now very close to adopting one). This leaves the government the possibility to support certain preferred industries, but also the EU retains the right to impose anti-dumping duties on Turkish goods. In the strategic sectors of coal and steel, Turkey needs to adopt restructuring plans that would phase out the provision of state aid. Turkey has also yet to fully adopt EU standards for the production of certain goods, although the deadline for implementation passed in 2001. In addition, many analysts consider that both EU and Turkey would gain by further opening up bilateral trade.

Despite some setbacks, the continuation of the accession negotiations remains an important anchor for implementing domestic political and economic reforms. The recent signature of the intergovernmental agreement for the Nabucco pipeline represents not only an important economic development, but also a political signal regarding the mutual benefits of EU–Turkey cooperation in key areas, such as energy security.

### **Domestic reforms**

Far-reaching reform and policy initiatives were taken after the 2001 crisis. Initially motivated by the 2002 stand-by arrangement with the IMF and the National Programme for Convergence with the EU *acquis*, they were subsequently reinforced by the Urgent Action Plan of the current government. As the mechanisms of the strict fiscal consolidation and the

disinflation process were presented earlier, the focus will shift now to the structural reform measures per se. According to the OECD (2006), the Turkish economy bounced back and became one of the fastest growing economies in the OECD after the 2001 economic crisis thanks to the comprehensive reform agenda implemented and the favourable international environment. The main economic reforms took place in several key areas, such as fiscal and monetary policy, tax policy, financial sector prudential regulations, product market regulations, labour market regulations, capital markets, foreign direct investment, privatisation of state-owned enterprises, infrastructure and agriculture.

In the fiscal area, the central budget became the main fiscal policy instrument through the adoption of the Public Financial Management and Control Law. Fiscal predictability and transparency were increased by the introduction of a multi-annual (three-year) budget framework and a system of functional classification together with accrual-based accounting. In 2006, the government reduced corporate income tax from 30% to 20%. It also reduced personal income tax rates as well as the number of tax brackets, but broadened the tax base. But the reform process must be maintained. There is room for improvement in tax administration and collection, the institutional coordination of public financial management, the quality and efficiency of public spending and performance-based budgeting. In addition, the investment environment could be made more predictable and certain if tax legislation was not subject to such frequent amendment or fiscal budgets to revision. The central bank was made independent in May 2001 and mandated to focus on price stability. As of November 2001, direct financing by the central bank of the public debt issuance was prohibited.

A new banking regulatory and supervisory framework in line with international best practice was adopted. After the 2001 crisis, the Banking Regulation and Supervisory Agency (BRSA) implemented a "Restructuring and Rehabilitation Programme" which strengthened the private banks, restructured and privatised some of the state banks which represented a large part of the Turkish banking sector at the time, resolved the bankrupt banks taken over by the Saving and Deposit Insurance Fund (SDIF) and increased the quality of bank supervision. The restructuring of the banking sector resulted in 22 banks being taken over by the SDIF (Gunay, 2007) and came with a high price tag<sup>19</sup> – though some of the losses were subsequently recovered through the sale of the cleaned-up banks. Overall, the sweeping reforms in the banking sector allowed a significant entry of foreign capital into the sector in the form of both equity and lending, triggering a gain of productivity and efficiency for most of the banks (Aysan and Ceyhan, 2007). Foreign capital controls now about 42% of banking assets in the country. The BRSA tried to minimise financial risks during the bull market of 2003 to 2007 by raising the minimum capital adequacy ratios of Turkish banks to 12%, while international regulations required only 8%. At the same time, lending in foreign currency was only allowed for companies and individuals with revenues in foreign currency, thus minimising the foreign exchange mismatch on the bank balance sheets. However, a complex system of financial taxes encouraged the corporate sector to borrow overseas, which increased its exposure to foreign exchange risk.

There was a second factor behind Turkey's success in attracting FDI, namely the upgrading of the legislation regulating foreign direct investment in 2003. This eliminated the requirement to obtain a preliminary permission from the general Directorate of Foreign Investments to establish foreign capital participation and granted national treatment to foreign firms.

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<sup>19</sup> Josefsson and Marston (IMF, 2005) estimated that the total cost to the government of restructuring the banking system since the crisis amounted to about USD 47 billion, or around 32% of GDP.

Establishment procedures were streamlined and protection of property rights and transfer of profits/capital ensured. Large privatisations increased the size of the formal private sector, although large-size privatisations only really began in 2004-2005, after being delayed for more than a decade. Minority or indirect state ownership still remains in sectors like banking, telecommunication, oil refinery, sugar processing, tourism and sea ports, but the privatisation agenda is still ambitious despite the negative fallout from the international financial crisis. The energy sector represents the biggest challenge: it is in this field that the next wave of privatisations is planned, notably of power distribution and generation plants.

The business environment has significantly improved in recent years. A Co-ordination Council for the Improvement of the Investment Environment (YOIKK) was set up in 2005 and has initiated a comprehensive reform programme of the investment climate in the country. The Investment Advisory Council made up of executives of leading multinational companies, domestic business associations and representatives of international institutions is also actively involved in issuing recommendations and legislative actions for the improvement of the business environment. As a result, Turkey's ranking in the World Bank's Doing Business reports improved from 84<sup>th</sup> out of 155 countries in 2005 to 73<sup>rd</sup> out of 183 in 2009, and its ranking in the Economic Freedom Index compiled by the Heritage Foundation from 112<sup>th</sup> out of 161 countries in 2005 to 75<sup>th</sup> out of 179 in 2009.

Conditions on the labour market have improved too. The adoption of an employment package in 2008 increased its flexibility to some degree, although there are still significant rigidities related to the labour taxation, the minimum wage, severance payments and other regulations. In addition to dismantling these obstacles Turkey needs to improve its human capital – low-skilled labour being the economy's most abundant resource<sup>20</sup> – and hence its competitiveness. To do so it must boost education and vocational training attainment, and accelerate the development of the formal sector of the economy, where firms enjoy better access to financial services, technology, skilled labour and FDI. In 2006, a social security reform was implemented which has significantly improved the long-run sustainability of the pension system<sup>21</sup>. Nonetheless, the pension system still represents a barrier to formal employment which needs to be addressed by further reforms which go beyond parametric changes.

In the agricultural sector, new legislation adopted in 2006 set out a new set of policy instruments and reduced the amount of state subsidies. Market-distorting price supports were significantly reduced and replaced with direct income support for farmers.

The implementation of the Health Transformation Program since 2003 has improved the governance and efficiency of, and access to, the health system (by providing universal health insurance under a single social security institution). But the cost must be reined in by a greater focus on efficiency.

Finally, progress was made in reducing informality and corruption, as witnessed by Turkey's advance in the rankings of the Corruption Perception Index of Transparency International<sup>22</sup>, although more remains to be done in order to improve the rule of law.

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<sup>20</sup> See also OECD (2008), "Policy Brief".

