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Turkish Economic Successes and Challenges

By Anne O. Krueger

Turkey has never been a more strategic country than it is now. With a large Muslim majority, the nation is by its constitution a secular state. It is a democracy, and with 75 million people, it has a population about the same as Germany's. Although its per capita income is still low by European standards, Turkey had the highest growth rate of any European country during much of the last decade. As with other major emerging markets, however, growth has slowed abruptly and there are major uncertainties as to whether Turkey will fall into a "middle-income trap" or resume her stellar performance.

With the Middle East in turmoil, Turkey is a crucially important nation. Because of her location, her geopolitical importance cannot be underestimated. Because the country offers a model of democracy for other Muslim, and especially Arab, countries, her political success is vital. The Turkish economy is already big, and if economic growth accelerates — as it has the potential to do — Turkey's real GDP will be among the largest in Europe.

The period since 2001 has seen the first majority government in many years, although political divisions have recently increased sharply. And the Arab spring seemed to promise a much better neighborhood for the Turks until recent reversals and the conflict in Syria, which have undermined that. The country itself is at a turning point. There are critical foreign policy issues, challenges to economic policy at home, and sharp divides in the electorate.

Turkey became a separate country after the First World War. Over the next two decades, Ataturk revolutionized the nation in countless ways. The language

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About The Author

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of the nation was changed from Arabic to Turkish; the fez was made illegal; the Swiss legal code replaced earlier law; and a drive for economic development was begun. The new constitution made Turkey a secular state.

By the 1930s, many State Economic Enterprises (SEEs) were established in manufacturing and other sectors to lead the development effort. Ataturk died in 1938, but his policies were continued. The Second World War disrupted the economy, but in the immediate postwar period, the Turkish economy grew rapidly

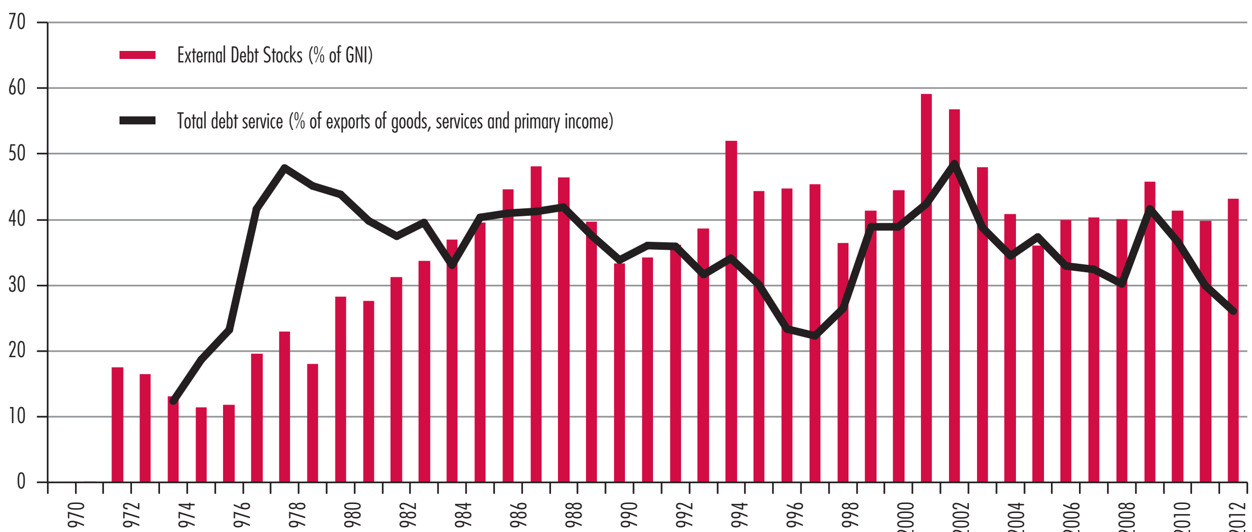
As efforts to stimulate growth through SEEs gathered steam, inflationary pressures intensified. The economy ground to a halt in 1958 until a first stabilization program was undertaken under the auspices of the International Monetary Fund. The exchange rate was devalued, monetary and fiscal policy tightened, and the chaotic regime for regulating and restricting imports was reformed. But the SEEs and government regulation remained the pillars of government economic policy toward the economy.

