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Emerging Markets: Theory & Practice / Turkey's Reforms Post 2001 Crisis

Duygu Uckun* and Mark Doerr**

The global financial downturn of 2001 affected broad swaths of the increasingly interconnected global economy. The global effects of the economic downturn in the U.S. in 2008 showed that decoupling had not occurred to the extent many thought, and showed that indeed emerging market countries, including Turkey, were not immune from economic trouble in America. This paper addresses the question, whether the fiscal, financial, and regulatory reforms in Turkey after the 2001 economic crisis cushion the global financial crisis world is facing toward the end of the decade. In doing so we analyze the policies implemented by Turkey before and after the 2001 global economic crisis and identify the successes as well as failures of those reforms. The results of our research show that despite significant reforms in key economic and regulatory areas in the post-2001 crisis period, vulnerabilities remained; especially concerning the large current account deficit, volatility of exchange rates, increased private sector indebtedness, and persistent unemployment. These vulnerabilities will be visible in the deteriorating liquidity conditions in the global financial markets. We conclude by recommending infrastructure, education and health spending as well as restructuring of the economy to further attract FDI and avoid reliance on speculative foreign capital in order to achieve a more balanced and sustained growth in the long run.

Keywords: Emerging Market, Turkey, Post-2001, Economic Crisis, International Money Fund (IMF), Privatization, Double Mismatch, Liquidity Model, Investment Model.

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Introduction

This paper argues that Turkey's experience with economic crisis in 2001 demonstrates the effects of the *investment model* of economic development interacting simultaneously with the *liquidity model*. Investment model focuses on *pull* factors. "Rich country investors continuously evaluate profit opportunities at home and abroad, and when growth prospects in less developed countries (LDCs) seem favorable, they make the decision to invest" says Michael Pettis, as he explains the cycles of hot money inflow to LDCs according to this model.[1] Liquidity model, however, puts emphasis on the changes in the liquidity of rich country markets as determining forces to invest abroad. Therefore, 'capital investments precede and cause growth.'[2]

These two theories in concert help explain Turkey's economic crisis in 2001, its resurgence following the crisis, and Turkey's recent economic distress during the current global financial crisis.

This paper argues three main points. First, capital flows in and out of Turkey can largely be explained by the liquidity model of development. Secondly, Turkey's reforms helped attract those capital flows and effectively "put Turkey on the map" in the eyes of global financial markets, thus rendering Turkey an attractive target for global liquidity. Finally, Turkey's reforms, although helpful, did not promote long-term sustainability, thus leaving Turkey vulnerable to fluctuations in global liquidity.

Authors of this paper conclude by discussing the prognosis for Turkey's economic future and providing several recommended policy reforms that may help Turkey establish itself as a more modern and sustainable destination for international investment.

In order to apply liquidity and investment economic models, that are mainly developed for emerging markets, to Turkey, it is essential to see emerging market characteristics of the country. Turkey has several commonalities it shares with other well-known emerging markets (EMs) and place it in this category. Turkey is a significant regional power with large population and a large market. It is the 17 largest economy with 794.2 billion USD GDP according to 2008 World Bank data. Another major characteristic of EMs is replacement of traditional economies with open door policies via economic and political reforms, which we will elaborate in coming sections. Turkey has similar

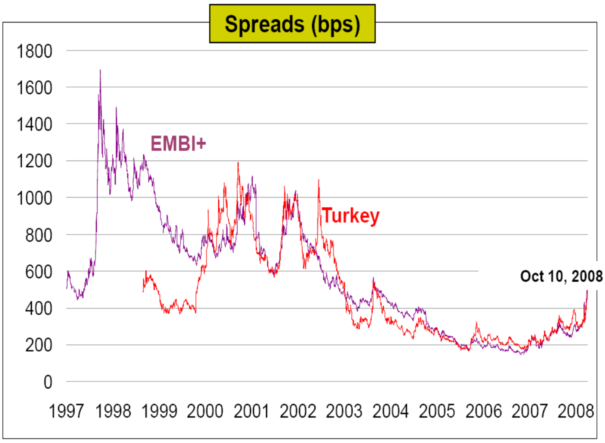
[1] Michael Pettis, The volatility machine: emerging economies and the threat of financial collapse, (New York: Oxford University Press, 2001), (pg. 35).

[2] Ibid (pg. 36).

per capita incomes as many other prominent, similarly situated emerging markets such as Mexico, Indonesia and Iran.[3] Its financial markets also bear several positive indicators of an emerging market: there is significant volatility in Turkey's equity and credit markets and Turkey's currency experiences significant and frequent fluctuations. Figure 1 below compares spreads in Turkey's bond markets with the JP Morgan Emerging Market Bond Index (EMBI), which is a way to track total returns for traded external debt instruments in the emerging markets. The figure shows how Turkey is very much on the same track with the fluctuations in the index.

Political instability is another EM characteristic Turkey shares with countries such as Russia, Argentina, and India. The 2001 economic crisis was famously precipitated by an altercation between the Turkish President Ahmet Necdet Sezer and Prime Minister Bülent Ecevit during a meeting at which the President threw a physical copy of the Turkish Constitution in the face of the Prime Minister. Within hours, nearly USD 4 billion had left Turkish markets, and three days later the Turkish currency was devalued.

Figure 1 Credit Spreads versus the EMBI+



Source: JP Morgan

Finally, excitement over Turkey's growth prospects have led Goldman Sachs to label Turkey one of the "Next Eleven" countries that are poised to experience dramatic growth.[4] Some of Turkey's proponents have gone so far to suggest that Turkey has such growth potential it should be considered amidst the "BRICs," putting it on par with the well-known cases of Brazil, Russia, India, and China.

The well-known 2001 economic crisis has been selected as the mile stone for this paper because it was the impetus for the economic reforms that contributed to the mid-2000s resurgence in the Turkish economy and financial markets. Since the crisis was so far-reaching and foundational, we cover it here briefly with quick facts. In 2001:

- GDP growth fell to -5.7% (down from +3.8% in 2000);
- the Consumer Price Index soared by 54.9% year-to-year;

[3] For example: Turkey -- $9,400; Mexico – $12,500; Iran -- $12,300; Indonesia -- $3,400

[4] Dominic Wilson and Anna Stupnytska, The N-11: More Than an Acronym, Goldman Sachs Economics Paper No: 153, March 28, 2007, available at www.chicagobooth.edu/alumni/clubs/pakistan/docs/next11dream-march%20'07-goldmansachs.pdf.