<sup>21</sup> See also ECFIN's Country Focus (2007), "The pension reform challenge in Turkey"

<sup>22</sup> From the 77<sup>th</sup> position out of 133 countries in 2003 to the 58<sup>th</sup> place among 180 countries in 2008

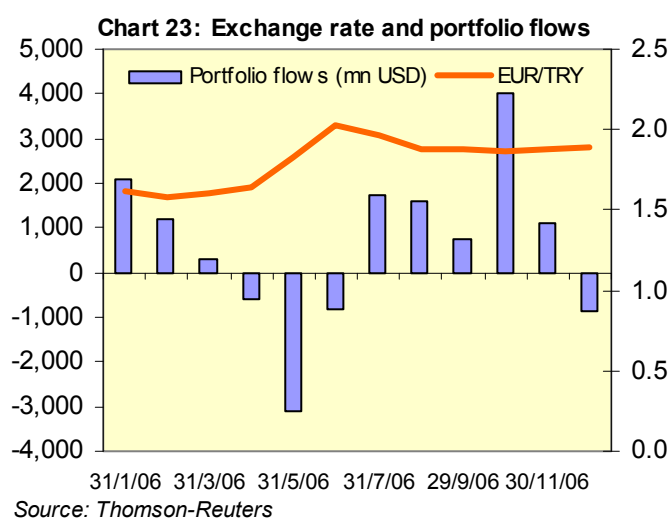
## 4. The ongoing economic crisis

The global economic crisis has led to a sharp contraction of economic activity in Turkey, which may exceed that of 2001. The impact has come mainly through two channels: the collapse in external demand has affected Turkey's key exports while subdued domestic lending and capital inflows have depressed domestic demand. But, in contrast to past episodes, a full-fledged currency and financial crisis has been averted by a more resilient financial sector, macroeconomic stability, a more flexible economic structure and a swift response by the central bank. Access to external financing remained open and external borrowing continued broadly in line with the sluggish economic activity in the real sector. Interestingly enough, the economic slowdown started much earlier, in mid-2006, when a sharp depreciation of the currency occurred after serious political tensions in Turkey combined with a tightening of liquidity on the international capital markets.

### The mid-2006 episode

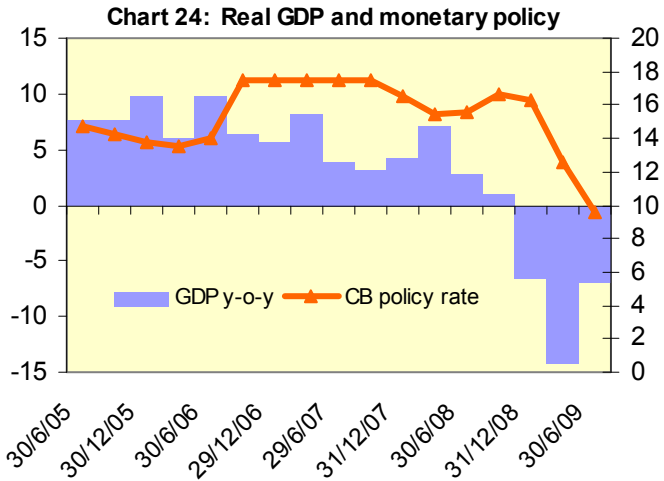
Some analysts take the view that 2006 showed the Turkish economy to still be vulnerable to boom and bust, and that 2001 did not mark the beginning of the end for this growth pattern. Yeldan (2004), Voyvoda and Yeldan (2006) and Onaran (2006) argue that despite the solid disinflation process since 2002, nominal and real interest rates remained high and were thus conducive to attracting inflows of "hot" money. This led to the appreciation of the lira in real terms against the USD and the EUR under the conditions of an open capital account and monetary policy primarily targeting price inflation. This trapped Turkey "in a policy of overvalued exchange rates and very high real interest rates" which hurt its external competitiveness and expanded its external deficits and imbalances. It may also be a reason for the economy's sluggish capacity to generate employment. They conclude that Turkey remains a fragile economy with respect to a change in the risk appetite of investors, and that its vulnerability mainly stems from an overvalued local currency and relatively high external indebtedness ratios. Indeed, the events of 2006, when the domestic currency came under intense pressure, revealed the growth cycle to still be subject to speculative influences.

Other observers have pointed to external imbalances as a weak link. They note that the strength of domestic demand caused a significant widening of the current account deficit to more than 6% of GDP in 2006. The OECD, IMF and others had raised concerns about the sustainability of the external imbalances, in particular as easier access to credit had led to a rapid increase in private consumption and household debt. And indeed these fears were realised as the tightening of international capital market conditions in spring 2006 coincided with the emergence of domestic political tensions and resulted in outflows of short-term capital and a sharp depreciation of the lira in May and June 2006 (chart 23).



Nonetheless, the currency crisis was short-lived and it did not lead to a full-blown crisis as was the case in 1990-1993 or 2000-2001. Capital flows were restored by the swift intervention of the central bank with successive increases of its policy rate totalling 425bps within three months. And confidence in the financial/banking sector and the real economy held up. The Turkish lira recovered about 70% of the ground lost against a EUR-USD basket by the end of the year and portfolio inflows exceeded USD 8bn in the second half of 2006, after an outflow of about USD 4.5bn in April-June. This showed the Turkish economy to be more resilient than in the past to domestic political or external shocks and was already a positive sign that the post-crisis reforms backed by credible external anchors may have put an end to the boom-bust growth scenario.

This more optimistic view is supported by evidence of a gradual improvement in Turkey's external vulnerability indicators and changes in the economic structure that would enable it to better accommodate external shocks. Not only did short-term capital inflows pick up in the aftermath of the 2001 crisis, they were also complemented by a sufficiently significant rise in foreign direct investment and long-term external borrowing by Turkish and multinational companies, much less prone to sudden reversals. By the end of 2006, the country's gross external debt had declined to below 40% of GDP from 56.2% of GDP in 2002, a decline which was entirely accounted for by the public sector and the central bank. The share of short-term external debt was relatively low at around 20% of total while the indicators of external indebtedness relative to exports or international reserves had all improved and seemed fairly benign. Furthermore, the flow of long-term capital into productive activities enabled the Turkish economy to shift its focus from traditional to more productive sectors. High labour productivity growth in an increasing number of sectors kept in check a real appreciation of unit labour costs. Moreover, as shown below, the economy continued to weather even the more powerful external shocks that followed in mid-2007 and October 2008 relatively well. That said, after the monetary tightening in mid-2006, economic activity decelerated gradually throughout 2007 and 2008 (chart 24), impacted among other things by continued political uncertainty around the general elections, a slowdown in domestic reforms and accession negotiations and the worsening global conditions.



