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TURKISH ECONOMY: WHERE DOES THIS ROAD LEAD?

The economic crises of 1994 and 2001 damaged the Turkish economy greatly. It took a long time and high costs before the Turkish economy was able to recover. Turkey, through the guidance of Kemal Derviş (who was then Minister of State for Economic Affairs), managed to successfully navigate the 2001 crisis and restore macro-economic stability.

The Turkish economy improved considerably in 2002. As a result, Turkey was ranked 16th among the Group of Twenty Finance Ministers and Central Bank Governors (G-20) nations. It also became the sixth strongest European economy. There are two important reasons for Turkey's economy success during this period. Firstly, the Justice and Development Party (AKP) government, which came to power the same year, continued the stabilising policies of the International Monetary Fund (IMF). Additionally, the reforms launched by Prime Minister Erdoğan's government were fully supported by the USA and the European Union (EU). The economic stability in Turkey during that period enabled the country to hold accession talks with Brussels in 2005. Secondly, the steady rise of global economy in 2002-2008 bolstered Turkey's economic growth and the country was able to benefit greatly from these global monetary funds.

However, the global recession of 2008-2009 that started in the USA came to have a negative impact on Turkey's economy. As a consequence, Turkey's growth slowed, exports declined and unemployment rates soared. The situation has improved in recent years, owing to a surge in domestic demand for Turkish goods and services. This, in turn, led to increased public and consumer spending.

What has changed? Why has the economy become fragile?

2013 was a turbulent political and economic year for Turkey. Last year saw the country's macro-economic indicators slipping into the negative. This short article will explore recent developments in the Turkish economy by delving into their causes.

In 2013, the AKP government, which has in power for the past 11 years, faced two important and unexpected political developments. These took the forms of the Gezi Park protests and the corruption scandal of 17 December 2013 respectively. After the 2013 corruption scandal in Turkey, radical changes were made in the staffing of the judicial and security forces. In addition to limiting internet access, the AKP government demanded that social media platforms develop the necessary self-control mechanisms to regulate itself. As these were indicative of the government's monopoly of all political and economic authority in the country, the AKP and the Prime Minister have been harshly criticized by the international community.

RECENT DEVELOPMENTS AND PROBLEMS IN THE TURKISH ECONOMY

Ben Bernanke, Chairman of the United States Federal Reserve, said on 22 May 2013 that the decision of the Federal Open Market Committee (FOMC) to reduce the pace of its bond purchases to US$85 billion a month has significantly increased the risk premiums in emerging economies and decreased the willingness of investors to take risks. In brief, the declining liquidity and disinclination of global investors to take risks have culminated in economic struc-

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tural fragility. The FOMC further exacerbated this financial fragility in emerging economies on 18 December 2013, when it declared additional reductions to its pace of asset purchases. This announcement engendered sharp fluctuations in foreign exchange markets. The value of the US dollar fell by 16% against most major currencies, especially those from emerging markets. The Turkish Lira, likewise, fared poorly from the beginning of 2013, falling 23.4% against the US dollar and 27.5% against the Euro. Political instability in Turkey aggravated concerns of the country's socio-economic security and amplified its fragility.

As of the first quarter of 2014, Turkey, South Africa, Brazil, India and Indonesia are the five most fragile economies in the world. Dubbed the "Fragile Five" by Morgan Stanley, these countries are extremely susceptible to a withdrawal of foreign capital vis-à-vis the reduction of the US Federal Reserve's monetary stimulus policy.[1] Although they are emerging economies, these countries' vulnerabilities are heightened by their slow growth rates, high interest rates, high inflation, large current account deficits and the depreciation of their respective national currencies. To better understand the present situation of the Turkish economy, we will now examine these indicators one by one.