That 1958 crisis marked the beginning of five decades of roller-coaster economic performance. Periods of rapid growth and accelerating inflation were followed by "foreign exchange crises," sharp slowdowns in economic growth, and needed monetary, fiscal and exchange rate corrections.

The "stop-go" cycle continued with crises in 1970, 1976, and 1980. Until 1980, however, no efforts were made to address the underlying problem: The Turkish economy was highly regulated and growth was skewed far toward the domestic market with few incentives for increasing foreign exchange earnings. The 1980s reforms attempted to deal with that issue, providing more flexibility to the exchange rate and greater incentives for exports. But fiscal deficits recurred and inflation accelerated again. Until the late 1990s, the role of SEEs (which had been responsible for a sizeable portion of the growing fiscal deficits) and regulation of the economy were not seriously addressed and further crises took place in the late 1980s and the early 1990s. By the late 1990s, the banking

Chart 1

Central Government External Debt in Turkey



Source: OECD, World Bank

system was in serious trouble, inflation was reaching triple digits, economic growth was stalling, and government debt was over 100 percent of GDP, much of it external (Chart 1).

Far-reaching reforms were undertaken between 1999 and 2001 (again with support from an IMF program). The banking and financial systems were greatly strengthened; procurement laws and procedures were streamlined and made transparent; the tax system was reformed; many government controls were relaxed; and much more.

Turkey had joined a Customs Union in manufactured goods with the European Union at the end of the last century. The increased competition and other benefits that resulted further contributed to strengthening Turkish competitiveness. In addition, Turkey had been accepted as a candidate for accession to the European Union early in the last decade, and negotiations were concluded for some aspects of economic policy. Although negotiations were subsequently suspended, the measures that were agreed upon led to further benefits for the economy.

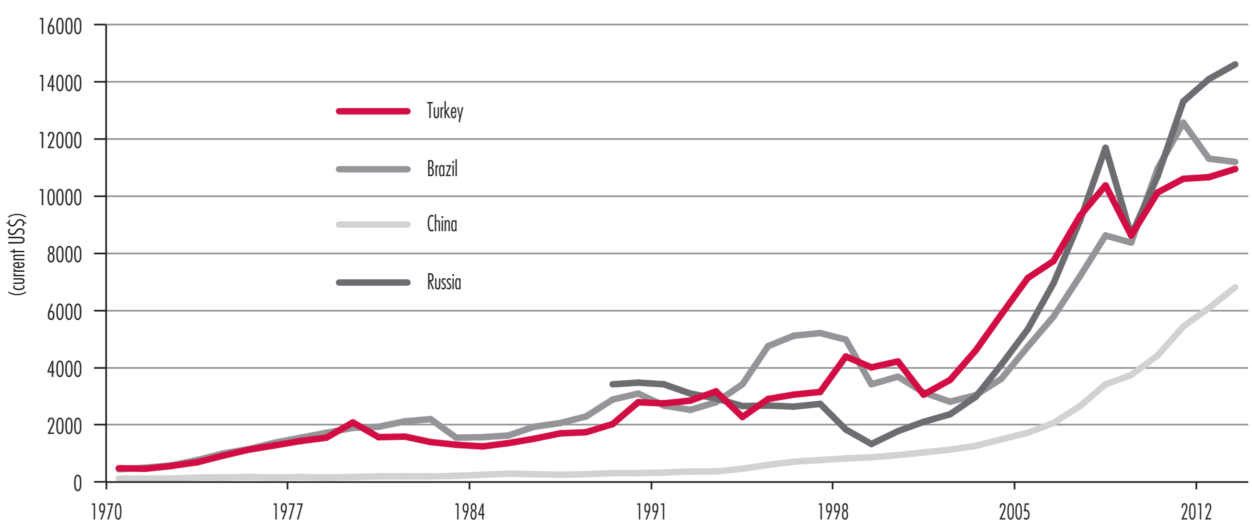
After 2001, the inflation rate fell sharply, the banking system was stabilized, regulation was strengthened, and fiscal policy was finally brought under control so that the external debt-GDP ratio was brought down to less than 40 percent by 2013 (Chart 1). Overall, real per capita income had tripled in a decade (Chart 2). Although there was still a long way to go to attain industrial country status, with additional reforms needed, the Turkish economy had become middle-income.