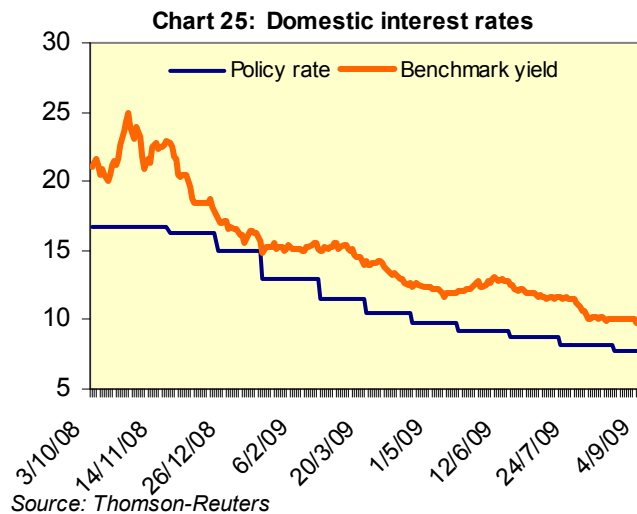
Source: Thomson-Reuters

**The impact on financial markets**

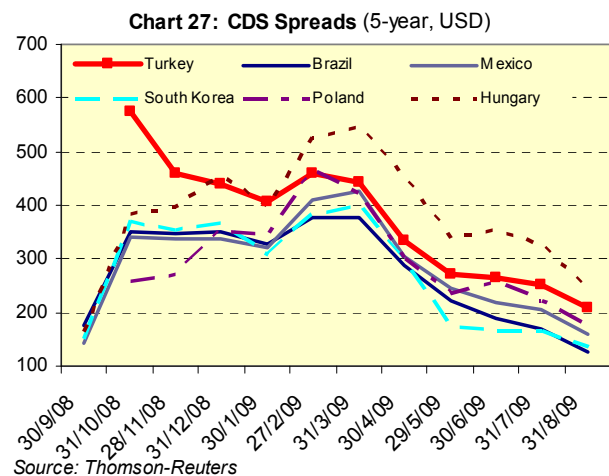
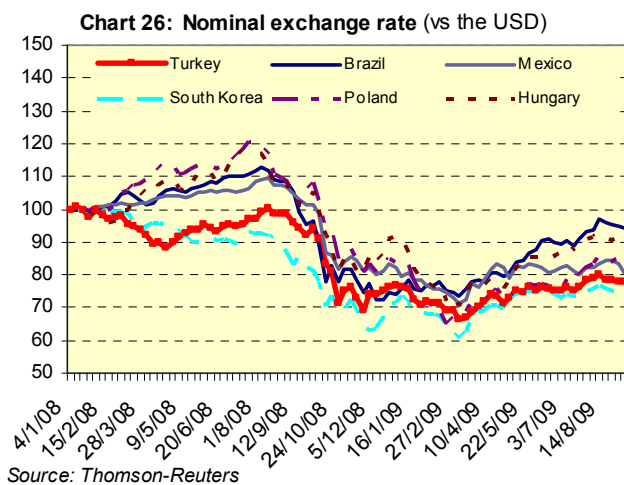
The Turkish currency and financial markets came under significant pressure from the turmoil in global markets that broke out in July 2007 and the subsequent decline in risk appetite for emerging market investments. The Istanbul Stock Exchange Index lost about 55% of its value from July 2007 until March 2009, when a rebound started. Between March and June 2009, the stock exchange regained some ground, but remained around 30% below the July 2007 value. The lira became more volatile during the sub-prime credit crunch, but did not depreciate strongly until October-November 2008 – after Lehman Brothers collapsed. From October 2008 until March 2009, the lira lost around 25% of its value against the euro, but has since



regained about 10%. Interest rates on the domestic market have eased significantly since the liquidity crunch in October 2008. After an increase of around 250 bps in the midst of the turmoil, the average interbank interest rate fell by more than 1,000 bps until June 2009, helped by the easing monetary conditions both in Turkey and worldwide (chart 25). Similarly, the domestic bond benchmark yield has regressed by around 1,200 bps to below 13% in June 2009 from the peak recorded in October 2008. It is evident that the recovery in global risk perceptions regarding emerging markets from spring 2009 has favourably impacted Turkey's exchange rate, domestic market interest rates and risk premium.



The performance of the Turkish lira, stock exchange and risk premiums also compares relatively favourably with that of other emerging countries, such as Brazil, Mexico, South Korea, Poland and Hungary. For example, Turkey's exchange rate was less volatile than Hungary, Poland, South Korea and Brazil during September 2008-March 2009. And only the Brazilian real and Hungarian forint have fared better in terms of depreciation since the beginning of 2008, the latter helped by hefty financing from the IMF and the EU (chart 26). The overall decline of the Istanbul Stock Exchange index since the beginning of 2008 has been lower than in Poland or Hungary, but bigger than in Brazil, Mexico and South Korea. Turkey's risk premium has also fared better than other emerging markets. This can be seen in the evolution of emerging market bond indices and credit default swaps (CDS). As a matter of fact, Turkey's risk premium has weathered the global increase in risk aversion much better than implied by its credit rating. Although before the October 2008 turmoil Turkey's CDS spreads were more than 100 bps above the group, once the situation on the international financial markets had calmed down, Turkey's spreads came down faster than those of some of its peers (chart 27). This relatively favourable evolution of the international risk perception was an important factor in allowing the central bank to make aggressive policy rate cuts.

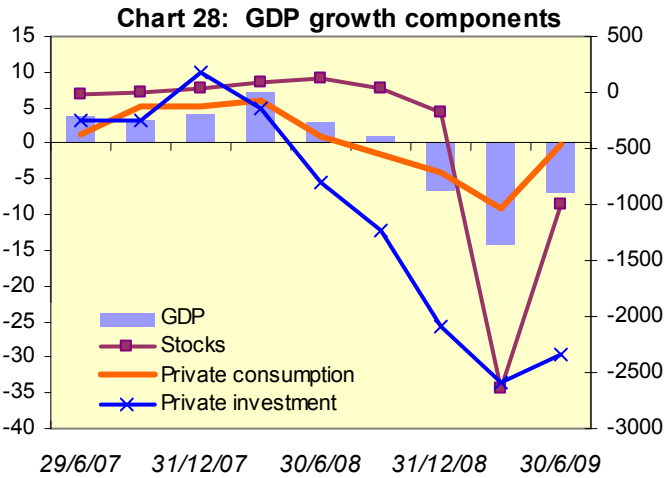


With regard to Turkey's international bonds, the JP Morgan Emerging Market Index for Turkey has constantly outperformed by more than 100 bps the general Emerging Markets

Bond Index. Turkey has also managed to maintain its credit rating of BB- (Standard and Poor's) since the global crisis started, although the outlook was revised downwards from stable to negative in November 2008. In a recent report<sup>23</sup>, Moody's stated that Turkey's credit rating could even be upgraded if the government puts in place realistic plans to rein in the fiscal stimulus.