- the Turkish Lira depreciated 51%;
- unemployment rose to 10%;
- real wages were reduced by 20%.

An efficient cause of the Turkish financial crisis, as we have seen across the board in relevant case studies, was a large "double mismatch" in the banking sector. Turkish banks had borrowed excessively in foreign-denominated debt in the short-term and had loaned out in domestic currency in the long-term. When the economy began experiencing crisis, stoked by significant political instability, the banks were caught in an untenable situation.

As a result of the 2001 economic crisis, Turkey enacted an expansive set of reforms to revitalize its economy and financial system. Turkey's most important reforms were in (1) the regulatory system, (2) the privatization process, and (3) in its fiscal and monetary policy. During this post-2001 period, the global financial markets experienced a significant increase in liquidity, which helped set the stage for Turkey's economic expansion, and indeed, was the main driver of that expansion.

Several important domestic factors contributed to Turkey's ability to expand. First, a pro-European Union government was elected in 2002, which signaled to the global financial markets that Turkey was prepared to take the steps necessary to encourage further development. Further, the International Monetary Fund and World Bank announced the "Revised Strengthening of the Turkish Economy 2002-2004 Program" soon after the new government's election, further stoking optimism in Turkey's future. Clearly, following the 2001 economic crisis, the stage was set for Turkey to rise from the ashes.

Regulatory Reforms

The summer of 2003 marked a period of intense regulatory reform for Turkey. Indeed, the scope and variety of Turkey's reforms in such a short period of time indicate the country's willingness to respond rapidly to economic conditions and to take the drastic steps necessary to ensure future economic prosperity and stability. As we argue, those reforms aided in creating temporary economic development, but failed to create economic stability in the long-term.

In the short-term, however, Turkey's regulatory reforms created an environment in which the increase in global liquidity was able to find its way into Turkey's financial markets. The most significant reforms follow:[5]

Foreign Direct Investment Law No. 4875 (June 2003)

The new FDI provisions removed the requirement that a foreign company, in order to create a new company in Turkey with foreign capital, obtain a permit.[6] Formerly, an interested company would have to get approval from up to twenty government organizations to get such a permit. The bureaucracy that resulted was rampant, discouraged investment, and created the manifest potential for cronyism and

[5] Note that these reforms took place immediately following the Enron disaster in the United States. Indeed, some of the Turkish reforms are strikingly similar to the provisions in the Sarbanes-Oxley act in the United States.

[6] However, all companies must still formally register with a Turkish regulatory institution as required by the Turkish Commercial Code.

corruption. Today, the International Finance Corporation claims that “company formation procedure in Turkey has become one of the easiest in the world.”[7]

Secondly, the FDI law created a new, comprehensive equality principle that created equal duties and privileges for foreign and domestic companies. This equal treatment permitted foreign companies to compete on equal grounds with domestic companies, thereby encouraging further investment.

Turkish Capital Markets Board Law (July 2003)

The Turkish Capital Markets Board (CMB) Law expanded the existing powers of the independent authority that oversees Turkey’s financial markets.[8] The CMB law also included a small-shareholder-friendly provision. This “mandatory offer” provision requires that, if an individual or group of individuals or firms working in concert were to acquire 25% of a company or take over management of a company, that individual or group of individuals must make a fair, good faith offer to purchase the entire company.[9] This law was enacted in response to situations in which a controlling shareholder acted in ways that would unfairly prejudice minority shareholders, especially retail investors, both foreign and domestic. Reforms such as these made the Turkish financial markets much more attractive to investors from a variety of backgrounds, but especially small investors.

Enhanced Corporate Governance and Disclosure Laws (July 2003)

These laws require broad disclosure on the part of public companies. In the context of a public offering, for example, the Capital Markets Board itself reviews corporate documents of registered companies to determine whether “there are any share transfer restrictions affecting the liquidity of the shares to be offered or any provisions contrary to rights of minority shareholders.”[10] Extraordinary measures such as these, which directly benefit minority shareholders, have encouraged investment from parties with a broad array of investment expertise and resources.

Further, the CMB requires a company to disclose any material change in its policies, financial matters, or assets of the company that may affect an investor’s judgment of that company as an investment target.[11] These disclosure requirements are incredibly broad and, although somewhat onerous for the entities that must comply with them, appear to have encouraged investment in Turkish capital markets.

Expanded Privatization Laws (August 2003)

The main goal of Turkey’s new privatization laws is to accelerate the process of privatizing government assets. The Privatization Law No. 4046 was first enacted in 1994 and provided the general framework for privatization in Turkey.[12] Revisions to

[7] Elvan Aziz and Burcu Doner, Private equity and venture capital regulations in Turkey, Paksoy & Co. (2004), available at www.paksoy.av.tr/pdf/Private_equity_and_venture_capital_regulations.pdf.

[8] The CMB has similar responsibilities and powers as the Securities and Exchange Commission in the United States.

[9] Aziz and Doner, (2004).

[10] Aziz and Doner, (2004), (p. 2).

[11] Aziz & Doner, (2004), (p. 3).

[12] United Nations, available at unpan1.un.org/intradoc/groups/public/documents/apcity/unpan018681.pdf

the privatization laws were put into effect via Law 4971. The privatization laws are designed to:

- expand the scope of assets to be privatized,
- provide adequate framework, funds and mechanisms to speed up privatization,
- establish a social safety net for workers who lose their jobs as a result of privatization, and
- establish the Privatization High Council and the Privatization Administration to facilitate the decision-making process in the privatization endeavor.[13]

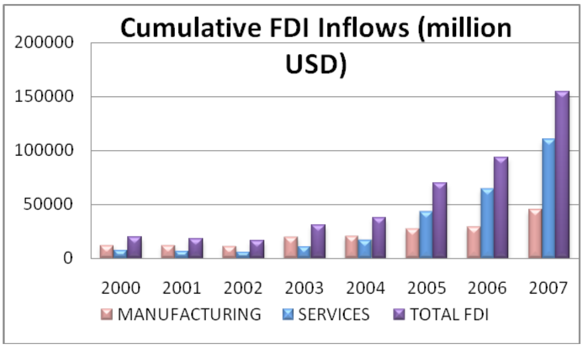
Banking Restructuring and Reform (January 2002)

Banking reforms during this period were modest but important. The main reform was an increase in capital requirements for banks.[14] Capital adequacy requirements were raised to a ratio of own funds to risk-weighted assets, non-cash loans, and obligations at a minimum of 8%.[15]

Also significant, yet not government implemented, the phenomenon of "creative destruction," combined with M&A activity reduced the number of banks from 81 to 54 during the 1999 to 2002 period, thereby concentrating assets in fewer banks which increased banks' ability to maintain adequate capital reserves.