Hence, Turkey's economic and political prospects looked bright. Growth was rapid, and the government continued to command a majority in Parliament and was seen as reformist. The country seemed politically stable, with a thriving economy. Although growth slowed down in 2008–09 partially in response to the worldwide recession, it rapidly resumed, rising 8–9 percent in the next two years (Chart 3).

In the past several years, however, the outlook has dimmed, at least in the short run. Economic

Chart 2

Per Capita GDP Comparison



Source: World Bank

growth has slowed dramatically, to just over 4 percent in 2013; projections for 2014 are for only 2.3 percent. The slowdown has been accompanied by large current account deficits and rising inflation (Chart 4).

A number of factors, both economic and political, have contributed to the problems. On the economic side, the growth slowdown seems to have taken place mostly because reform momentum has diminished and there has even been some backsliding. The fiscal stance has become more inflationary, and the current account deficit in the balance of payments rose sharply to 7.9 percent of GDP in 2013. Although the deficit is projected to drop somewhat in 2014, it is nonetheless expected to remain well above comfortable levels. There are also concerns about inflation, which, given historical memories of the economic dislocations at the turn of the century, are worrying.

Moreover, geopolitical events have contributed to both the growth slowdown and political problems. Turkish exports to its southeastern neighbors have been seriously affected, and an influx of refugees has strained resources.

But the effects of these factors are amplified by the Turkish political situation. The AK party came to power in 2001, resulting in a majority in Parliament for the first time in many years. In its first years in power, the party's focus was on the economic reforms that have served the country so well. But in recent years, politics have become more divisive and the reform drive has stalled. The AK party retains a majority in Parliament, and in elections last August Prime Minister Erdogan was elected president.

By its constitution, Turkey is a secular country. But under Prime Minister Erdogan, a number of measures were taken that seemed to expand the role of religion in government and society. The role of the president in Turkey has been largely ceremonial. But after President Erdogan was elected he indicated that the role of the president should be greatly strengthened. The gulf between those wanting to strengthen the secular state and the leaders of the AK party has widened.

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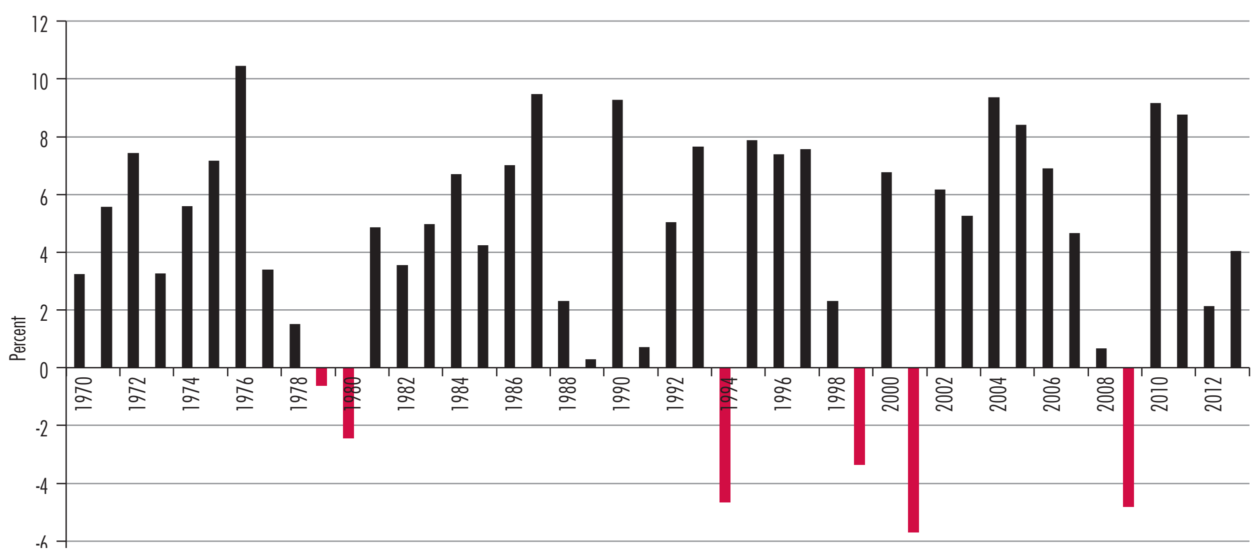
Chart 3