**Significant negative impact in the real economy**

Although the deceleration of economic activity in Turkey started as early as mid-2006, the economy slid into negative annual real GDP growth only in the last quarter of 2008 when the economy shrunk by 6.5%. Cumulative growth in 2008 amounted to only 0.9%, sharply down from the 6.8% real GDP growth recorded during 2002-2007. The economy contracted in the first quarter of 2009 at an accelerated pace and real GDP fell by 14.3% y-o-y, worse than in any single quarter of the 2001 crisis. Private consumption fell by more than 10% while private investment contracted by a staggering 35.8%. The positive contribution of public consumption and investment could not offset the large decline in private sector activities, also given the high base – real GDP growth in the first quarter of 2008 was 7.2%. The output decline decelerated to 7% y-o-y in the second quarter of 2009, showing that the economy was bottoming out (chart 28). The annualised q-o-q real growth (seasonally adjusted) was in the double-digit range, thus being quite impressive. It confirmed signals from the business and consumer confidence indicators which had started to improve more notably as of the second quarter of 2009, helped by the stimulus measures introduced by the government. On this basis, private consumption moderated its annual decline to 1.2% in the second quarter. On the other hand, private sector investments and exports performed almost as badly as in the first quarter, putting into question the scenario of a V-shaped or speedy recovery. Domestic demand recovered in the second quarter mainly due to tax incentives on sales of durable goods - which have been gradually phased out starting from the third quarter, while signs of an improving external demand remain weak. Slightly falling leading confidence indicators and other high-frequency data also point to only a gradual recovery in the second half of the year. Overall, the consensus forecast<sup>24</sup> shows that the economy is expected to decline by almost 6% in 2009, but to rebound by around 3% in 2010.



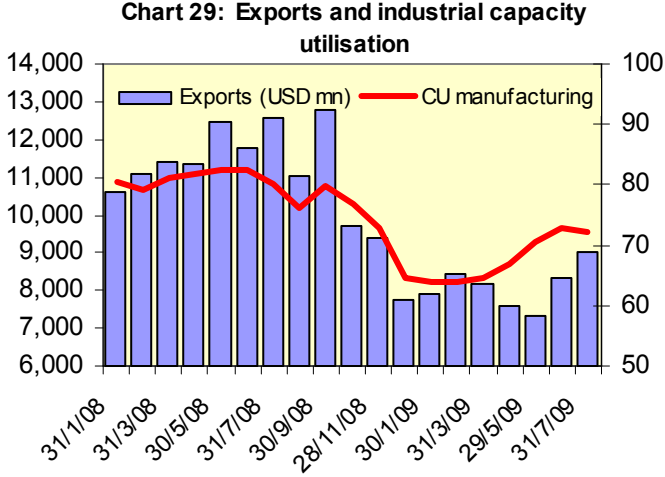
Source: Thomson-Reuters

The real sector has been impacted through two main channels: external demand has shrunk significantly since October 2008, and domestic demand has contracted in tandem with deteriorating business prospects and lending conditions. As we have seen, the contraction in private consumption and investments is illustrated by the national accounts data. On the external side, the positive trends recorded in recent years, i.e. Turkey's specialisation in higher value-added sectors such as automotive, white goods or equipment and deeper engagement in international trade turned to Turkey's disadvantage once international trade flows collapsed.

<sup>23</sup> September 2009.

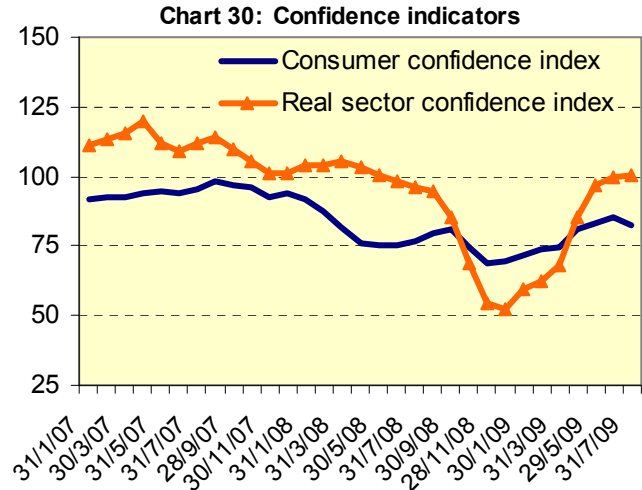
<sup>24</sup> by Consensus Economics Inc.

All these sectors, and in particular the car industry, were highly sensitive to a drop in external demand, mainly that originating from the EU countries. Production in the automotive sector contracted on average by almost 50% annually in the first half of 2009. The machinery and textiles sectors also contracted by around 24% and 20%, respectively. Even before the crisis, traditional sectors such as textile, clothing and leather products had been squeezed between increased competition from emerging Asian countries and the more technology-intensive domestic sectors. However, in the current difficult economic conditions, they have a higher potential to maintain their activity and employment, in particular as they include a larger component of SMEs, which are more flexible in developing new products and finding new market niches. A geographical re-orientation of exports to countries less affected by the crisis such as African countries and the Middle East is already providing some relief. For example, in the first quarter of 2009 the annual drop in domestic cement consumption was compensated by growing demand from Iraq and West Africa. Overall, Turkey's exports contracted by almost 30% in annual terms on average in the first half of 2009 (chart 29). The contraction in volume terms has been less dramatic, at around 13%. The pivotal role of the drop in external demand on the fall in domestic production is best illustrated by the automotive sector, where the contraction of domestic sales was outpaced by the contraction of exports.



Source: Thomson-Reuters

So far, real sector hard data show that the contraction of the annual rate of industrial production slowed in the second quarter (to 15.2% from 22% in Q1 2009) and that the capacity utilisation rate improved (to above 72% in July from a record low of 64% in February)<sup>25</sup>. Also, the consumer and business confidence indicators have been rising since their trough in November/December 2008(chart 30). In July, business confidence reached the critical 100-point threshold which separates optimism from pessimism. Consumer confidence, on the other hand, remains below the 100 mark and actually dropped by around 3 percentage points in July when some of the consumption tax breaks expired. Given the good track record of these confidence indicators in forecasting the inflection points of economic cycles, it appears that both consumption and production bottomed out as of Q1 2009 and that the economy is on the way to recovery. But it is not yet clear how strong or rapid that recovery will be,



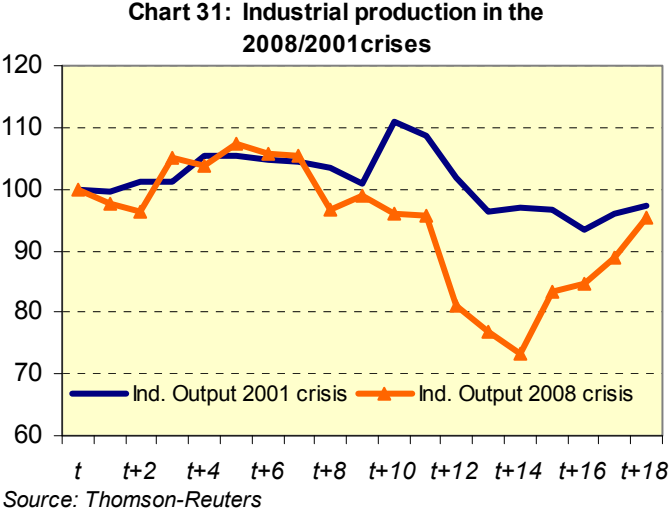
Source: Thomson-Reuters

<sup>25</sup> The capacity utilisation rate dropped again to 69.7% in August.

and several factors warn against over-optimism. In the first phase, the crisis resulted in an abrupt decline in production as inventories were adjusted to the new depressed demand level. After the depletion of inventories production should improve even if demand conditions remain weak. The stimulus provided by a temporary consumption tax cut accelerated the recovery, but may not be sufficient to trigger a strong and lasting trend, as the July and August indicators show. At the same time, the weakness in exports, which were still down by around 26% y-o-y in June, suggests that the recovery cannot gain enough strength to lead to a swift return to potential growth without a solid rebound of external demand. Similarly, it is not possible to return to a strong growth performance without a recovery in foreign and domestic investment, and this is highly dependent on credible and prudent government policies, in particular on the fiscal side.

