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STRENGTHENING TRANSATLANTIC COOPERATION

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Summary: Favorable economic prospects encourage Turkey to strengthen its presence in the Middle East North Africa (MENA) region. By leveraging both its geographical proximity and a series of bilateral agreements on free movement of people and goods, Turkey is significantly increasing its exports to the region, which now account for more than a quarter of its total exports. This is supporting rapid economic recovery and the growing assertiveness of Turkish foreign policy in the region. Sustainability of economic growth in the medium- to long-term requires structural reforms to improve productivity and enhance competitiveness. However, reforms have a significant political cost, and are slowed down by the upcoming elections. If the government does not take advantage of the current favorable conditions to achieve these reforms, Turkish economy prospects will be damaged. This would also weaken the economic foundations of current Turkish foreign policy in the MENA region.

1744 R Street NW
Washington, DC 20009
T 1 202 745 3950
F 1 202 265 1662
E info@gmfus.org

Turkey as a Regional Economic Actor: Successes and Weaknesses

by Franco Zallio[*]

Turkey's 2010 economic growth is the highest among the OECD. Among G20 countries, it is lower only than that of China and India. In the first half of the year, real GDP grew by 11 percent and forecasts indicate a full year growth of 8 percent. Turkey's data on employment is quite significant given the sharp contrast with the trend in the EU and the United States. Between July 2009 and July 2010, total employment grew by 1,265,000 positions, mostly in the industry and services sectors (933,000), while unemployment rate dropped from 14.0 percent to 11.7 percent.[1]

The high economic growth simultaneously supports and is supported by the growing regional assertiveness of Turkey. Strong commercial interests bind Turkey to the regional context and its success in gaining new markets in the region has sustained its economic growth at a time when traditional markets (primarily the EU) are stagnating after the sharp fall in 2008-2009.

However, both Turkey's outstanding economic performance and its growing regional assertiveness need to pass a sustainability test: will Turkey be able to confirm its recent economic successes in the medium to long term, or, as it has often happened in past decades, will these successes prove to be only transitory? If the latter is true, the current regional assertiveness of Turkish foreign policy may prove too ambitious.

This brief examines the two main challenges the Turkish economy has to face: its strong reliance on the foreign capital that finances the wide trade deficit caused by the high import elasticity of growth and international competitiveness. The link between the two is evident: low productivity reduces international competitiveness, and increasing the trade deficit also increases dependence on foreign capital.

Turkish Foreign Trade and the Increasing Role of Regional Partners

In the first eight months of 2010, Turkey registered a trade deficit of $42 billion according to data from customs on a free on board/cost, insurance and

[*] Franco Zallio is senior consultant to Paralleli, and has published extensively on issues related to the economics and international relations of the Mediterranean and the Middle East. The views presented in this paper are the personal views of the author and not those of the institutions he represents or The German Marshall Fund of the United States. These papers are translated from the Italian by Kamilah Khatib.

[1] Unemployment is closely correlated to economic growth, as shown by the previous boom-and-bust cycles.

freight basis; exports grew by 13 percent in respect to the same period in 2009, while imports have expanded by 30 percent, causing a 79 percent increase in the trade deficit.

The trade deficit originates mainly from trade with Asian countries (for a total of $15.3 billion, an increase of 103 percent in respect to the same period in 2009; $9.2 billion is with China), the European Union ($10.9 billion, an increase of 70 percent) and other European countries ($11.9 billion, an increase of 39 percent, of which $10.9 billion is with Russia, which is the principal energy supplier of Turkey).

As an illustration of trade interests that sustain the new regional foreign policy, the Middle East and North Africa (MENA) is the only region with which Turkey is registering a trade surplus: $6.8 billion. MENA represents 11 percent of Turkish imports and 27 percent of its exports. This share has risen quickly in the past years; it was only 10 percent in 2000, but reached 17 percent in 2005.

