TURKISH ECONOMY 2013
Challenges and Opportunities

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5 June 2013
Overview

• Turkey had a «stellar» recovery post-2009
  – Fast growth, falling unemployment, financial and fiscal stability, etc.
  – Surprising many at home and abroad

• Puzzle: why such a deep recession before?
  – Political economy very interesting
  – I leave it to other occasions

• Mid-long term view – forest not trees
  – Short term policy discussion is outside my scope
  – Review historical trends
  – Emphasise structural characteristics
  – Establish challenges and opportunities
  – Obtain clues about the near future
Warnings for Comparaisons

• Some data needs adjustment
  – Turkey has less households (19 million) compared to countries with stable population
  – Understating per capita welfare indicators (car, telephone, tv sets, etc)
  – PPP income is 50 % higher than current exchange rate income (in EU it is either at par or lower)

• High employment in low productivity agriculture
  – 40 % of the employment : self-employed, unpaid family labour and employers

• Pronounced dual structure of the economy
  – Modern, high value added, formal sector
  – Traditional, low value added, informal sector
Brief history

• Long term growth performance: mediocre
  – Not a failure (Argentina) nor miracle (Korea)
• Four phases of post-war growth
• 1950-80: Import substitution
  – Inward looking command economy; ends in crisis
• 1980-99: Opening up - Customs Union with EU
  – Market reforms without fiscal stability; end in crisis
• 2000-10: Fiscal consolidation
  – Financial stability; high growth at the cost of large external deficits
• 2011+: towards sustainable growth
  – Rebalancing domestic and external demand; jury still out
### Comparative political indicators, 2011-12

(0-10, standardized and population-weighted)

<table>
<thead>
<tr>
<th>Country or country group</th>
<th>Corruption perceptions</th>
<th>Rule of law</th>
<th>Civil liberties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa (non-Arab)</td>
<td>2.7</td>
<td>2.9</td>
<td>5.8</td>
</tr>
<tr>
<td>India</td>
<td>3.1</td>
<td>4.9</td>
<td>7.0</td>
</tr>
<tr>
<td>China</td>
<td>3.6</td>
<td>4.2</td>
<td>4.0</td>
</tr>
<tr>
<td>Middle East</td>
<td>3.0</td>
<td>3.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Arab League</td>
<td>2.8</td>
<td>3.5</td>
<td>4.4</td>
</tr>
<tr>
<td>Iran</td>
<td>2.7</td>
<td>2.8</td>
<td>4.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>4.2</td>
<td>5.3</td>
<td>7.0</td>
</tr>
<tr>
<td>OECD (except Turkey)</td>
<td>6.6</td>
<td>8.0</td>
<td>8.6</td>
</tr>
</tbody>
</table>

Sources: Transparency International, World Bank, Freedom House (2011-12)
## Growth in the very long run

GDP per capita PPP, 1990=100

<table>
<thead>
<tr>
<th>Difference in annual growth %</th>
<th>World Economy</th>
<th>West Europe + US</th>
<th>Under-develop. Econ.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1500-1820</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0</td>
</tr>
<tr>
<td>1820-1914</td>
<td>-0.3</td>
<td>-0.7</td>
<td>0.3</td>
</tr>
<tr>
<td>1914-1950</td>
<td>-0.1</td>
<td>-0.5</td>
<td>0.3</td>
</tr>
<tr>
<td>1950-1980</td>
<td>0.5</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>1980-2010</td>
<td>0.6</td>
<td>0.8</td>
<td>-0.2</td>
</tr>
</tbody>
</table>
GDP per capita relative to US
PPP; US = 100; 1953-2000 (Penn Tables)

Argentina  Korea  Turkey

US=100

1953  1979  2000
Per capita GDP relative to Turkey
PPP; Turkey=100; 1998-2011 (World Bank)

Turkey = 100

Argentina
Korea
Euroland

1998 2003 2011
Per capita GDP post-crisis
PPP; Euroland=100; 2008-11 (TUIK)

Euroland=100

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP</th>
<th>Real Consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td></td>
<td>45</td>
</tr>
<tr>
<td>2009</td>
<td>30</td>
<td>40</td>
</tr>
<tr>
<td>2010</td>
<td>50</td>
<td>48</td>
</tr>
<tr>
<td>2011</td>
<td>55</td>
<td>54</td>
</tr>
</tbody>
</table>
Turkey: trade in GDP
Goods and services as % of GDP (World Bank)
Profile of labour force (2009)