Above mentioned regulatory reforms set the stage for broad economic expansion and drew more attention to Turkey from the global financial markets. This situation created a positive feedback loop that drew more investment to Turkish markets. As a result of these reforms and the increased global liquidity available at that time, Turkey witnessed a 500% increase in its ISE 100 stock market index from 2003 to 2007 and an 800% increase in foreign direct investment between 2002 and 2007. Turkey's post-2001 reforms, in conjunction with the staggering availability of global liquidity during this period, led to unprecedented economic growth in the country. Year-to-year FDI went from a paltry $20 billion USD in 2002 to approximately $160 billion USD in 2007, an 800% increase.

Figure 2 Cumulative FDI Inflows



Source: Undersecretariat of Treasury

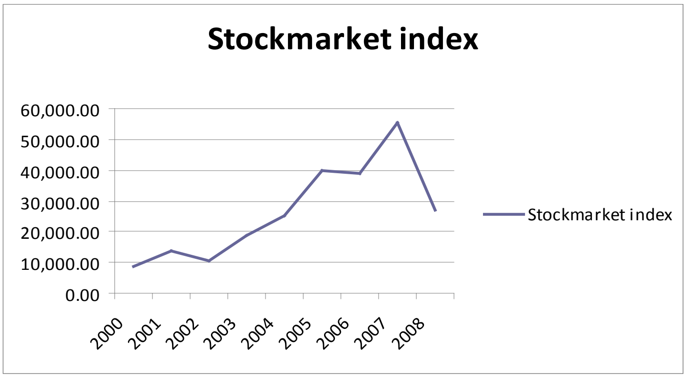
[13] Id.

[14] Thompson, Berker & Scott, Turkish Bank Capital Adequacy – Too Little, Too Late, Fitch Ratings, May 1, 2002, available at www.econturk.org/Turkisheconomy/fitchratings.pdf.

[15] This capital adequacy requirement is in line with the Basel risk-based capital minimum threshold.

Turkey's equity markets, measured by the broad ISE 100, leapt 500% from 2003 to 2007. Again, we argue that this resurgence in Turkey's markets would not have occurred in the absence of the global liquidity surge. As Pettis puts it, "when Chile for example, is benefiting from improvements in these underlying factors, there is no reason to assume that, coincidentally, Turkey, New Zealand, and Austria are also undergoing political and economic changes that suddenly make them better places in which to invest." (pg. 53). This argument in support of the liquidity model is showing one of the reasons for expansion of FDI into Turkey but this flow would not have been effective or even possible if Turkey had not done the necessary changes in its law and regulatory system. In other words, Turkey, as opposed to other emerging markets, would not have been a target for such liquidity had it not made the above-mentioned reforms.

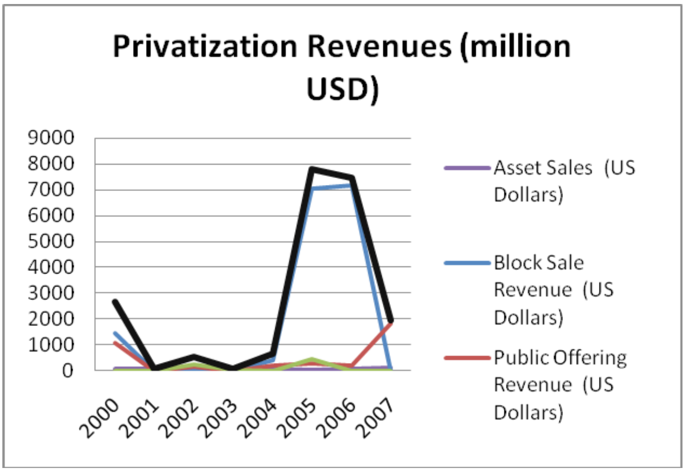
Figure 3 Stock market index



Source: EIU

Privatization revenues during this period were also significant. As a result of the new privatization laws, which were designed primarily to accelerate the process, USD 30 billion were collected as a result of privatizations between 2003 and 2009.

Figure 4 Privatization Revenues



Source: Undersecretariat of Treasury

Monetary Policy Reforms

In addition to the above mentioned regulatory reforms Turkey engaged in several significant monetary policy reforms. In 2001, Turkey was already implementing a standby agreement with the IMF, which was signed at the end of 1999 (see Table 1). This stabilization program employed a pre-announced crawling peg exchange rate regime. According to Ozatay and Sak, the novelty of the managed floating exchange rate system was that both the exit strategy and the date of exit were publicly known from the onset of the program.[16] According to the plan after 18 months of a crawling peg, the exchange rate would be allowed to fluctuate in a continuously widening band. However, four months before the exit date, political crisis and instability in Turkey caused overnight rates to spike, reaching 6200 basis points uncompounded. The Central Bank had to surrender its pegged exchange rate system in February 2001.[17]

Although it was earlier than planned, Turkey has moved on to a floating exchange rate regime. The main principles of which state that: the rate shall not be used as a monetary policy tool and the Central Bank does not have any specific exchange rate target. Exchange rates are to be determined by supply and demand conditions in the foreign exchange markets. One positive effect of a floating exchange rate system is that the Central Bank does not lose its foreign exchange reserves while defending the exchange rate. Instead, it can interfere in the market, albeit implausibly, via exchange auctions. According to Husain, Mody and Rogoff, an exchange regime does not have a systematic effect on inflation or growth in emerging markets. However, it is argued that pegged systems make these markets vulnerable to banking and exchange rate crises.[18]

Table 1 Lastest IMF agreements

	Date of	Expiration	Amount Approved	Amount Drawn
Type	Arrangement	Date	(SDR Million)	(SDR Million)
Stand-By	May 11, 2005	May 10, 2008	6,662.04	6,662.04
Stand-By	Feb 04, 2002	Feb 03, 2005	12,821.20	11,914.00
Stand-By	Dec 22, 1999	Feb 04, 2002	15,038.40	11,738.96
of which SRF	Dec 21, 2000	Dec 20, 2001	5,784.00	5,784.00

After Turkey's 2001 financial crisis, the Central Bank was made an operationally independent body with the policy target of achieving price stability. Central Bank Law No. 1211 was amended in 2001 to include the phrase: "the Bank shall enjoy absolute autonomy in exercising the powers and carrying out the duties granted by this Law under its own responsibility."[19] With this powerful amendment, the main objective of the Bank became achieving and maintaining price stability. The Bank was allowed to choose its own monetary policy instruments by which to achieve those goals.

