# Turkey: A Dynamic Economy Confronted With Political Uncertainty

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Turkey is an atypical emerging country. It is a longstanding member of Western institutions in the club of developed countries: the Council of Europe since 1949, NATO (1951) and the OECD (1960); it is connected with the European Union by an Association Agreement since 1963, superseded by a Customs Union in 1995, and official European Union accession talks were launched in 2005. Compared with its degree of institutional integration in the developed world, Turkey's level of economic and social development is seriously out of step. Its economic takeoff was late, slow and most of all chaotic. The weight of its socio-political problems long inhibited its growth potential. And although the impact of these problems has dwindled in recent years, they continue to weigh on the future of the Turkish economy.

Turkey is close to mature markets (the former European Union of 15) as well as growth markets (Russia, the Middle East, South East Europe). As a neighbour of the Balkans as well as the Middle East and the Caucasus, controlling the straits that give fleets in the Black Sea access to the Mediterranean, it possesses a considerable geostrategic resource. It also enjoys an extensive and dynamic domestic market. Its population is estimated at 72 million inhabitants and—another strong point—its demographic growth is experiencing a rapid deceleration. Above all, Turkey currently has a demographic window of opportunity. The population dependency rate (the ratio of under 14 and over 65 to the total population) is on a downward slide; it fell from 82% in 1975 to 55% in 2000. According to demographic forecasts, it will continue to decrease in coming years to reach 31% in 2025. Such a population structure is generally considered to be a favourable condition for a quick takeoff; South Korea in the 1970s is an illustration.



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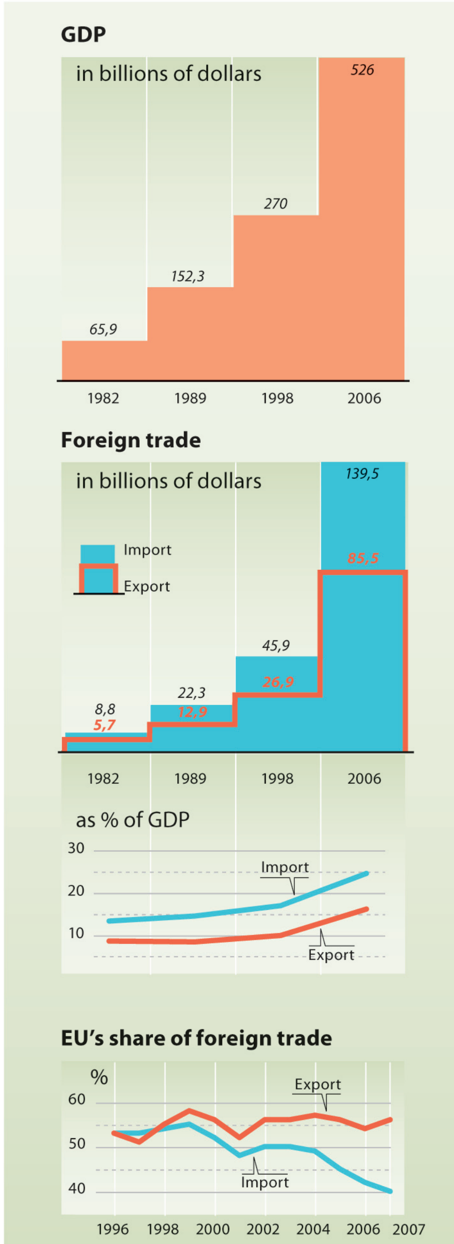
## EU oriented dynamism

Turkey began its emergence process in the 1980s. The economic liberalization programme implemented in the wake of the 1980 military coup espoused the structural adjustment policies recommended by the international financial institutions. By deploying a monetarist policy and a liberalization policy accompanied by direct export incentive measures, Turgut Ozal's government encouraged companies, which had developed in the shadow of import substitution policies, to seek markets abroad. The liberalization policies of the 1980s made a reality of the emergence potential, accumulated during decades of protectionism and state development policies. Turkish companies, integrated as they were into a fairly diversified industrial fabric with a certain level of know-how and production capacities, were able to penetrate the markets of Arab oil-exporting countries in the 1980s and those of the CIS in the 1990s. When the Customs Union with Brussels came into effect, Turkish foreign trade made its second leap forward and the European Union became its main trading partner (over half its exports and imports).