**Deeper contraction than in the 2001 crisis**

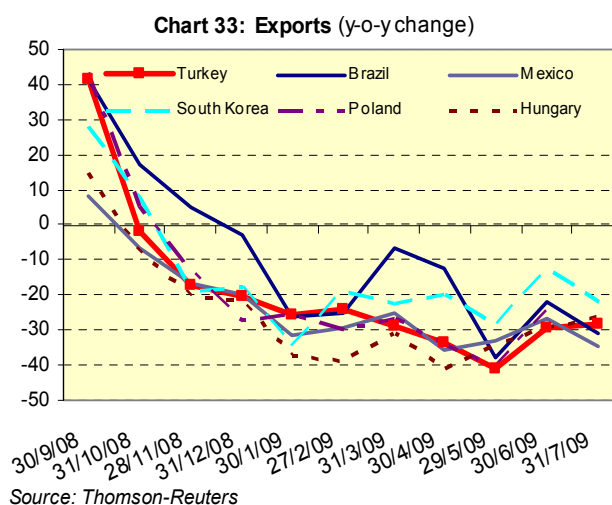
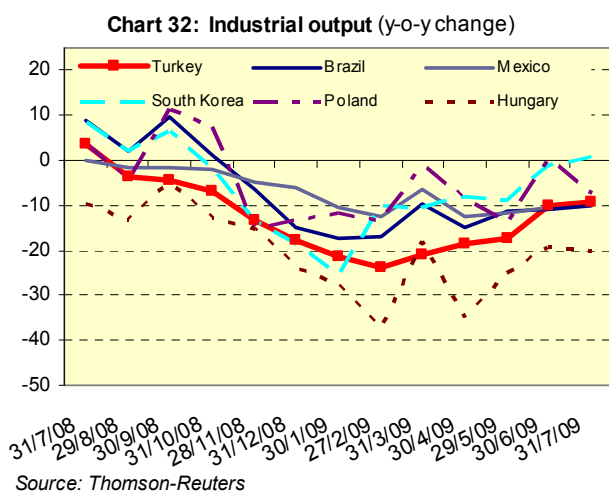
The real sector has taken more of a battering in this crisis than in 2001. This is because of the global nature of today's downturn on the one hand, and the severity of the corrective phase of the previous boom on the other. So far, the decline in industrial production has been much more pronounced than in 2001<sup>26</sup>, measured from the years 1999 and 2007 as the starting points for the two crises (chart 31). As mentioned above, the annual decline in the automotive sector output averaged almost 50% in the first six months of 2009, almost double the rate recorded in the 2001 crisis. Moreover, the share of the car sector into total exports had increased from around 7.5% in 2001 to about 15% in 2007, showing the mounting dependence of the Turkish real sector on external developments. This trend is also confirmed by the evolution of the capacity utilisation rate in the manufacturing sector. In the 2001 crisis, the lowest level attained by the drop in the capacity utilisation rate was 68.5% in April 2001, whereas in the current crisis, the capacity utilisation rate sank to 63.8% in both January and February 2009. In a similar vein, the decline in exports has been significant in the current crisis whereas in the previous one they were barely affected. This is not surprising, given that in 2001 only Turkey and not the whole world were in recession. This aspect can be expected to weigh heavily on the recovery path this time round. Helped by the depreciation of the lira, exports picked up rather quickly in 2001/2002, which contributed to the recovery. This time, it is not clear how the strength of the recovery will be affected by external demand. Finally, the statistical distorting effect of the shift of labour resources from the troubled industries back into the agricultural sector or informal economy should not be underestimated when analysing the severity of current crisis. The decline in economic activity this time has been comparable with developments in other emerging countries. The decline in industrial production has been more pronounced in Turkey than in the other countries on average in the first months of 2009, but improved significantly in relative terms as of July 2009 (chart 32). At the same time, with respect to exports, all countries in Turkey's peer group



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<sup>26</sup> Data availability is limited owing to a break in the series, but this should not have a material impact on the intra-comparability of the two data sets.

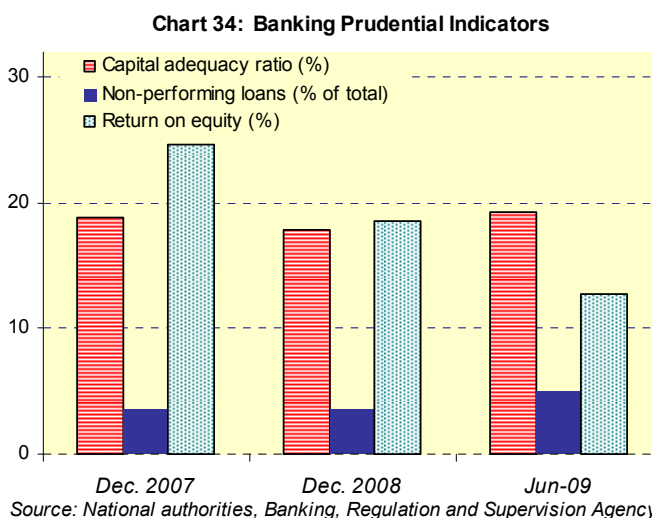
– Brazil, Mexico, South Korea, Poland and Hungary - were severely hit by the collapsing external demand, Turkey having performed somewhat better than the average until March 2009 and worse afterwards (chart 33).



Recovery may also be hindered by the large increase in the unemployment rate to 13% in June 2009 from 9.2% a year before. The non-agricultural unemployment rate climbed to 16.4%, 4.5 points higher than in June 2008. A vicious circle may emerge between high unemployment rates, depressed domestic demand and potential deflationary pressures; the authorities are trying to combat it by creating temporary employment and providing vocational training for the unemployed. The economic downturn has prevented the absorption of newcomers into the workforce (at the very fast annual rate of about 3% in 2008), while many people have also lost their jobs. The dip in the unemployment rate in the second quarter of 2009 was mostly due to seasonality, while non-farm employment continued to decline in annual terms, the manufacturing sector being hit hardest. The sectoral breakdown of employment showed that the agriculture sector and services sector stood out as drivers of a marginally better unemployment rate in the tourism season, while the manufacturing sector continued to suffer, losing more than 400,000 jobs in a year.