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The Turkish balance of trade is positive with almost all of the countries in the region. The major surplus is the one registered with Iraq ($2.9 billion); followed by the United Arab Emirates ($1.6 billion), Libya ($1 billion), Egypt ($1 billion), Syria ($600 million), Israel ($400 million), Jordan ($400 million), Lebanon ($300 million), and Saudi Arabia ($200 million). Surpluses with other monarchies of the Gulf Cooperation Council (GCC) are more modest: trade relations with the GCC are still limited, awaiting a free trade agreement, which seems far from being achieved.

In the past years, Iraq has represented the most dynamic market for Turkish exports, and today is its fifth largest. In the first eight months of 2010, Turkey exported goods worth $3.7 billion to Iraq, a value only inferior to its exports to Germany, Great Britain, Italy, and France. The increase in exports to Iraq can be explained by both the geographical proximity and the recent improvement of security in Iraq, which allowed the increase in oil production, thus funding the growth of Iraqi imports. It is important to remark that the significant increase of Turkish exports to Egypt, Jordan, and Syria is favored by the free trade agreements that Turkey signed with these countries.

In such a favorable regional landscape, two exceptions stand out, both related to energy suppliers: Iran, with which Turkey registered a trade deficit of $2.8 billion in the first eight months of 2010, and Algeria, with a deficit of $500 million. As far as Iran is concerned, the Turkish deficit — after expanding from $4.6 billion in 2006 to $5.2 billion in 2007, and to $6.2 billion in 2008 — was greatly reduced in 2009 ($1.4 billion). This can be explained by the simultaneous fall in Turkish energy demand and the price of hydrocarbons. The trade deficit has increased again this year with the growth in energy demand related to the economic recovery and the rise of oil prices. The analysis of trade with Iran is nevertheless complicated, as a share of Turkish exports transits through Dubai and therefore appears in Turkish statistics as exports to the United Arab Emirates. This is, however, a declining phenomenon given the increasing controls recently applied in the Emirates to the transit trade with Iran.

Market penetration in the MENA has thus witnessed a considerable success in both oil and nonoil producing countries. This is destined to continue as MENA-favorable growth prospects, compared with the more limited prospects of European economies, promote geographical diversification of export markets. Opportunities are rather considerable: by exploiting the network of free trade agreements built in the past years, Turkey could become the integration pole of regional productive systems. However, in order to capture these opportunities, the Turkish economy must undergo profound reforms, reducing its dependence on imports and foreign capital.

Challenges: Productivity and Dependence on External Savings

The economic history of Turkey is marked by several episodes of rapid growth, which have turned into extended periods of stagnation or severe crises. International and national contexts changed, but growth has always been interrupted by the same phenomenon. Inflows of foreign capital, which initially sustained economic growth and financed the increase of imports, have later caused a real appreciation of the Turkish lira. This occurred in a context of low productivity with a rather rigid labor market, thus decreasing the international competitiveness of the country. Capital inflows have subsequently fallen sharply and imports were cut. This was followed by prolonged stagnation, or even a crisis, like the one related to the foreign debt which took place at the end of the 1970s or the one that hit the local financial system in 2001.

Will this negative evolution repeat itself? Will dependence on foreign capital and imports, coupled with low productivity, again limit economic development? To avoid this, Turkey faces a double challenge: on one hand, there is a need to maintain international confidence to guarantee the continuous inflow of foreign capital. On the other hand, new economic policies that can increase productivity and participation in the labor market are needed to reduce dependence on imports and preventing foreign capital inflow from translating into a loss of international competitiveness.

In relation to capital inflows, increasing concerns relate to their recent qualitative deterioration, namely less foreign direct investment (FDI) and more portfolio investment and credits. This amounts to an increase in the most volatile flows, creating debit rather than productive capacity. The decline of FDI, which fell from a record $22 billion in 2007 to $18 billion in 2008 and further to $8 billion in 2009, can only be partly explained by the impact of international economic crisis. Actually, FDI decline continued in 2010 (-14 percent in the first eight months of the year) notwithstanding the strong Turkish economic recovery. The trend of FDI could therefore be the first symptom of a loss of competitiveness. This is, however, a tentative assessment given that other factors may have played a role, including seasonality (2010 figures refer to the first eight months only).

On the other hand, portfolio investments have increased to an extraordinary degree: $15 billion in the first eight months of 2010 compared to $3 billion for the same period in 2009. The inflow is part of the current emerging market rally, and is fed by the global liquidity flood, thus having a significant volatility.