Turkish society's dynamism, both regarding population movements (immigration to Europe, emigration from the country to the city and from east to west) and in economic terms, accelerated in the 1990s. Taking advantage of an available supply of cheap labour, SMEs went after surrounding foreign markets, new industrial and financial groups appeared on the Turkish economic scene, and certain provincial cities became industrial clusters. The dampening of employee bargaining power by the new labour code, the greater flexibility granted employers in their recruitment practices, and a public policy allowing the informal sector to develop have made Turkish companies much more competitive. The main accelerating factor of Turkey's emergence was its engagement in a fairly deregulated

figure 34: **Turkey's foreign trade, 1982-2006**




Source: Compilation by Ahmet INSEL, from TUIK (Turkish Statistics Institut) data.

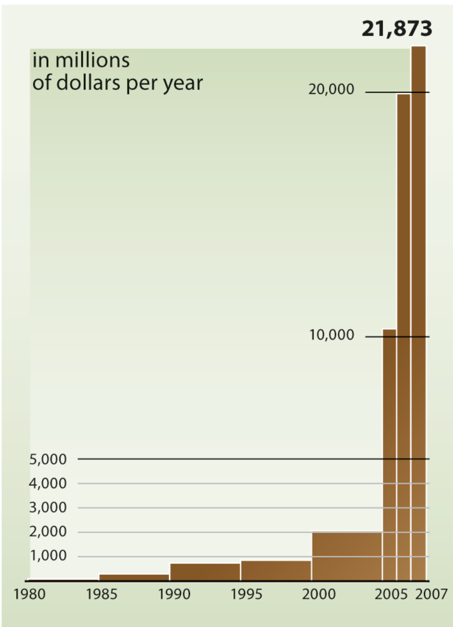
Sciences Po / CERI et Atelier de cartographie, février 2008 market economy. The same factor was also responsible for the repeated financial crises in the 1990s.

The most patent sign of Turkey's entering the emergence process was the sudden rise in its foreign trade. The volume of foreign trade has multiplied 15-fold in the past 25 years and it has considerably changed in make-up. Turkey went from being an exporter of agricultural and mining products in the early 1980s (57% of its exports came from agricultural products and livestock) to a supplier of industrial products (90% of Turkish exports now include textiles and clothing, semi-processed goods, durable consumer goods including cars and household appliances). Despite this performance, Turkey still has a trade deficit (another atypical situation among emerging countries) due to its concentration of imports in energy, semi-finished manufactured goods and investment credits. Exports cover about 60% of imports. Growth is structurally dependent on imports. On the other hand, finished consumer goods occupy a minor place in imports, and Turkey remains to a large extent self-sufficient in food.

Foreign direct investment (FDI), starting at a very moderate level in the 1980s, followed this opening up but with a lag of nearly a decade. Acceptance of Turkey's application to the European Union at the Helsinki conference in 1999 and the official opening of accession talks in 2005 prompted a rise in FDI. The volume of FDI actually made in 2006 was equivalent to the amount received in the six years between 2000 and 2005 and much higher than the sum of FDI received between 1980 and 2000. In reaction to this overture, Turkish companies began investing in CIS countries, in the Middle East and more and more in the European Union. In 2006 the stock of Turkish company investments abroad nevertheless remain fairly low ($8 billion, 60% of which was in the 25 EU member countries), while the stock of inward FDI entering Turkey was $88 billion.

Since currency exchange restrictions were lifted and the Turkish lira became a convertible currency in 1989, Istanbul has gradually become a prominent financial centre among emerging countries. Offering among the highest positive real interest rates in the world, Turkey has attracted a large flow of portfolio investments whose stock amounted to nearly that of FDI in 2006. This foreign exchange resource enables it to cover the growing current transactions deficit (equivalent to 7.5% of GDP). The structural vola-

figure 35: **Inward FDI flows to Turkey, 1980-2007**




Source: Compiled by Ahmet INSEL from Turkish Treasury data.

