

## Analysis

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**Summary:** There is a widespread perception that the past decade has been transformational for Turkey's economy. This article discusses views on what changed and what did not, what old problems were addressed and what new problems emerged, and what parts of the transformation set the stage for permanently better macroeconomic performance and what parts were more ephemeral.

## Turkish Economy 2000-2010: A Decade of Transition

by Dr. Sena Eken and Susan Schadler

### Introduction

There is a widespread perception that the past decade has been transformational for Turkey. In late 2011, experts drawn from the fields of economics, political science, sociology, journalism, investment banking, and history convened in Istanbul, Brussels, and Washington, DC to discuss the nature of the changes in Turkey's political economy in the past decade. This article discusses the main conclusions from these meetings.<sup>1</sup> More specifically, it portrays views on what changed and what did not, what old problems were addressed and what new problems emerged, and what parts of the transformation set the stage for permanently better macroeconomic performance and what parts were more ephemeral.

### Macroeconomic and Financial Policy Changes Were most Obvious and Clear

The macro environment had reached a crescendo of instability at the turn of the century: inflation had hovered

around a growth-defying 80 percent for years; savings rates had fallen; the financing of soaring fiscal deficits had pushed public debt, real interest rates, and capital inflows to unsustainable levels; and risk-taking by under-capitalized banks went uncurbed. This perfect storm of vulnerabilities paved the way for Turkey's most devastating post-war economic crisis in 2001, pressing the necessity for a broad post-crisis reformulation of macroeconomic policies and institutions.

Improvements in macroeconomic and financial policy frameworks in the aftermath of the crisis were impressive. Fiscal policy was anchored on a target for the primary surplus. The monetary policy framework shifted to a floating exchange rate regime. The Central Bank, in a new inflation-targeting framework, was granted independence vis-à-vis policy actions. The financial sector underwent pervasive reforms: banks were recapitalized; supervision was strengthened; supervision and regulatory practices were brought in line with international practices; and new banking laws refined the legal structure underlying these reforms.

These changes helped Turkey overcome longstanding sources of insta-

<sup>1</sup> This article is an excerpt from a recently published book, *Turkey 2000-10: A Decade of Transition – Discussions Among Experts* by Sena Eken and Susan Schadler, Foreign Economic Relations Board. [http://en.deik.org.tr/4454/A\\_new\\_book\\_assessing\\_the\\_changes\\_in\\_Turkey\\_s\\_economy\\_during\\_2000\\_10\\_published\\_by\\_DE%20C4%B0K.html](http://en.deik.org.tr/4454/A_new_book_assessing_the_changes_in_Turkey_s_economy_during_2000_10_published_by_DE%20C4%B0K.html)

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bility and secure strong economic performance during the middle of the decade. Public sector finances strengthened and the government was able to hold the primary surplus steady around 5 percent of GDP through 2006. The strong primary surplus position and the greatly reduced financing needs, together with the resumption of GDP growth after 2002, permitted a steady reduction of the public debt to GDP ratio. By the end of the decade, net public debt was a moderate 36 percent of GDP, just above half its level at the beginning of the decade. Inflation was brought down to single digits by 2004.

The shift to more stable macroeconomic policies also increased Turkey's resilience to shocks. Indeed, the 2008-09 global crisis has been a first major test of this resilience. The scope for counter-cyclical monetary and fiscal policies and the strength of the financial sector were key ingredients of the speed and strength of recovery from the hard impact of the global crisis.

### Effects of Greater Macroeconomic Stability on Growth Were Questionable

Although the economy grew at an average annual rate of 7 percent during 2000-07, the average annual growth of 4.2 percent for 2000-10 was not higher than in the previous decade and was lower than that in many other emerging and developing economies. Moreover, the volatility in growth did not decline.

However, the general perception was that, for several reasons, economic prosperity had improved by more than simple GDP growth suggested. First, the sharp burst of growth during 2002-07 — the fastest of any five year period since the beginning of the Republic — represented a distinct break from the past. Second, the real appreciation of the Turkish lira contributed to higher purchasing power

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of wage-earners in particular. Third, growth had been more inclusive than in the past: not only did income distribution improve slightly, but also the government was successful in bringing basic services and amenities to people. Finally, the recoveries from the two crises, helped by appropriate policy responses and the resumption of capital inflows, were rapid and vigorous.

### Microeconomic and Structural Reforms Were Generally more Timid

Though the global financial crisis most certainly constrained the response of GDP to macroeconomic stabilization, unaddressed microeconomic and structural weaknesses were also a drag on growth.

In contrast to hard decisions and actions on macroeconomic policies, there were missed opportunities to do better in structural and social policies, especially in 2005-07, when the conditions were right for galvanizing change. While change for the better had occurred in several areas, serious impediments to strong and equitable growth remained to be tackled. Most importantly, problems continued to fester in the flexibility of the labor market and the effectiveness of the education system. The negative implications of these problems have been significant for the country's productive capacity, its global competitiveness, and the welfare of Turkish citizens.