Real GDP Growth in Turkey



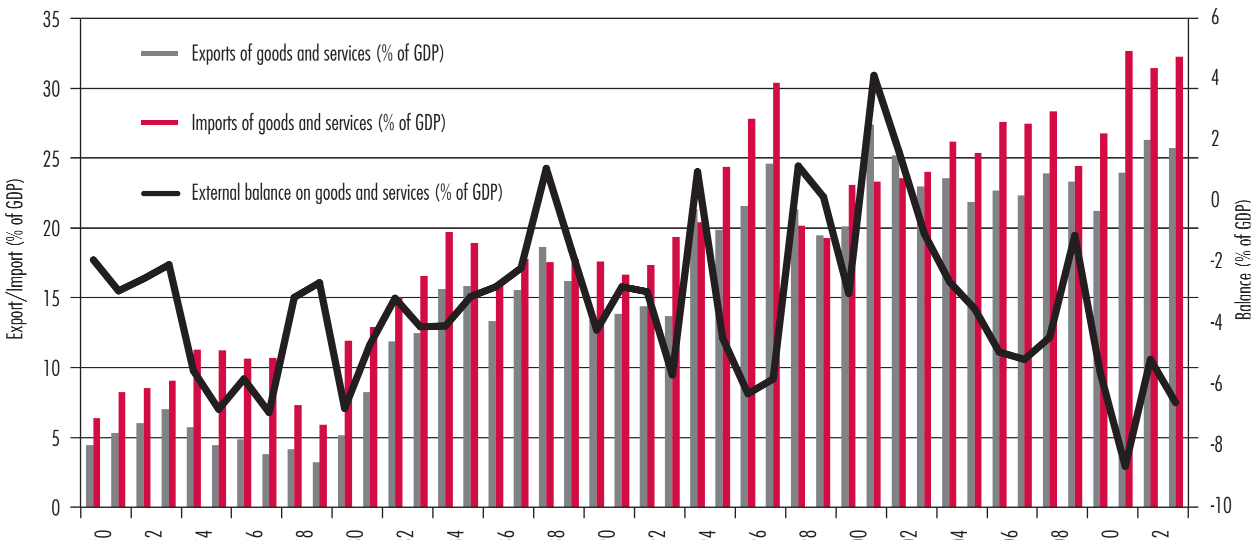
Source: World Bank

The political split would in any event be serious, but coming at a time when economic growth has slowed and there is conflict in the southeast , it has clouded the short-run outlook for Turkey. If the political issues can be resolved and peace can be restored to the southeast, Turkey should be able to resume much more rapid growth.

The prospects for the Turkish economy and body politic therefore are hanging in the balance. If conflict in Turkey's southeast stops, if the political conflict over the powers of the presidency can be satisfactorily resolved, and if the government chooses to resume the reform process, Turkey could emerge as a major growth center, possibly displacing one of the current "BRICS." If, instead, conflict continues to the southeast, the political impasse is not resolved, and reforms remain stalled, the country will not resume its promising path of the last decade. For the world as a whole, it must be fervently hoped that a good outcome materializes.

Chart 4

Trade Imbalances



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