Sciences Po / CERI et Atelier de cartographie, February 2008



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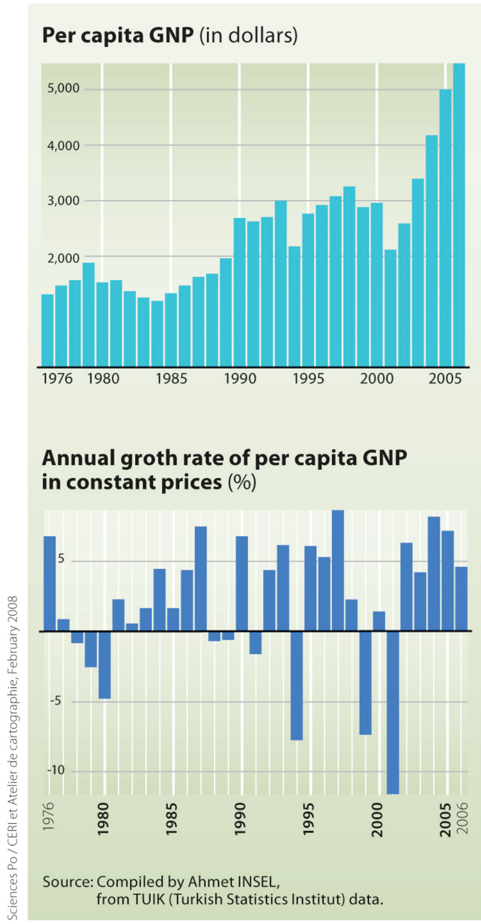
tility of portfolio investments has made the economy more vulnerable to financial and political crises. Nevertheless, in 2007, during international financial tremors and domestic political crises, capital flight was minimal and the Turkish lira resisted. The dollar crisis and real interest rates among the highest in the world, together with investments denominated in Turkish lira, have reinforced stability. The backlash of this latter fact is the cost of public debt: in 2007, servicing the debt continued to mobilize 32% of Turkey's budget resources, compared to 78% in 2000.

## Insufficient investments for progress

The Turkish economy, after stagnating for a long time in the lower bracket of the group of intermediate income countries, manage to pull off its second takeoff, enabling it to surpass the threshold of $5,000 per capita GDP in 2005. Expressed in purchasing power parity, the per capita GDP has gone from $6,550 in 2002 to $8,400 in 2006. The economic results of the 1990s, marred by recurrent financial crises and an annual inflation rate wavering between 50 and 100%, were very mediocre indeed. On emerging from the last crisis in 2001 (a 9% drop in GDP), the Turkish economy recovered its 1994 level of per capita income. Implementation of an austere budget policy with a primary budget surplus (before interest was paid) amounting to 6.5% of GDP, and the stabilization of the banking system helped to break the vicious circle of the 1990s. Since 2002, the Turkish economy has entered a cycle of sustained growth, accompanied by gradual disinflation, which has enabled it to increase the volume of its GDP by 40% in six years. During that same timeframe, the annual inflation rate fell from 80-100 % to 8-10%.

This exceptional growth (18 successive quarters with a growth rate of over 3%) took the emergence of the Turkish economy one step higher. This was achieved by additional buttressing of the Turkish economy against the European Union (hence the acceleration of FDI), a spectacular leap forward in labour productivity,

figure 36: **Turkey's Gross National Product (GNP), 1976-2006**




Source: Compiled by Ahmet INSEL, from TUIK (Turkish Statistics Institut) data.



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and renewed political stability after the end of 2002. However, growth has not been backed by a substantial investment effort. The per capita level of investment has remained practically unchanged over the past ten years (1,450 euros in 2005 compared to 1,375 euros in 1997). Here we find one of the long-term weaknesses of the Turkish economy. Without a significant resumption of investments, labour productivity gains are likely to dry up quickly, particularly because of delays accumulated in education and health care.

According to UNPD data, Turkey has come down about 20 pegs on the world Human Development Index (HDI) with respect to its rank in terms of per capita GDP expressed in purchasing power parity (among 177 countries, 84th in the first case and 66th in the second). This downgrading is basically due to the low percentage of children attending school. Despite the youth of its population, the country devotes only about 4% of its GDP to education. By comparison with the achievements of other emerging countries, the average length of education (six years) remains low and the education available, quantitatively insufficient and elitist, remains particularly deficient at the secondary education level. Low average investment in human capital is likely to cripple the competitiveness of the Turkish economy with respect to other emerging economies in the years to come.

The overvaluation of the lira with respect to international currencies and the growing current transactions deficit are factors of short-term vulnerability in the Turkish economy. The fairly high level of public debt, especially the acceleration of internal indebtedness denominated in local currency, heightens this vulnerability. Moreover, the low rate of internal savings and the lack of human capital, by making the Turkish economy susceptible to competition from low-wage countries and emerging countries with greater investment capacity, heighten the risk of long-term vulnerability.