Spiralling foreign currency rates and Increased interest rates

The Central Bank of the Republic of Turkey tried to prevent the increase of foreign exchange rates in 2013 by selling its foreign currency reserves. Unfortunately, the Central Bank failed to mitigate the rapid climb of the foreign exchange rate. It could have attenuated the further depreciation of the Turkish Lira by raising interest rates in the country. However, the Central Bank missed the opportunity to do so. Turkey avoided any initial raising of interest rates for two reasons. Firstly, Prime Minister Erdoğan was opposed to it. Secondly, market players and economists in favour of the floating exchange rates opined that the rising foreign exchange rates could not be avoided or stopped. Despite Prime Minister Erdoğan's assertion that high interest rates would only lead to high inflation, the Central Bank raised interest rates from 7.75% to 9% and finally to 12%. This was a belated decision and unable to overturn the Turkish Lira's loss in value against the rising foreign exchange rates.

If the foreign exchange rates continue to soar, it is necessary to increase interest rates. However, so doing would lock the economy in a never-ending spiral where the interest rates would have to steadily rise in tandem with the Lira's rapid depreciation against the foreign exchange rate. Increased interest rates that continually rise are additional burdens to consumers and industrialists who have taken loans from banks. The debt burden of the state will likewise rise with the increased interest rates. The treasury will end up paying higher interest rates for both old debts and new bonds. Owners of low-interest governments bonds of earlier years will likewise incur losses, as the market value of their bonds will fall against the rising interest rates.

According to the Central Bank's official figures, the private sector has US$151 billion long-term and US$129 billion short-term foreign currency loans abroad. As foreign exchange rates increase, the amount of Turkish Lira needed to repay foreign debt

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[1] Morgan Stanley Global Currency Research Team, *FX Pulse: Preparing for Volatility*, Morgan Stanley, 1 August 2013. Online. http://www.morganstanleyfa.com/public/projectfiles/dce4d168-15f9-4245-9605-e37e2caf114c.pdf (accessed 5 June 2014)
See also, Morgan Stanley Global EM Macro Strategy Team, *Global EM Investor: The Fragile Five*, Morgan Stanley, 5 August 2013. Online http://www.docstoc.com/docs/162669710/Morgan-Stanley---The-Fragile-Five (accessed 5 June 2014).
See also, Morgan Stanley Global Emerging Markets Equity Team, "Tales from the Emerging World," *Investment Management Commentary*, 3 December 2013. Online. http://www.morganstanley.com/public/Tales_from_the_Emerging_World_Fragile_Five.pdf (accessed 5 June 2014)

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will increase in portion to prevailing foreign exchange rates. Similarly, those with foreign currency loans from local financial institutions will be saddled increase Turkish Lira denominated debt.

Inflation cannot be controlled

Simply put, high interest rates and high rates of foreign exchange will be reflected in production costs as well in the prices of goods and services. Inflation will accelerate as a result. The Central Bank initially estimated the inflation for 2013 at 5%, but it grew to 7.4% at the end of the year. In other words, the Central Bank has been unsuccessful in fighting inflation.

Low savings rate and Large current account deficits

There are two fundamental problems with the Turkish economy. First, the ratio of domestic savings to gross domestic product (GDP) is low. While this ratio is 45% in China, it is only 14.5% in Turkey. Therefore, investments in the country have to be financed through outsourcing. Secondly, the imbalance between investments and savings has led to the country's large current account deficit. In fact, the foreign exchange expenses of the Turkish economy are higher than its income. To close the current account deficit, Turkey has to borrow money from abroad. Through these foreign direct investments, portfolio investments and loans from abroad, Turkey will meet its deficit. So far, Turkey has had no problems closing the current account deficit through external resources. As long as real interest rates are high and hot money continues to flow into Turkey, the country should be able to close its current account deficit in time. This is because the interest accrued from hot money cannot be taxed.

However, the current account deficit problem has grown in 2014 and a deficit of US$55 billion is expected. Turkey's total external debt is now US$372 billion. Furthermore, the short- and long-term foreign currency debt payments (inclusive of interest owed) in 2014 amounts to US$ 65 billion.