In the labor market, job growth lagged behind working age population growth and unemployment remained high. Impediments to job creation included the influence of Turkish lira appreciation and globalization alongside structural obstacles such as excessive regulation geared toward protecting jobs in the formal sectors, steep severance pay requirements, an undifferentiated minimum wage, high labor taxes, and skill mismatches.

In the education system, there were improvements in infrastructure, internet access to schools, school enrollment, and curriculums. But the fundamental problem — that education remained too uneven in quality and too focused on the objective of nation-building at the expense of teaching critical thinking skills essential to social mobility and to competing in the global economy — remained to be tackled



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through innovation in both the curriculum and objectives of education.

### **Pre-Reform Vulnerabilities Were Lowered, but New Ones Emerged**

Macroeconomic stability, while addressing many of the longstanding vulnerabilities — high inflation, profligate fiscal policy and a fragile financial system — opened the door to new vulnerabilities. With greater confidence in the Turkish economy and in an environment of ample liquidity, capital inflows surged. As a result, the Turkish lira appreciated, bank lending surged, private savings continued to fall, private investment rose, and imports increased. These influences created strong pressures on the current account balance, which was financed too heavily by short-term capital inflows. Thus the new vulnerabilities centered on a large current account deficit and exposure to sudden stops, variable risk premiums, and exchange rate variability.

The success of stabilization also changed the basic policy trade-off in situations of overheating. In the previous decades, the most important macroeconomic trade-off was between growth and inflation. During the past decade, however, the trade-off was transformed. Inflation targeting with a flexible exchange rate, an open capital account, and globally tame inflation meant that episodes of excess domestic demand gave rise to larger current account deficits. In other words, the central trade-off that policymakers faced was between faster growth and lower current account deficits. Thus, a recipe for sustainable growth has yet to be found.

### **Turkey Faced New Challenges Stemming from Globalization during the Decade**

Turkish exporters faced difficult conditions with pressures for specialization, competition from globalization, and the appreciation of the Turkish lira. They were successful in meeting these challenges due in no small part to Turkey's shift toward more outward-oriented trade and supporting diplomacy. This shift in perspective, along with stable macroeconomic conditions, contributed to renewing export growth, increasing Turkey's global market share, diversifying product lines and markets, and in moving up the technology ladder.

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While there had been change in the composition of exports in favor of medium-tech products, such a transformation was not achieved in the case of high-tech products, which have high growth potential. Moreover, while the penetration of new markets, especially in the Middle East and North Africa, had been highly favorable for exports, Turkish exports have not been able to penetrate and take advantage of markets with the most growth potential.

### **The Goal of EU Accession was a Profound Force for Change**

The EU membership process had important effects in political, social, and legal spheres during the decade and had contributed importantly to economic successes. However, the vigor and single-mindedness of the push to adopt changes required by the EU faded after the middle of the decade because of external factors, disruptions in domestic politics, the difficult nature of remaining reforms, and the drop in support for EU convergence in Turkey.

It is not clear what this will mean for the future. Will the Turkish people and their political leaders recommit to the process of membership? If not, the absence of an EU push could eliminate interest in the continued pursuit of many institutional changes. Alternatively, changes early in the decade in response to the drive for EU accession could set in motion a process that would eventually resume. Thus, the EU accession process was the beginning of a major transformation, with as yet unclear economic implications for the future.

### **Substantial Challenges Remain for the Next Decade**

Changes, even ones that endure a decade of challenges, can be undermined as they encounter new circumstances. It is



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certainly too soon to tell whether the achievements in the monetary, fiscal, and financial frameworks over the past decade will be permanent and able to steer the economy away from the risks of overheating and excessive dependence on foreign financing. Moreover, with successes came higher expectations and greater ambitions for the speed of income convergence with advanced countries and for the inclusiveness of prosperity.

Several key challenges must be met to complete the unfinished parts of the 2000-10 transformation and to ensure that changes for the good will last. These challenges include:

1. ensuring macroeconomic and financial stability by reining in overheating pressures and committing to a specific rule on fiscal policy;
2. managing vulnerabilities by addressing the large current account deficit and structural causes of low private savings;
3. managing growth potential and inclusive growth by improving the use and the quality of Turkey's human capital through reform of the labor market and the education system as well changes in the role of and attitudes toward women in the economy; and
4. grasping opportunities of globalization by improving cost competitiveness, removing structural impediments to productivity growth, and promoting private investment in export sectors to push the structure of exports further and faster up the technology ladder.

Should choices be made to address these challenges actively, Turkey could secure a stronger and steadier development path in the decade to come.

### About the Authors

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