### Resilient banking sector

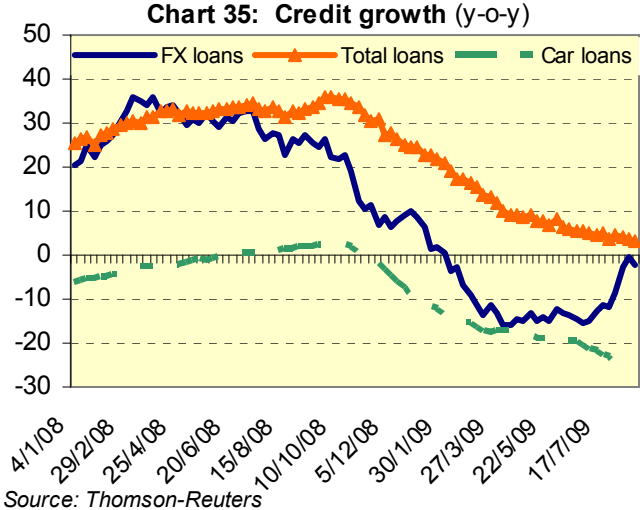
Turkey's banking sector underwent a drastic process of restructuring, privatisation and improved regulation and supervision after the 2001 crisis. In addition, it took a more cautious stance than its peers during the recent credit boom in south-east Europe, by striking a better balance between financial deepening and excessive risk-taking. As a result, its smaller size in terms of GDP (total domestic credit stood at around 39% of GDP at the end of 2008) and slower growth dynamics became valuable strengths when the global financial crisis sharpened in October 2008. At the time, the Turkish banking sector seemed well positioned to weather the



international crisis, although there were concerns about a possible negative feedback loop from the real economy to the financial sector, the opposite of the situation in the EU and the US where the crisis was first triggered by the financial turmoil.

The banking sector was strong on many fronts: it had virtually no exposure to the US sub-prime crisis, was largely funded by deposits and not reliant on wholesale international funding<sup>27</sup>, had a low stock of retail loans of around 10% of GDP, had well-contained foreign-exchange risks<sup>28</sup> and displayed solid capitalisation and profitability ratios. And so far it remains sound, with no major fallout from the real sector debacle. The most recent indicators (chart 34) prove the point – the capital adequacy ratio has increased above 19%, profits have increased by 33% y-o-y in the first half of 2009 and liquidity remains high. The ratio of non-performing loans has increased moderately to 4.9% from 3.4% at the end of 2008, while provisioning remains at around 80%. Currently no bank has a capital adequacy below 13% and the stress-tests performed by the BRSA conclude that even if the non-performing loan ratio were to increase to 15% no bank would have a capital adequacy ratio lower than 8%.

Credit growth decelerated from around 26% year-on-year in December 2008 to around 5% in July 2009 (chart 35). The slowdown is being driven by a decline in car and housing loans: car loans were down by around 24% in the first seven months of 2009. Foreign currency loans are also in negative territory. Credit conditions have become more restrictive as banks have been tightening their lending standards and the demand for loans is also shrinking in tandem with the depressed economic activity and private investments. The weak retail and investment loan demand are less likely to be a by-product of the globally feared credit crunch, in particular as the Turkish banking sector is quite liquid and well capitalised. This high level of liquidity in the banking sector has been increasingly channelled into holdings of government securities, thus permitting very high roll-over rates for the Treasury's issuance of debt. This can be interpreted as a sign that the depressed lending activity is driven mainly by reduced demand and stricter lending standards rather than supply constraints. Moving forward, the aggressive cuts in the interest rate by the central bank, the tax rate cuts on consumer durables which helped boost domestic demand, the sharp recovery in consumer confidence and the steady decline in inflation to around 5.4% in June are likely to support a recovery in lending activity towards the end of 2009.



Banks continued to borrow from abroad by issuing syndicated loans or increasingly tapping the EIB/EBRD resources. The costs of the syndicated loans have gone up, but in general, do not appear excessive at around LIBOR/EURIBOR + 250 basis points. Nonetheless, their external debt roll-over ratios have come down to a little above 50% on average in the first half of 2009, in line with the decelerating domestic lending activities. The profitability of the banking system is more dependent on exchange rate developments now, as banks have

<sup>27</sup> The loan-to-deposit ratio was less than 90%.

<sup>28</sup> Domestic lending in foreign currency was allowed only for companies and households with foreign currency revenues.

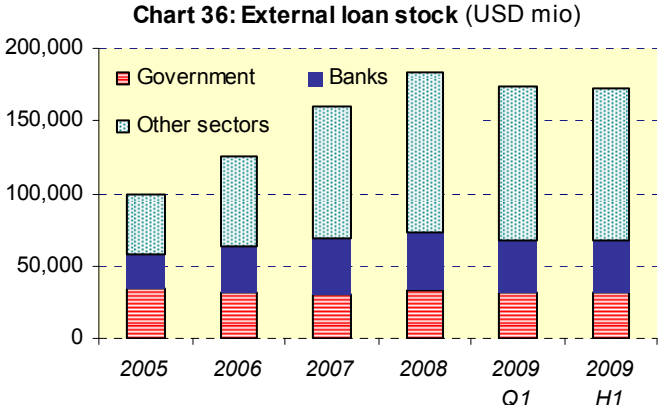
increasingly funded their bond holdings with foreign currency deposits, suggesting that the system is likely to defend its margin levels throughout 2009 as long as the lira stays strong. Nonetheless, in the short and medium term, the sector's profitability will continue to be very much dependent on the evolution of the non-performing loans.

**More scarce foreign capital inflows**

The biggest concern for Turkey at the start of the global financial crisis has been whether it will be able to finance its large current account deficit and service its external debt held by the private sector. At the end of 2008, it needed large amounts of foreign currency from domestic or foreign sources, as a result of non-negligible risks stemming from the balance sheets of the non-financial private sector. The current account deficit amounted to 5.6% of GDP and the amount of gross external debt stood at around 51% of GDP. On the other hand, the external assets held by Turkish entities also amounted to around 24% of GDP, which reduced greatly the repayment risk, at least on an aggregate level.

So far, the risk of Turkey having difficulties in meeting its external payment obligations has not materialised. Several factors have played in its favour. The current account deficit has shrunk significantly as a result of depressed domestic demand and lower volumes and cheaper imports of energy. In 2009, the current account deficit is projected to shrink to around 1.5% of GDP. As of June 2009, the 12-month rolling deficit declined to around USD 20 bn and if mineral fuel and oil were excluded, the current account balance would show a surplus of around USD 12 bn. Long-term capital outflow and FDI for the previous 12 months was USD 2.2 bn and USD 10.8 bn respectively, while short-term capital inflows reached USD 2.7 bn and portfolio outflows about USD 7 bn. In the first half of 2009, net FDI inflows (which were around 40% of the previous period's level) and unrecorded inflows of around USD 8.5 bn largely covered the portfolio and capital outflows and the current account deficit. The moderate (about 15%) decline in foreign reserves since September 2008 has been reversed in recent months and the monthly coverage of imports has actually gone up. Lastly, the current account figures show a large amount of net errors and omissions. This amount appears to comprise asset repatriation by Turkey residents (due to reduced investment opportunities abroad plus the squeeze on domestic credit) and the use of under-the-mattress savings, as well as some purely accounting issues. Although these unregistered inflows may not be sustainable, they certainly point to durable confidence in the Turkish lira and economy.