Graduates of Middle School in age groups % (TÜİK)

8 years + Education

<table>
<thead>
<tr>
<th>Age Group</th>
<th>Female</th>
<th>Male</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-54</td>
<td></td>
<td></td>
</tr>
<tr>
<td>45-49</td>
<td></td>
<td></td>
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<tr>
<td>40-44</td>
<td></td>
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<tr>
<td>35-39</td>
<td></td>
<td></td>
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<tr>
<td>30-34</td>
<td></td>
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<tr>
<td>25-29</td>
<td></td>
<td></td>
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<tr>
<td>22-24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18-21</td>
<td></td>
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</tr>
</tbody>
</table>
«The Great Transformation»

- There is no magic; «it’s the budget, stupid»
  - Impressive fiscal effort on the revenue side
  - Resulting in record fiscal adjustment
  - High primary supluses (up to 6 % of GDP)
  - Lowest debt ratio among large EU members

- The end of high inflation
  - CPI in single-digit after 30 years
  - Floating exchange rates and dedollarisation
  - Normalisation of real interest rates

- Structural reforms
  - CB independence
  - Strict regulation of banks / healty balance sheets
  - Investment in infrastructure (roads, ports, etc)
Fiscal balance (real) 1993-2011

Real Public Balance/GNP (%)
Net public debt 2000-12

Net Public Debt/GDP


Net Public Debt

Net Public Debt/GDP


Net Public Debt/GDP
Consumer inflation 1970-2012

Consumer price inflation (annual %)

0 20 40 60 80 100 120

Consumer price inflation (annual %)
Real interest rates 2003-11
Political economy of success

- IMF and the EU supplied the road maps
  - Disinflation initiated by a weak coalition government
  - Strong local constituency for reform
  - Minister Derviş defines the setting

- The role of AKP
  - Single party government – political stability
  - Pro-business, pro-market and pro-globalisation
  - By instinct fiscal conservative
  - Overall better governance
  - Sensitive to solidarity – poverty reduction

- New global image
  - Jump in inward FDI
  - Large scale privatisation
## FDI & privatisation

<table>
<thead>
<tr>
<th>FDI inflows</th>
<th>US$ bill.</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980s</td>
<td>2,4</td>
<td>0,3</td>
</tr>
<tr>
<td>1990s</td>
<td>8,1</td>
<td>0,4</td>
</tr>
<tr>
<td>2000s</td>
<td>98,4</td>
<td>2,0</td>
</tr>
<tr>
<td>2003-07</td>
<td>55,1</td>
<td>2,3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Privatisation Revenue</th>
<th>US$ bill.</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986-02</td>
<td>6,1</td>
<td>0,2</td>
</tr>
<tr>
<td>2003-07</td>
<td>22,0</td>
<td>0,9</td>
</tr>
<tr>
<td>2008-10</td>
<td>14,0</td>
<td>0,7</td>
</tr>
<tr>
<td>Total</td>
<td>42,1</td>
<td>0,6</td>
</tr>
</tbody>
</table>
The curse of success

• The failures of the last decade are well known
• Ever larger external deficits
  – Remember the «Dutch syndrome»?
  – Overvalued currency: high demand for TL assets
  – Role of monetary policy
• Collapsing private savings
  – Rapid credit expansion
  – Cheap tradable goods
  – High non-tradable income
• Low employment rates
  – Structural issues dominate the debate
  – Growth created payroll employment
  – But employment rates remain low (women)
Current account: 1990-2011

Current account balance (% of GDP)

-10
-8
-6
-4
-2
0
2

Current account balance (% of GDP)
Real exchange rate: 1980-2010

REER-WPI (1995=100)
Private savings 2001-12
Current prices (1998 series)
Employment rates 2011
Employed to 15+ population (%); WDI
Rebalancing the economy

- Large external deficits despite fiscal discipline
  - Vulnerabilities in private balance sheets
  - As in Spain, not Greece
- Change in policy position since Fall 2010
  - To balance domestic and external demand
  - «Orderly correction» is difficult; first time for Turkey
- Definition of sustainable external deficit
  - Captive capital: FDI; BIST; project finance
  - Is 5 % of GDP sustainable?
  - Puzzles: Net Errors Omissions; Gold
- No free lunch: hard choices
  - Inflation and growth trade-off
  - Sudden versus gradual correction
Global headwinds