The inflow of portfolio investment has been accentuated by the upgrade of Turkey's sovereign debt rating (from BB- to BB) awarded by Standard & Poor's last February. It should be noted that despite some favorable fundamentals (public and external debt are both less than 50 percent of GDP and the financial system is rather solid), Turkish sovereign debt continues to be evaluated in a cautious manner (Ba2/BB)[2] remaining below the investment grade. Improving the rating could therefore stimulate a greater inflow of foreign capital. The crucial factor affecting rating is the management of public finances, especially given the imminent political cycle. Parliamentary elections will be held in mid-2011, followed in 2012 by the first direct presidential elections. On this matter, opinions of analysts are mixed: the optimists point out that the outcome of the September 2010 constitutional referendum has strengthened the government, making public spending for electoral purposes less relevant. The pessimists point instead to the lack of agreement with the International Monetary Fund regarding a new economic program[3] and delays in the approval of the Fiscal Rule that from next year would have imposed a brake on deficit and public debt, but that was postponed to 2012 and might even be abandoned.

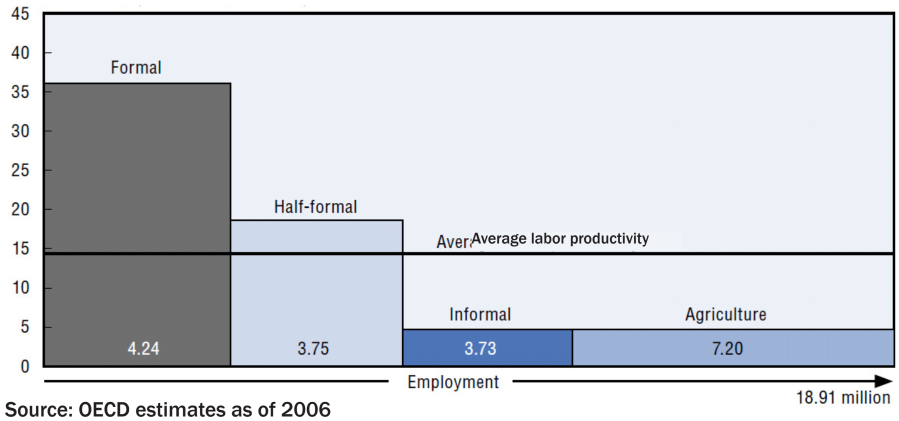
The political cycle will be also critical for the other key challenge, the one that relates to productivity and hence to the structural elements of the Turkish economy. To support the country's international competitiveness, structural reforms that promote productivity growth, mainly through

[2] On a regional scale, it is a rating equal to Jordan, lower than Israel, Tunisia, Morocco, and Egypt, and only higher than Lebanon. Neither Moody's nor Standard & Poor's have so far assigned a rating to Syria.

[3] The latest agreement, which entered into force in 2005, expired in May 2008. Subsequent negotiations have not led to a new agreement. With the outbreak of the international economic crisis, Turkey has chosen to avoid an agreement that would limit its economic policy options.

Figure 1

Labor Productivity ($1,000 per worker)