[16] Ozatay, F and Sak, Guven, "The 2000-2001 Financial Crisis in Turkey", (CBRT Publications, 2002).

[17] Ozatay, F and Sak, Guven, "The 2000-2001 Financial Crisis in Turkey", (CBRT Publications, 2002).

[18] Husain, A., Mody, A. and Rogoff, K.,"Exchange rate regime durability and performance in developing versus advanced economies." Journal of Monetary Economics 52 (2005), 35-64.

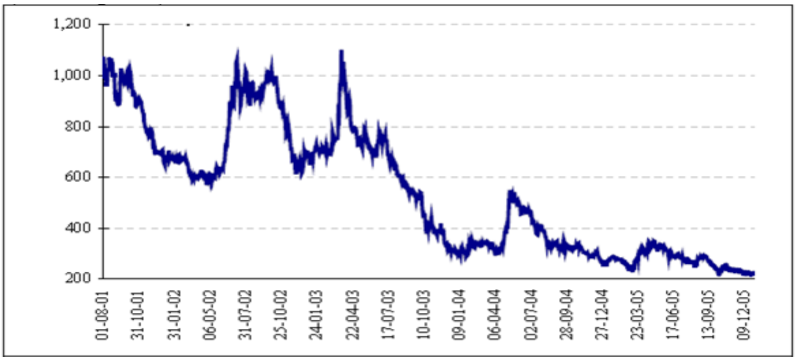
[19] CBRT web page. Available at: http://www.tcmb.gov.tr/yeni/eng/

Another important institution, the Monetary Policy Committee (MPC), was established in 2001. The MPC has overlapping duties with those of the Board of the Central Bank of the Republic of Turkey (CBRT) in determining and implementing monetary policy. Additionally, the Committee gives priority to maintaining price stability, determining the inflation target together with the Government, and informing public via reports. As former Central Bank president Sureyya Serdengecti put it, "the Central Bank's social responsibilities increased."[20]

Law 1211 made significant changes to the Central Bank's operations. Its duties are stated in the amended version: "as the lender of last resort, [the Bank] may provide daily or end-of-day credit facilities to the system against collateral to eliminate some payment problems to continue smooth operating financial markets against temporary liquidity shortages." Article 56 of the Law titled 'Operations Prohibited for the Bank' makes it a truly independent body. The most relevant clause provides that: "the Bank shall not, grant advance and extend credit to the Treasury and to public establishments and institutions, and shall not purchase debt instruments issued by the Treasury and public establishments and institutions in the primary market." These changes allowed the CBRT to pursue tight monetary policies in the following years.

Inflation targeting has been another concern for Turkey, a country with historically high inflation rates. At the end of 2001, inflation had increased 68% and reached a level of 43% in annualized terms in June.[21] Dealing with inflation was extremely important to restore credibility to the new monetary regime. The Central Bank started its operation as an implicit inflation targeter at the beginning of 2002. The reason for not starting with full-fledged inflation targeting was the extreme volatility in the market, making year-end inflation forecasts rather difficult. Some factors that contributed to this volatility included a restructuring of the economy in accordance with the new IMF program and the transition to the newly floating exchange rate system. Above all, excess sensitivity to economic and political "news" in international and domestic markets made the Central Bank's inflation forecasts very unstable. The main indicator of this sensitivity is the risk premium, measured via the EMBI spread throughout 2000-2001 (see Figure 5.)

Figure 5 Risk Premium Under Implicit Inflation Targeting Period (EMBI spread)



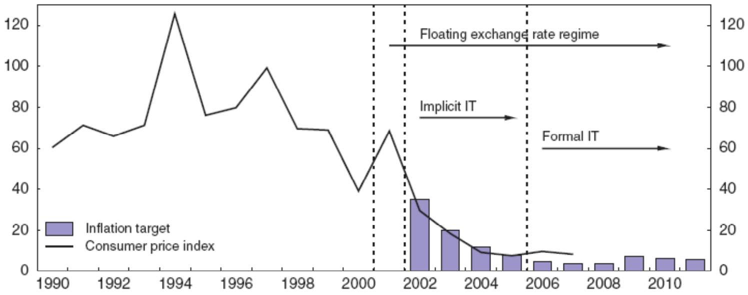
Source: JP Morgan

[20] Ibid.

[21] F. Ozatay and G. Sak, (2002).

Implicit targeting proved to be a wise policy choice because the Central Bank succeeded in restoring credibility to the new monetary regime. Inflation dropped considerably over the period (Figure 6). The Policy impact of tight monetary policy was also apparent in the significant drop of inflation from levels of 58% to 10% by 2005. Explicit inflation targeting started in 2006.

Figure 6

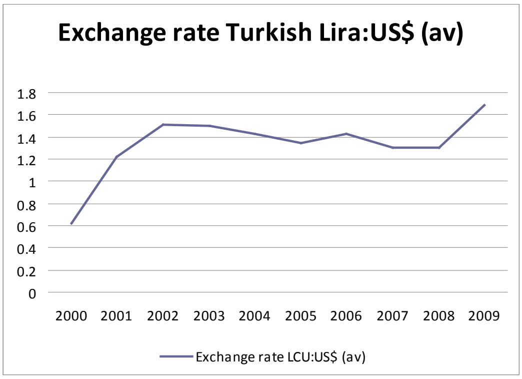


Source: Turkstat, CBRT.

These policies, on the other hand, led to the appreciation of Turkey's exchange rate. As the Turkish Central Bank restricted its monetary policy target to reduce inflation, the value of Turkish lira was to be determined by market forces. In this process, the Turkish lira depreciated approximately 40% in real terms against the USD[22] (see Figure 7.)