In short, Turkey needs to garner US$18 billion every month for a year. The ratio of current account deficit to GDP in 2013 was approximately 7.7%. The unstable political climate in Turkey in December 2013 increased the credit default swap rapidly. As a result, economists have speculated that the re-evaluation of the Turkish economy's credit rating may soon be on the agenda.

Problematic foreign trade

Foreign trade deficit is largely responsible for the large current account deficit in Turkey. Imports have increased, but exports have reached the end of its capacity. Exports decreased by 0.6% in 2013, while imports increased by 7.6%. This distorted structure of Turkish economy can be explained with simple examples from some Turkish industries. The local iron and steel manufacturers spent US$18 billion on imports, but made US$10 billion from exports. Machinery and equipment cost US$30 billion to import, but US$12 billion to export. In short, goods and raw materials needed for production were imported for US$182 billion, while Turkey's total exports only made US$151 billion.

It is apparent from Turkey's export structure of Turkey that the less emphasis should be placed on labour intensive and capital intensive goods. Instead, the share of goods produced with advanced technology based on education and innovation should be increased within the manufacturing industry. The ratio of high-tech manufactured products makes up only 3.7% of Turkey's exports. In the EU, this ratio is approximately 20%. To produce advanced technological goods, Turkey first needs to have a high-level human capital, outstanding educational institutions and well-equipped research centres.

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Public Finance

Public finance is the most successful area of the Turkish economy. Due to disciplined approaches in public finance, the ratio of public finance debt to GDP has decreased to 38%. Regardless as to the outcome of the local and presidential elections in 2014, fiscal discipline in public finance will continued. At present, its projected budget deficit to GDP ratio is -1.9%.

Income distribution and Unemployment

The Turkish economy has long been plagued by two major problems. The first is the inequality in income. Due to income distribution statistics, 10% of the people in the higher echelons of society make up 29% of the national income. Similarly, 20% of the people in the higher echelons of society make up 45% of the national income. In other words, 55% of Turkey's national income comes from 80% of households. Turkey's Gini coefficient is 0.40. Furthermore, in 2010, 16.9% of Turks lived below the poverty line.

Structural unemployment is the Turkish economy's second problem. According to official figures, Turkey has an unemployment rate of 10%. Workers in the agricultural sector make up 25.5% of the total workforce. This figure is very high, when compared to the EU countries.

Turkish economy entering 2014

The main problems faced by Turkish economy may be summarised as follows:

Slow growth rate, increased inflation, large current account deficits, unequal income distribution and unemployment.

Methods of bolstering the Turkish economy through increased interest rates, cheap foreign exchange rates, strengthening the value of the Turkish Lira, ignoring the need to increase domestic savings, and using hot money to plug the gaps in its current account deficits are no longer viable.

As Kemal Derviş has noted, another danger awaits the economy, namely, "…repositioning of economic institutions, like the Central Bank, the Banking Regulation and Supervision Agency (BDDK), the energy watchdog and the competition authority, closer to politics again. The most important structural arm of the 2001 reforms is that those institutions, which audit and structure the economy, are separated from politics. Every citizen should know that they are treated the same. The interference of politics to daily market routine and private enterprise would collapse the country. This is the core problem and should be fixed."[2]

Before the Turkish economy can be restabilised, political stability must be ensured through elections. Turkey's relations with the EU must improve and the government must devote its full attention to the country's economic problems.

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[2] "Turkey is not in crisis but there is serious mistrust, Kemal Derviş," *Hürriyet Daily News*, 3 February 2014. Online. http://www.hurriyetdailynews.com/turkey-is-not-in-crisis-but-there-is-serious-mistrust-says-economist-kemal-der-vis.aspx?PageID=238&NID=61903&NewsCatID=344 (accessed 5 June 2014)