- Global economic conditions are not favourable for an orderly correction
- Euro crisis and recession in EU
  - Real economy: half Turkey’s exports go to EU
  - Finance: risk of contagion and sudden stop
- Oil and commodity prices
  - Turkey is resource poor country
  - Worsening terms of trade requires larger exchange rate correction
  - Pass through effects to higher inflation
- Risks on both sides
  - Lower growth with tighter policy to fight cost inflation
Real exchange rates 2006-13

2003=100

Jan-06  Feb-07  Mar-08  Apr-09  May-10  Jun-11  Jul-12

PPI-based  CPI-based

100
110
120
130
140
Current account deficit 2007-12

<table>
<thead>
<tr>
<th>Month</th>
<th>CAD/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep-07</td>
<td>-6</td>
</tr>
<tr>
<td>Mar-08</td>
<td>-6</td>
</tr>
<tr>
<td>Sep-08</td>
<td>-6</td>
</tr>
<tr>
<td>Mar-09</td>
<td>-2</td>
</tr>
<tr>
<td>Sep-09</td>
<td>-2</td>
</tr>
<tr>
<td>Mar-10</td>
<td>-2</td>
</tr>
<tr>
<td>Sep-10</td>
<td>-2</td>
</tr>
<tr>
<td>Mar-11</td>
<td>-2</td>
</tr>
<tr>
<td>Sep-11</td>
<td>0</td>
</tr>
<tr>
<td>Mar-12</td>
<td>0</td>
</tr>
<tr>
<td>Sep-12</td>
<td>0</td>
</tr>
</tbody>
</table>

(Chart showing the current account deficit from Sep-07 to Sep-12 with CAD/GDP values ranging from -12 to 0.)
Domestic demand 2004-12
Seasonally adjusted, annualised (1998 prices)

TL bill.

Domestic Demand

GDP

2004Q1 2005Q1 2006Q1 2007Q1 2008Q1 2009Q1 2010Q1 2011Q1 2012Q1

80 95 110 125

80 90 95 100 105 110 115

Domestic Demand  GDP

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5/6/2013
A.S.Akat

30
Private investment 1998-12
Constant price (1998); seasonally adjusted

Bill. YTL

Machinery & Equip. (private) Hptrend

Political economy of rebalancing

• Risks of gradualism
  – Rough times ahead for the global economy
  – Markets have a tendency to overshoot

• Impact of changing relative prices
  – Non-tradable sectors face austerity

• Sensitivity to exchange rate movements
  – Legacy of dollarisation period

• Construction and real estate
  – Is there a bubble in real estate? Will it burst?

• The virtuous cycle of growth is crucial
  – Pains of adjustment are eased by fast growth
  – How to sustain growth during correction
  – Difficult policy (political) choices ahead
Structural challenges

- Turkey lacks global champions
  - Critical sectors dominated by foreign firms
  - Successful firms are usually small
  - Industrial policy very low on policy agenda

- Large informal economy
  - Tax evasion distorts efficiency and equity
  - Formal sector labour markets lack flexibility

- Human capital problems
  - Education is not just years in school
  - Major quality issues need to attended

- Political risks persist
  - Civil war in Syria
  - Recent demonstrations in big cities
Structural assets

• Half of the glass is full
• Interesting geography
  – Largest economy in the region
  – Valuable strategic position (NATO, EU)
  – Young and relatively well educated population
• Relatively developed institutions
  – Muslim country with a working democracy
  – Established property rights
  – Customs Union with EU
• Experienced policy team
  – Babacan is the longest serving minister
  – CBT, Treasury technically very competent
  – Excellent policy coordination
Opportunities of the crisis

• Global conditions could be turned to advantage
  – Bright star in the dark sky; growth premium
  – Fast growth attracts the attention of others
  – Supports «animal spirits» at home

• Regional growth is strong
  – Turkish firms enjoy distance & culture advantage.
  – Diversified and flexible economy also helps
  – Rapid expansion of trade, tourism & financial flows

• Falling commodity prices
  – Offsets loss of EU export markets

• Istanbul: the Megapolis
  – Already a regional hub for many activities
  – Only metropolis between London and Mumbai
Conclusion

• Turkey’s economic and political transformation is finally turning into a success story
  – Integration with the global economy
  – Financial and fiscal stability

• To consolidate the gains a difficult adjustment lays ahead
  – Reducing the external deficit to sustainable levels
  – Increasing domestic saving rate
  – Without breaking the growth virtuous circle
  – «An orderly correction»

• The glass is half full
  – Despite big risks, it has a fair chance of success
  – I remain in the optimist camp