2008 OECD report illustrates the policy dilemma of emerging economies, particularly Turkey. As monetary policy makers try to enhance the credibility of a given macroeconomic framework, market interest rates remain high relative to international standards. This causes capital inflows, and therefore the economy becomes fragile to a sudden stop of those inflows. [23]

Figure 7



Source : EIU

Fiscal Policy Reforms

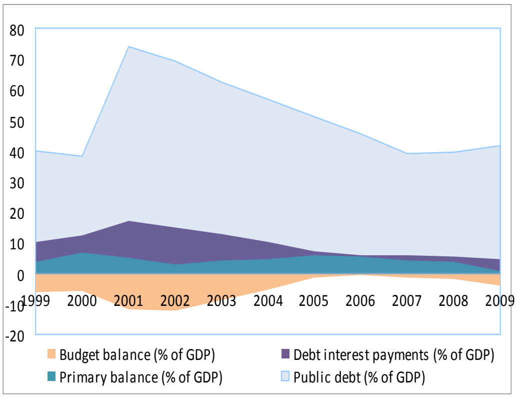
Turkey experienced a major fiscal tightening between 2001-2005. Determined fiscal austerity and significant privatization efforts were very effective in decreasing its public

[22] E. Yeldan and E. Voyvoda, "Turkish Macroeconomics under the IMF Program: Strangulation of the Twin-Targets, Lopsided Growth and Persistent Fragilities", (2005).

[23] OECD Economic Surveys: Turkey, Volume 2008/14, (2008), (pg. 117).

debt. Turkey has maintained a public sector primary surplus of more than 6% of GNP during 2004-2006. Net public debt fell from 66.4% to 34% of GDP.[24] Figure 7 shows the sharp decline in the public debt of Turkey starting in 2002. A decline in debt stock means a decline in interest payment on these debts as well – interest on debt was as high as 25.4% of the GDP in 2001, and declined to 9.6% in 2005. On the spending side, a new Financial Management and Control Law (PFMC) was enacted in 2003 to establish a control mechanism in public fiscal management. Setting expenditure priorities and annual budget ceilings were some of the other measures taken to bring down public debt.[25] This new financial management system exemplifies the transparency and accountability trend observed in the post-2001 reforms.

Figure 7 Public debt % of GDP



Source: CBRT

A 2006 World Bank report states that improvement in public debt financing was mainly revenue driven, due to substantial tax reform efforts achieved between 1999-2001. This balance shifted towards the expenditure side in the post-2001 years.[26]

Almost all of the 6.1 percentage points of GDO increase in Consolidated General Government (CGG) primary surplus came from revenue increasing measures, specifically from higher indirect taxes. Indirect tax revenues increased from 11.7% of GDP in 199 to 16.7% in 2005.

Recovery Report Card

Two characteristics of Turkey's growth following the 2001 economic crisis were that it was fueled by inflows of "hot money" and it was accompanied by high rates of unemployment. In short, it was jobless growth. Although capital inflows seem to be successful in terms of financial markets' trust in Turkey's stability, it can quickly turn into a weakness in case of a speculative attack; similar to the massive hot money outflows in February 2001.

The rate of open unemployment was 6.5% in 2000. It rapidly increased to 10.3% in 2002. The unemployment rates remained the same despite consecutive positive GDP

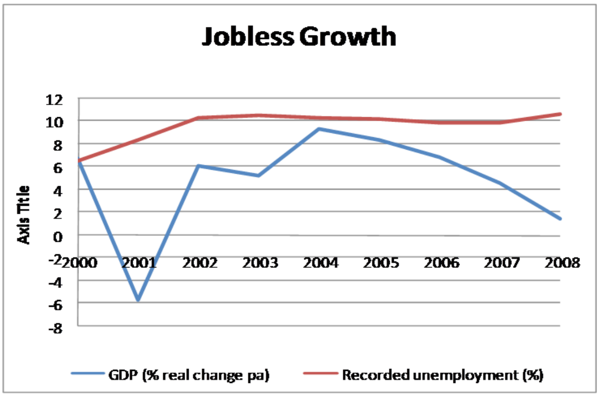
[24] Ibid (pg. 61).

[25] World Bank, "Turkey: Public Expenditure Review" Report No. 36764-TR, (Washington, DC, 2006).

[26] Ibid.

growth (approximately 7%). Figure 8 shows the unresponsiveness of unemployment rates to positive GDP growth over the years.

Figure 8



Source: EIU

Job creation has been anemic in the post-2001 era. Despite rapid growth performances across industries and services, employment creation was minimal. Growth was mainly generated through productivity gains associated with capital deepening. It was especially driven by private sector investment, modern domestic firms, foreign controlled firms, and emerging medium-sized enterprises.[27]

Spending on education, health care and infrastructure was extremely limited during this period. Central government capital spending has been reduced from 2.8% of GNP in 2002 to an estimated 2.1% of GNP in 2005 and 2006. These levels of government investment are inadequate vis-à-vis Turkey's need for infrastructure development and maintenance.[28]

In 2004, Turkey spent approximately USD 1,100 per student in primary education, and USD 1,800 per student in secondary education, compared to an average of USD 5,500 and USD 7,300 respectively for OECD member countries. In this respect it lags significantly behind many emerging markets such as Estonia, Russia, Chile, Mexico, Poland, Greece, and S. Korea, among others.

Public spending on health care is likewise considerably lower than the OECD average. Such spending is only USD 418 compared to the Czech Republic, Greece, Hungary, Ireland, Korea, Mexico, Poland, Portugal, the Slovak Republic, and Spain, which spent on average USD 1,135 on health care. On top of all, regional disparity is another issue regarding education and health services' quality.

Current Developments in the Turkish Economy

Although concealed by high-growth performance due to favorable global liquidity conditions up until September 2008, the weaknesses of the Turkish economy became more visible during the current global financial crisis.

[27] OECD Economic Surveys: Turkey, Volume 2008/14, (2008), (pg 22-24).

[28] Ibid. (68-70).

Despite significant reform in key economic and regulatory areas in the post-2001 crisis period, vulnerabilities remained; especially concerning the large current account deficit, volatility of exchange rates, increased private sector indebtedness, and persistent unemployment. Given that the growth of Turkey's economy was mainly financed by foreign capital inflows, shifts in external market conditions and investor sentiment added to the vulnerabilities of the economy. These fragilities increased Turkey's risk premium in international markets, resulting in very high real interest rates.[29] This consequently fed the 'high interest rate-hot money inflows' cycle and resulted in 'speculative-led growth'.[30]

The global financial crisis precipitated the end of this speculative growth period, and the Turkish economy is now experiencing a severe economic downturn. Deteriorating liquidity conditions in the global financial markets and worsening external and internal demand are mainly responsible for the slowdown in the economy.

In the following sections, recent economic performance of the Turkish economy and the impacts of the global financial crisis will be analyzed and several recommendations for attaining sustained growth will be discussed.