Source: OECD estimates as of 2006

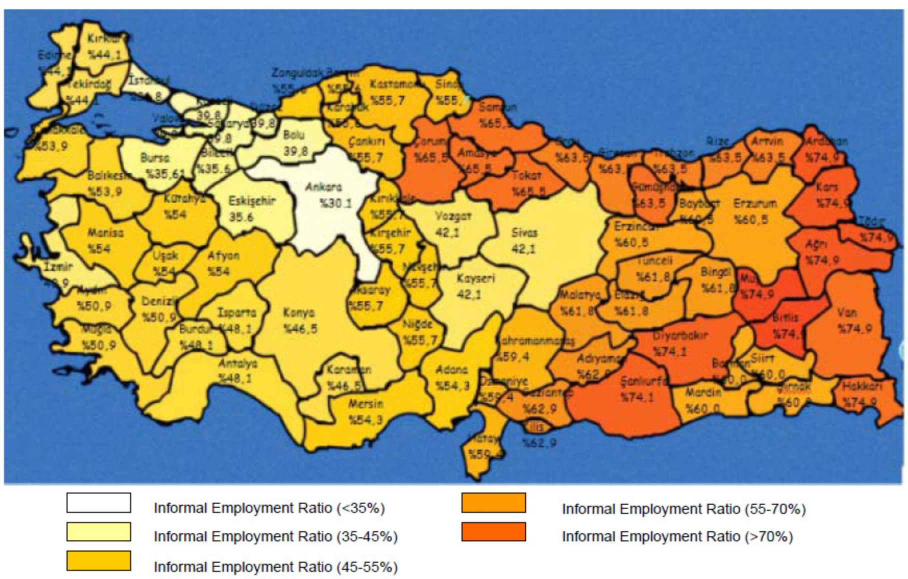
reducing the black economy, are needed.[4] Relying on the informal economy has enabled many companies to achieve employment flexibility and price competitiveness. At the same time, this has prevented them from fully using highly skilled labor and accessing capital markets. Productivity has suffered greatly: according to the OECD estimates shown in Figure 1, labor productivity is 80 percent less in the informal sector, and 40 percent less in the semi-formal sector than in the fully formal sector.

Additionally, employment flexibility obtained through informality has strongly segmented the labor market, increased social inequality and slowed labor participation. Employment rate in Turkey is now the lowest among OECD countries: 43 percent overall, and only 25 percent for women. This highlights the current paradox — and is therefore a difficult situation to sustain — in which Turkey is achieving the fastest economic growth among OECD countries despite having the lowest employment rate.

Low employment and the high recourse to informality are caused by a very rigid labor market, and in particular by a minimum wage that, in U.S. dollar terms, has tripled since 2002 and is now higher than in the countries of Central and Eastern Europe that joined the EU in 2004 and 2007 (with the only exception of Slovenia). The rapid growing wage rate (in the second quarter of 2010, the hourly labor cost index rose by 7.2 percent compared to the same quarter the previous year) is impinging upon international competitiveness. In addition, the minimum wage is uniform throughout the country, including the poorest areas, where — as seen in Figure 2 — the use of informal labor is therefore very high.

Figure 2

Informal Employment Ratio



Source: Ministry of Labour and Social Security

The battle to reduce the informal economy is therefore a very sensitive political challenge that could have a significant political cost for the AKP, which has some strongholds in the areas where the informal economy is more robust. Moreover, it could further complicate the Kurdish issue. More generally, it could enhance the division of the country

[4] The need to reduce the black economy to strengthen the economic prospects of the country has long been advocated by the main international observers of the Turkish economy. This has been the central theme of the 2006 edition of the *Economic Survey* on Turkey published by the OECD as well as subsequent ones up to the one published last September. The World Bank has devoted its recent report on Turkey to this topic: *Country Economic Memorandum 2010 — Informality: Causes, Consequences, Policies*, March 2, 2010.

on geographical lines in a political framework already highly fragmented on a territorial basis, as shown by the results of the 2009 local elections and the recent constitutional referendum.

Conclusion: The Sustainability of Turkey's Economic Role in the Region

The current high economic growth rate and the reduction of unemployment offer a very favorable context for the strengthening of public finances necessary to guarantee the ongoing inflow of foreign capital, as well as for the implementation of the economic structural reforms needed to avoid losses in competitiveness.

If the government succeeds in seizing this opportunity, Turkish productivity may achieve large structural improvements. This may also allow Turkey to become pivotal in the economic integration of the MENA, consolidating and increasing recent successes.

The months leading to the parliamentary elections in July 2011 will be crucial to assess the government's will to meet the big economic challenges of the country. The first signals, such as the postponement of the Fiscal Rule, are, however, not encouraging. Moreover, rapid wage increases, a growing trade deficit, and declining FDI are all hinting towards a reduction in Turkey's international competitiveness. If the challenges are neglected in favor of short-term electoral calculations, economic development is likely to stall. Turkey's economic role in the MENA will suffer, undermining the economic foundations of current Turkish foreign policy in the region.

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