As mentioned in the previous chapter, banks continued to borrow from abroad, but they also repaid some of their external debt so that the roll-over ratios declined in line with the lower domestic lending. The corporate sector has also drawn down some of its holdings of foreign assets, as the roll-over rate of external loans decreased to around 72% in the first half of 2009. The use of own resources in financing activities was a result of increasing borrowing costs and uncertainty of holding reserves abroad and the large amounts of deposits held abroad by Turkish banks and the corporate sector – around USD 74 bn or 10% of GDP at the end of 2008 – helped cushion the impact of the global credit crunch. The Treasury issued three Eurobonds between January and



Source: National authorities, Central Bank of Turkey

July with a cumulated value of USD 3.75 bn. This already exceeded the total amount of total external issuances of USD 3.5 bn planned for 2009. It can be inferred that although Turkey's access to foreign capital has been constrained by the impact of the global credit crunch, it continued to service its debt obligations and pay for its imports with the help of large holdings of recorded and unrecorded foreign assets. The declining roll-over ratios seem to reflect primarily the reduced domestic activity and production, the drawdown of holdings of foreign assets and the collapsing external demand for Turkey's exports. In the third quarter of 2009, capital inflows started to pick-up again. Unlike in the 2000/2001 economic crisis, the pressure on the domestic currency has not triggered a widespread sell-off. On the contrary, the behaviour of the market participants was largely and remarkably counter-cyclical, i.e. they sold foreign currency when the Turkish lira lost in value. Overall, the stock of external loans declined by around 6% in Q1 2009 from the end of 2008, but subsequently stabilised in Q2 2009 (chart 36).

### **Domestic policy response**

The anti-crisis measures adopted by the authorities initially focused on the monetary side and subsequently became more pronounced in the fiscal policy area. This was broadly in line with the crisis-response packages adopted internationally, while taking into account the particularities of Turkey's macroeconomic framework in terms of available room for counter-cyclical measures. However, by postponing the announcement of a clear and credible road map regarding the fiscal easing and its subsequent correction, the Turkish authorities challenged investor confidence and implicitly the strength of the recovery<sup>29</sup>. Given Turkey's previous boom-bust growth scenarios it is important to preserve investor confidence in the quality of the public sector response and relieve concerns that it might revert to the harmful policy of private sector crowding-out and high inflation.

Monetary policy has been significantly relaxed by aggressive cuts in policy rates, which have come down by 950 bps since November 2008<sup>30</sup>. This was somewhat sharper than the decline in inflation and inflationary expectations, but should also be seen in the context of the previous monetary tightening from mid-2006. In other words, although the monetary easing has been more pronounced in Turkey than in other emerging markets like South Korea, Brazil, Mexico or Poland, the risks have been contained by the fact that Turkey had more room to cut policy interest rates. Nevertheless, further monetary policy easing appears constrained by the risks of renewed pressure on the domestic currency, higher inflationary expectations and the likelihood of procrastinating necessary structural adjustments in the corrective phase of the global economic cycle.

The central bank also took several measures to ease foreign exchange liquidity in the banking sector. It re-opened the inter-bank foreign exchange deposit market after several years of closure, extended maturities and volumes for the deposits that it places on this market, cut the foreign exchange reserve required ratio from 11 to 9% and stopped purchasing foreign currency<sup>31</sup>. On a few occasions, the central bank also injected foreign currency into the market. The monetary policy easing has not impacted negatively the exchange rate stability, having gone hand in hand with the disinflation process; it also recently benefited from the return of risk appetite for the emerging markets. There has been a fairly limited pass-through

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<sup>29</sup> The adoption of the Medium-Term Economic Programme has been delayed from May to September 2009, while the adoption of a fiscal rule is only foreseen as of 2011.

<sup>30</sup> As of September 2009

<sup>31</sup> In early August 2009, the central bank resumed its forex purchases once the risk appetite regained strength and capital inflows to the country increased.



from the exchange rate developments to goods and services prices due to the weak domestic demand conditions. The transmission mechanism of monetary policy has functioned relatively well in the case of the yields on government securities benchmarks, but credit market conditions are still tight. This is somewhat normal given the increase in risk premia for private borrowers during the crisis and the reduced pool of real savings in the economy. Nonetheless, lending rates have recently declined below the levels recorded in October 2008, when the global financial turmoil was at its peak.

Since the beginning of 2009, the focus of the anti-crisis measures has moved to the fiscal area and the budget deficit has widened substantially. Before the local elections in March 2009, much of the fiscal easing was in the form of higher social spending and transfers, which cannot really be considered anti-crisis measures that would stimulate the productive capacity of the economy. The government also adopted several stimulus packages, including the provision of zero-interest loans for SMEs, a tax break for local investors in equities, and inducements for residents to repatriate savings held offshore or declare unregistered domestic assets. These measures were followed by other initiatives aimed at temporarily reducing VAT and the special consumption tax on domestic sales which provided more incentives for supporting economic activity in sectors such as cars, appliances, furniture or IT. Although this strategy had a more significant impact on economic activity and provides some temporary relief, it may not be sustainable in the medium term given its large fiscal costs. The fiscal deficit<sup>32</sup> reached around 3.4% of the projected annual GDP in January-August and the new deficit target for 2009 was increased to 6.6% of GDP in the Medium-Term Economic Programme from the 1.2% of GDP target included in the adopted budget.

The most recent initiative – an incentive scheme for investment and employment – aims to strengthen Turkey's potential growth rate and thereby ensure a more sustainable recovery. In particular, the investment scheme is meant to provide more than just a short-term boost for domestic demand. It is also intended to attract more foreign investment and reduce regional social/economic imbalances in order to enhance Turkey's competitiveness. The scheme encourages large-scale investments to be made until the end of 2010. Its incentives extend for the medium and long term (up to 20 years) and are differentiated according to region and sector of activity. It is further supported by well-designed corporate tax incentives and a partial exemption from the payment of the social contributions premium. The employment side of the package, as we have seen, provides for temporary employment in the public sector and vocational or on-the-job training. The authorities are also creating a credit guarantee fund that would benefit mainly SMEs. In total, the cumulative stimulus packages announced so far amount to around 5% of GDP over 2009-2011.