Growth Prospects

Until the reversal of favorable global economic conditions in 2008, Turkey registered above 5% GDP growth rates annually since 2002, except for 2007 when the real GDP growth was slightly below 5%.[31]

The strong growth performance of the economy also continued in the first quarter of 2008, with GDP in real terms growing by 6.7%. This created the impression that the recent global crisis would bypass Turkey.[32] After all, the global crisis that originated in the US economy was believed to be predominantly financial in nature and the Turkish financial system was seen to be robust enough to confront the rising anxiety in the global economy – especially after the reforms implemented following the 2001 crisis.

However, as the global financial crisis evolved into a global recession, the impacts of the unfavorable economic conditions began to be felt more seriously in Turkey. GDP growth rates turned out to be much weaker in the subsequent quarters of 2008. According to the Turkish Statistics Institute, the real GDP grew by only 1.1% in 2008.[33]

The main causes behind the weak growth rates have been shrinking domestic and external demand, and cuts in private sector investments. The latest press release of the Turkish Statistics Institute on manufacturing industry tendencies reveals that the capacity utilization rate of the industry fell to 64.7% in March 2009. This amounts to a

[29] OECD, "OECD Economic Surveys: Turkey", ISBN 978-92-64-04555-2, (2008), (pg.21).

[30] Yeldan, A. Erinc, "Turkey and the Long Decade with The IMF: 1998-2008", (2008).

[31] Turkish Industrialist's and Businessmen's Association (TUSIAD), "Quarterly Economic Outlook", Issue 23, January, 2009, pg. 2, web source: http://www.tusiad.org/tusiad_cms_eng.nsf/DKEko/Issue:23/$File/QEO23.pdf
The official growth rate target was set at 5% throughout the period covering 2002-2007 in line with the IMF program guidelines. Although Turkey experienced much higher growth rates in the given period (realized growth rates were 9.4% in 2004, 8.4% in 2005 and 6.9% in 2006, for instance), the official targets were not revised upwards. Yeldan (2008) interprets this as a sign of Turkish economic policy being guided by the IMF.

[32] Ibid. TUSIAD (2009), (pg. 2).

[33] Turkish Statistics Institute, "Press Release No. 52 on the Gross Domestic Product-2008 IVth Quarter", 31 March 2009, Web source: http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=4026

decline of 16.5% compared to its level in March 2008. A 52.7% contraction in domestic demand and a 29.5% decline in external demand for the given period were the key determinants of declining industrial activity.[34]

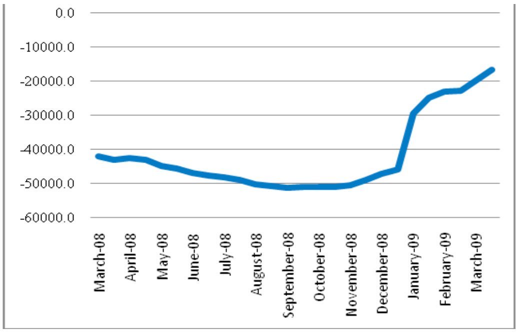
These are clear signals from the private sector that indicate that the slowdown in the economy is likely to continue under current conditions. This is also confirmed by the latest revisions of the official growth rate expectations for the medium term, according to which the economy is expected to contract by 3.6% in 2009.[35] The IMF's growth forecast for the Turkish economy is less optimistic though, predicting a 5.1% contraction of GDP in 2009.[36]

Balance of Payment Developments: Current Account Deficit

Turkey faced the recent global financial crisis with a very large current account deficit. Despite high growth performance accompanying the economic and structural reforms that have been in place since 2002, investor sentiment with regard to the prospects for Turkish economy has been volatile. This was mainly due to the fragility imposed by the record high current account deficits during this period, which reached to 6.1% of GDP by August 2008.[37]

However, since the end of 2008, the current account deficit has narrowed drastically as the global economic conditions led to a decline in demand for both exports and imports. As depicted in Figure 9, the EIU estimates indicate that the current account deficit, which exceeded USD 50 billion in September 2008, would narrow down to around USD 15 billion by March 2009.[38]

Figure 9 Current Account Deficit (March 2009 Estimates)



Source: Economist Intelligence Unit (EIU)

As mentioned above, worsening external and internal demand conditions were responsible for the changes in current account balance. On the external demand side, slowdown in the European economies depressed Turkish exports considerably. Traditionally, the European Union has been the largest market for Turkish exports.

[34] Turkish Statistics Institute, "Press Release No. 60 on Tendencies in the Manufacturing Industry-March 2009", April 10, 2009, Web source: http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=4032

[35] Republic of Turkey, "Pre-Accession Economic Program-2008", (Ankara, 2009), (pg.21), Web source: http://www.dpt.gov.tr/Portal.aspx?PortalRef=3

[36] IMF, "World Economic Outlook: Crisis and Recovery", April, 2009, Ch.2, (pg.78).

[37] Central Bank of the Republic of Turkey (CBT), "Financial Stability Report-November 2008", Vol.7, (pg.11), web source: http://www.tcmb.gov.tr/yeni/eng/

[38] Economist Intelligence Unit Statistics

Despite Turkish authorities' efforts to encourage trade with neighboring countries and other regions with the objective to reduce the dependence on Europe as the major export destination[39], Turkish exports to the EU still accounted for 48% of total exports in 2008.[40] Consequently, the recession that prevailed in Europe caused a significant decline in Turkey's external demand, and hence, a massive drop in exports, which had a negative impact on the current account balance.

On the other hand, the decline in imports has been much pronounced than the decline in exports; and this led to an ultimate contraction of the current account deficit. The key reason behind the reduction in import levels was the sharp decline in domestic demand, which was due to declining private sector investments and cuts in industrial production.[41] Furthermore, rapid decline in oil prices also helped narrow down the current account deficit because the energy sector is a major contributor to Turkish imports.

An analysis of the latest trade statistics by the Turkish Statistics Institute also points to the contraction in current account deficit as a result of declining economic activity. Although provisional, the data indicate that in February 2009 Turkish exports declined by 24.9% to USD 8.3 billion, compared to the same month of the previous year. Exports to the EU countries alone fell by 45.2%. On the other hand, imports fell by 47.6% to USD 8.4 billion, compared to February 2008. This led to a 98.4% decline in foreign trade deficit, compared to February 2008, which fell from USD 4.95 billion to USD 81 million.[42]

Additionally, the volatility of the exchange rate significantly increased in response to global uncertainties, and the Turkish Lira has depreciated substantially following the recent global crisis. The foreign exchange (FX) rate was around 1.2YTL/USD in July 2008, whereas it hovered around 1.80YTL/USD in the first week of March 2009. The FX rate was recorded at 1.66TL/USD on April 24th, 2009.[43] Yet the weak external demand, especially in Europe, hinders Turkey's ability to capitalize on export competitiveness that would normally arise due to the depreciation of domestic currency, and to achieve a robust improvement in exports.

On the financing side of the current account deficit, Turkey has been increasingly utilizing FDI inflows, which are accepted to be a more reliable source than short-term hot-money flows. In 2008 Turkey attracted another USD 15 billion of FDI inflows, which should be considered a success given the prevailing global liquidity

[39] WTO, "Trade Policy Review Report by Turkey", WT/TPR/G/192, 5 November 2007, (p.27).
Specifically, to reduce Turkey's dependence and concentration on certain regions and countries, the Undersecretariat of the Prime Ministry for Foreign Trade instituted "Neighbouring and Surrounding Countries Strategy" in 2000. This strategy enabled gaining access to the concerned markets via intensive trade promotion activities. Later on, specific regional strategies such as "The African Countries Strategy"(2003), "The Asian-Pacific Countries Strategy" (2005), and "The Americas Strategy" (2006) have also been implemented to improve trade relations.

[40] Undersecretariat of the Prime Ministry for Foreign Trade, Statistics, Exports by Countries, web source: http://www.dtm.gov.tr/dtmweb/index.cfm?action=detayrk&yayinID=253&icerikID=356&dil=EN

[41] Ibid. TUSIAD (2009), (pg. 3). According to TUSIAD, due to global economic slowdown, total investment fell by 5.4% in the 3rd quarter of 2008 despite the increase in public investment. For the given period, private sector's construction and machinery-equipment investment dropped by 8.4% and 12.8%, respectively. In contrast, annual average growth rates of construction and machinery investments have been 23.8% and 14.8% during the period of 2002-2007.

[42] Turkish Statistics Institute, Press Release No. 53 on Foreign Trade Statistics of February 2009, 31 March 2009, Web source: http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=4027

[43] Central Bank of the Republic of Turkey (CBT), Exchange Rates, Web source: http://www.tcmb.gov.tr/yeni/eng/

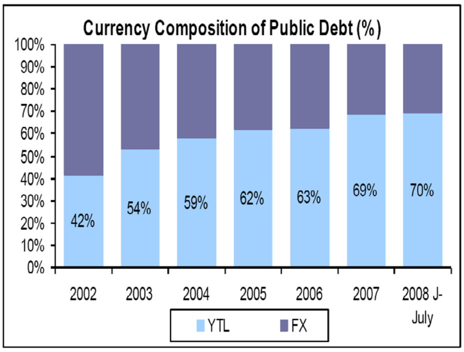
conditions.[44] Continuity and sustainability of FDI in Turkey might prove to be more difficult as the global economic recession deepens. However, slowing economic activity and the resulting current account balance improvements have made financing of current account deficit less of an issue.

Public Sector Finances

As previously stressed, management of public debt has been one of the success areas of Turkish economic policy following the 2001 crisis. Both the debt levels have been reduced significantly, and major risks in financing those debts have been controlled.

In this respect, an analysis of the currency composition of public debt reveals that Turkey has been increasingly reliant on domestic currency denominated debt rather than foreign exchange denominated debt since 2002. (Figure 10)

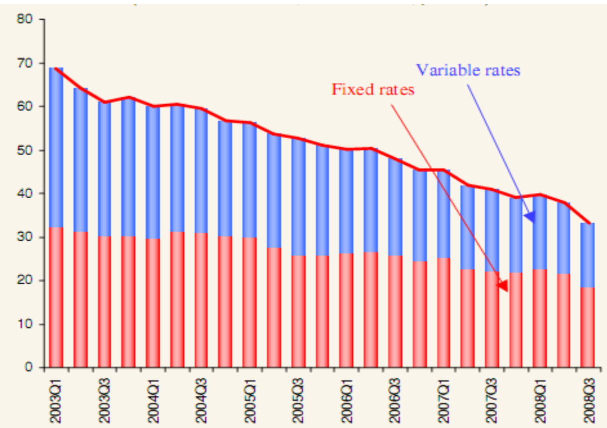
Figure 10 Currency Composition of Public Debt



Source: CBT, Financial Stability Report, Nov. 2008

Furthermore, the ability of Turkish government to borrow increasingly through fixed rate-instruments is worth noticing. (Figure 11) These two features of the debt composition imply that Turkey is faced with fairly low FX and interest rate risk in terms of its public debt.

Figure 11 Interest Rate Composition of Public Debt



Source: CBRT, Financial Stability Report, Nov. 2008

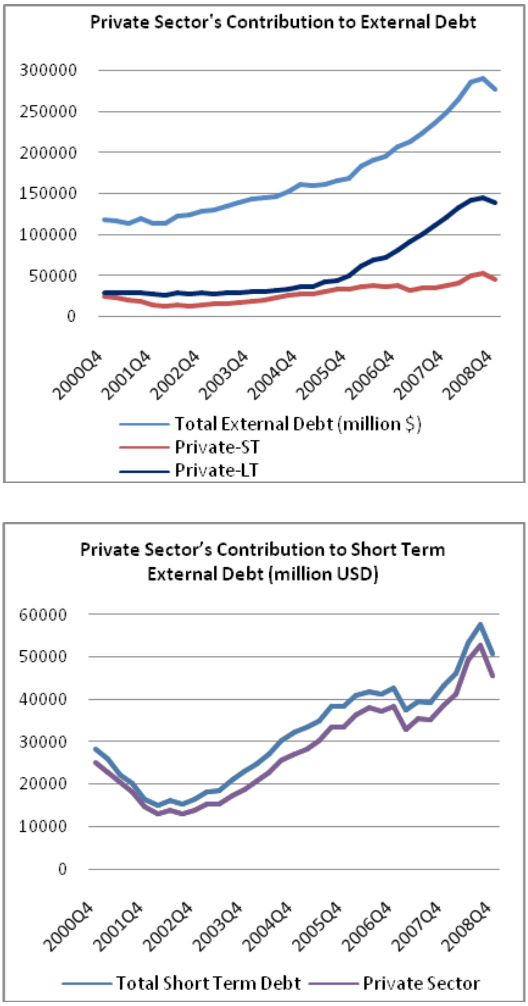
[44] Ibid. TUSIAD (2009), (pg.8).