Despite the apparent benefits of these schemes, concerns have been raised about the likely high budgetary costs and possible crowding-out of the private sector once the recovery takes hold. And it will be important to keep the focus on measures that improve the business environment or decrease the tax burden in general and for a longer period of time, such as the investment and employment incentive scheme, rather than increasing transfers in the form of social spending or to local governments, which weaken the quality of public finances. There is broad agreement among analysts and the authorities that given Turkey's previous boom-bust growth pattern, its high public indebtedness and remaining high real interest rates, running large budget deficits for a prolonged period of time may damage the prospects for a sustainable recovery and dynamic catching-up. With investor confidence being of paramount importance for maintaining the stability of the domestic currency and ensuring a recovery in

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<sup>32</sup> Central government, measured on a cash basis.

private sector investment, the ongoing fiscal easing should be viewed as temporary and the plan for its rolling-back should be credible.<sup>33</sup>

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<sup>33</sup> The fiscal framework included in the Medium-Term Economic Programme foresees only a gradual fiscal adjustment during 2010-2012, particularly when compared with Turkey's past efforts. Given also the lack of concrete measures to back the plan, the announced targets may not be sufficient to place the public debt-to-GDP ratio on a declining path over the programme period.

## **5. Conclusions**

This paper first looked into Turkey's growth patterns and economic catching-up since the end of the Second World War and observed that the performance was sub-optimal for two reasons. Until the 1980s Turkey was a closed economy with a strong interventionist economic model and starting with the 1990s Turkey experienced a boom-bust growth model which suffered from chronic macroeconomic instability. The liberalisation begun in the 1980s was not accompanied by sound macroeconomic policies or an adequate strengthening of the institutional and regulatory framework, in particular of the banking sector. As a result, the 1990s were marked by volatility which culminated in the 2000/2001 economic crisis. That crisis at last induced Turkey to revamp its political and democratic institutions and economic structures. Macroeconomic stabilisation, bold structural reforms and faster economic catching-up followed during 2002-2007. Having teetered on the brink of debt default, Turkey managed to slash its stock of public debt in the space of just a few years, from around 74% of GDP in 2001 to 40% of GDP in 2008. Fiscal consolidation and structural reforms made it a leading example of reform-driven growth acceleration. Real GDP growth surged from an average of 3.9% in the 1990s to 7.2% between 2002 and 2006, while real GDP per capita in PPS increased from about 36% of EU average in 2001 to 46% in 2008.

Turning to an analysis of economic trends in the current crisis we have shown that Turkey is now substantially more resilient to both domestic and external shocks. The pressures on the exchange rate have not resulted in a run on the banking sector or the currency. On the contrary, economic agents demonstrated counter-cyclical behaviour in late 2008 and early 2009, showing confidence in domestic assets. The banking sector has remained healthy, profitable and well capitalised through the crisis, despite the moderate increase in non-performing loans. Access to external financing has been maintained by both the government and the private sector, although the borrowed amounts have declined and the costs increased. The shrinking of the current account deficit shows that consumption patterns have adjusted in the crisis and that exporters are trying to adapt to the collapse in external demand by searching for new market niches. Foreign direct investment has continued to flow into the country, although at more modest levels.

It can be concluded that the economic performance under the current shocks – primarily external, but also to some extent domestic – validates the success of Turkey's past reforms. If the structural weaknesses which made Turkey so vulnerable to crises in the 1990s, in a relatively benign external environment, had not been largely overcome, Turkey would most likely have faced another full-fledged currency/balance of payments crisis today. The achievement is all the greater in that Turkey has so far managed the impact of the present crisis without resorting to the safety net of an IMF arrangement as it did in the past.

At the same time, the sharper-than-expected decline in economic activity and the rise in unemployment rates reveal that the Turkish economy does still have areas of vulnerability. Turkey's reforms and deeper integration in the international division of labour occurred in a period of global boom, underpinned by the ample liquidity available internationally during 1999-2007. As a result, many of the foreign and domestic investments made at that time may become subject to a rebalancing of consumer demand in the corrective phase. This may explain why the economy is experiencing a sharper slowdown in the real sector than it did in

2000/2001. According to many analysts the current crisis will take longer to overcome because of the weak external environment and the shrinkage of the external capital flows which had fuelled the domestic demand in recent years. The recession has most likely bottomed out in the first quarter of 2009, but the revival of domestic consumption in the second quarter was largely driven by tax incentives which have been gradually phased out because of their high fiscal cost. The improvement in private investment and exports remained marginal, suggesting a more protracted recovery than in the 2000/2001 crisis.

In addition, Turkey's relatively more severe decline compared to other emerging economies, such as Brazil, Poland, Mexico and South Korea, demonstrates that it still suffers from systemic bottlenecks<sup>34</sup>. The virtuous cycle of structural reforms, prudent macroeconomic policies and productivity-driven growth came under pressure during the elections in 2007-09. The fiscal relaxation in 2009 was primarily centred around the local elections and only later became more focused on providing anti-crisis solutions. Non-interest spending by the central government has increased from around 15% of GDP in 2004 to 18.5% of GDP in 2008 and will probably exceed 20% of GDP this year, mainly as a result of higher current transfers and quasi-fiscal losses. The financing gap of the state-run social security system has increased to around 3% of GDP today, pointing to the need for further reforms of Turkey's pension system. Further progress in enhancing the education levels, labour market participation and flexibility, privatisation and improvement of the business environment would accelerate productivity growth and help raise standards of living.

At this juncture, rationalising public expenditure and stabilising the public debt-to-GDP ratio remain paramount. The government's current fiscal measures intended to pick up the slack in labour and product markets during the trough of the cycle need to be followed by a clear and credible strategy of a timely reigning in of fiscal deficits, thus allowing the private sector-led economic recovery to take hold. After all, the experience of the exceptionally strong growth during 2002-2005 shows that achieving sustainable high growth rates is largely driven by robust private sector investments (foreign and domestic). On the monetary side, the monetary policy easing implemented since November 2009 has benefited from the considerable room for manoeuvre created by the earlier tightening in 2006. Going forward, an expansionary monetary policy appears constrained by the risks of renewed pressure on the domestic currency and of procrastinating necessary structural adjustments in the corrective phase of the global economic cycle through monetary accommodation.

As for the Turkish economy's future prospects, the fairly high real GDP growth rates recorded during 2002-2007 accompanied by sustained real convergence demonstrate that Turkey enjoys an outstanding long-term growth potential. The main drivers of the continued catching-up could be the people (Turkey's population is quite young – with a median age of 27 years – and growing rapidly, by 1.3% per year); a diverse and entrepreneurial human capital base; its strategic location as a turntable between Europe and Asia; and a relatively attractive business environment. According to projections by Goldman Sachs (2008), Turkey has the potential to become a USD 6 trillion economy by 2050, making it the third largest in Europe. Turkey could also rapidly narrow the income gap with the EU and achieve a per capita GDP level of USD 60 000 or 75% of the projected EU average by 2050. Current developments show that Turkey has managed to overcome a number of obstacles, but must continue to reform in order to fully realise its growth potential. The EU accession process can help ensure that the convergence takes place faster and in a less bumpy fashion than in the past.

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<sup>34</sup> See also Nomura Global Economics "Country outlook", June 2009

## 6. References

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