However, maintaining this favorable situation will not be easy, as it will depend largely on global liquidity conditions. Currently the weakening demand in the domestic economy imposes new burdens on public finances; as an example, tax revenues will be declining with GDP as Turkey relies to a great extent on indirect taxes. Furthermore, declining imports will also translate into reduced tariff revenues. On the other hand, public expenditures would be expected to increase due to possible economic stimulation efforts. As a result, deterioration in public finances seems likely under current conditions.

Private Sector Indebtedness

Though public debt has been disciplined significantly in the post-2001 crisis period, the private sector's external debt has accumulated considerably. This is a major vulnerability for the Turkish economy as increasing levels of short-term private debt adds to Turkey's external financing needs significantly.

Figure 12 Private Sector Debt



Source: CBRT

As seen in the above figures, the private sector has been the major contributor to the increase in Turkey’s external debt, recently. This is especially the case concerning the short-term external debt. The right-hand chart indicates that private sector debt makes up almost USD 50 billion of Turkey’s total short-term external debt.

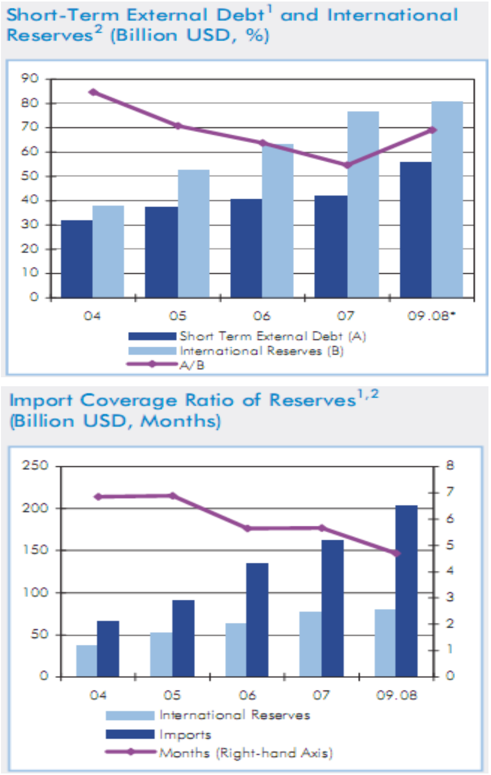
In addition, the left-hand chart indicates that the private sector has been borrowing from international financial markets largely through long-term instruments. This might imply that, in the coming years, the external financing needs of the Turkish economy will also be large when this debt matures. Yet the current liquidity conditions in the global markets obviously make the re-financing of external debt increasingly difficult.

Reserve adequacy

The adequacy of international reserves in servicing short-term external debt without resorting to an external source becomes important as the external financing needs of an economy increase.

Like many other developing countries, Turkey has accumulated significant international reserves during 2002-2007 while the global economic conditions were favorable. In this respect, it would be observed from Figure 13 that, the ratio of short-term debt to international reserves has declined significantly before starting to increase after 2007. Lately, worsening global liquidity conditions and increasing private sector short-term external debt levels have increased Turkey’s vulnerability in this area.

Figure 13



Source: CBRT, Financial Stability Report, Nov. 2008

Yet, the international reserves of the country still covered almost 5 months of imports as of September 2008, which is greater than the IMF's soundness criterion of 3 months.

Consequently, for the time being, foreign currency reserves of the Turkish Central Bank seem to be adequate to mitigate immediate short-term risks. However, a prolonging global crisis should be expected to increase the vulnerability of Turkey in terms of reserves adequacy.

Rigidity of Labor Market

The rigidity of Turkey's labor market is a deep-rooted structural vulnerability of the Turkish economy that needs to be addressed. According to an IMF study, in 2003 Turkey had the second most restrictive employment regime within the OECD countries. Turkey sets one of the highest minimum wages among the OECD countries, which reached 80% of GDP per capita in 2006. Furthermore, there is a high tax burden on corporations.[45] Together, these factors lead to the existence of a large informal sector, which results in an unsustainable production capacity. By reforming the labor market and increasing its flexibility, we believe that Turkey would be able to reduce the informality in its economy, improve FDI inflows, broaden its tax base and increase public revenues.

Outlook and Recommendations

The analysis of the latest developments in the Turkish economy reveals that, despite stronger fundamentals since the 2001 crisis, recent global uncertainties and worsening demand conditions have affected Turkey severely. For now, the outlook for the Turkish economy does not seem bright as the economy has clearly fallen into a deep recession, faced with expected negative growth rates and looming unemployment figures.

Under these conditions, in the short-term, interest rate cuts by the Central Bank seem necessary to stimulate growth and strengthen domestic demand. Declining inflation rates, due to the recent relaxation of oil prices, ease the Central Bank's hand in this respect. Indeed, the Central Bank has already taken steps in this direction -- the Bank cut interest rates 7 percentage points from 16.75% to 9.75% since November 2008.

Nevertheless, an IMF program to fund the external financing needs of Turkey seems inevitable due to adverse liquidity conditions in the global financial markets. Negotiations between Turkey and the IMF on a new program have been continuing for some time[46] and these are expected to conclude soon. We believe that the coming IMF funding should not be restricted to debt servicing only, but should be channeled towards stimulating small and medium size enterprises to increase domestic production, employment and thereby demand. Recent reforms in the IMF and their new policy stance on 'designing conditionality without constraining growth' would enable Turkey to allocate more resources to the stimulation of economic activity.

[45] Fletcher, Kevin, IMF European Department, "Unlocking Turkey's Labor Potential", IMF Survey Magazine: Countries & Regions, July 26, 2007, Web: http://www.imf.org/external/pubs/ft/survey/so/2007/CAR0726A.htm.

[46] Press Briefing by Caroline Atkinson, Director, External Relations Department, International Monetary Fund, Washington, D.C., March 26, 2009. Web source: http://www.imf.org/external/np/tr/2009/tr032609.htm.

To achieve a more balanced and sustained growth in the longer term, though, social spending on infrastructure, education and health should be a priority. The focus should be on restructuring the economy to further attract FDI and avoid reliance on speculative foreign capital.

Only by continuing reforms to achieve a sustainable production capacity independent of speculative capital flows will Turkey successfully restrain the negative effects of future capital reversals that are likely to take place in an ever globalizing and interdependent world economy.

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