The role of the informal economy in the dynamism of Turkish economy is a controversial topic in Turkey. It allegedly accounts for 30% to 40% of GDP, depending on estimates. The OECD estimates that in the parallel economy, productivity is low and work conditions mediocre, but administrative rigidities and the weight of social contributions encourage economic actors to stay in it. According to other analysts, the family SMEs that make up the informal economy fit into the world economy by positioning themselves as subcontractors. These small, highly flexible structures make up the heart of "Turkish-style post-Fordism". But by helping to worsen the welfare deficit, the informal economy has a negative impact on the state budget and the quality of social welfare services. In the face of competition from China, a major challenge for Turkish governments is to foster the absorption of the informal economy into a dynamics of growth more based on high added-value products.

The weight of the agricultural sector and its lack of productivity constitute the other weak point. Agricultural activity, which has been plummeting in recent years, continues to employ slightly less than 30% of the active population whereas



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it only contributes 10% of GDP. It is too often carried on by small family farms. Rural-urban drift is pushing up the number of the jobless in big cities (over 10%), an unemployment rate that economic growth has not managed to stem. Even if nearly the entire jobless population is covered by universal health insurance, only a minute portion of the jobless (about five per 1,000) receive payments from the unemployment insurance fund. The particularly low female unemployment rate (28%), atypical among emerging countries, also reduces the effects of the demographic window of opportunity.

Lastly, Turkey suffers from high energy dependence. Energy represents 20% of its imports and increases the trade deficit. One dimension of Turkey's foreign policy is to ensure the security of energy supplies by bilateral agreements with its neighbouring gas and oil suppliers and by a platform country strategy for the delivery of Caucasian and Iraqi gas and oil (the port of Yumurtalik has become a nerve centre of the Eastern Mediterranean). This strategy also puts Turkey in a position of rivalry with Russia. Along with the ambitious programme to control water resources, which kindles tensions with the countries bordering the Tigris and Euphrates and poses environmental problems, the government is also considering undertaking a highly controversial programme to build nuclear power stations starting in 2010.

## The slow demise of economic and political life

Despite strong economic growth in these past few years, several factors diminish the mean term predictability of the Turkish economy: growth was beginning to sputter towards the end of 2007, while political instability in the region (uncertainties about the future of Iraq, questions over the status of Iraqi Kurdistan, the growing tension between the US and Iran), the doubts expressed in Turkey about pursuing the strategic alliance with the United States, and more recently the threat of Turkish military intervention in the north of Iraq, have heightened risks of instability. Lastly, the uncertainties dawning in the past two years about the outcome of the EU accession talks have diminished the transformative capacities of the accession process. In fact, the pace of reform has slowed considerably since 2005, and Euroscepticism is gaining ground in Turkish society.

In the first half of the 2000s, the foothold in Europe provided most of the impetus for the explosion of political modernization. Sovereignty-concerned, nationalist and conservative resistance was weakened by the strength of the pro-accession social dynamics. But with this enthusiasm on the wane, the primary factors of internal tension have returned to the fore. Contrary to what supporters of the privileged partnership believe, limiting Turkish-EU relations to the economic sphere may revive domestic social and political tensions that would undermine growth, as they did in the 1990s.



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During that decade, growth was highly cyclical: high-growth periods were followed by equally strong recessions. Political instability, exacerbated by cobbled-together government coalitions, was in part responsible for the great economic instability. It must be admitted that the political stability following the November 2002 elections won by the Justice and Development Party has done much to promote the current stable economic growth.

On a domestic level, growing inequality in both social and regional terms is stirring social tensions. In 2005, one-fifth of the Turkish population was living below the absolute poverty threshold. That same year, the poorest 5% of the population earned 0.8% of the income as opposed to 23% for the richest 5%. Lastly, the gap between average incomes in the wealthy western provinces and the poor eastern provinces remains very high. The failure to resolve the Kurdish conflict condemns the eastern regions to underdevelopment and in the medium term risks spreading tensions related to the Kurdish problem across Turkey (increased terrorist action in the cities, multiplication of local interethnic conflicts, etc.). Added to that are the spasms caused by social and political change, of which the growing tension between the conservative (Muslim-liberal) and secular (secular-Republican) camps is a direct product. This tension reproduces the conditions that enable the Turkish Army to position itself as a political actor and compounds the uncertainties that weigh on Turkish political stability in the medium term.

For the past two decades, Turkish society has been experiencing the convulsions of its integration into the world economy. Today, as yesterday, the incapacity of the political class to normalize democracy and rebalance relations between state and society remains its Achilles' heel. The continuation of Turkey's emergence, however, depends on making improvements in both these areas. The contrast between the mediocre economic performance of the 1990s and the considerably more vigorous achievements of the 2000s is the best proof of the existence, in the case of Turkey, of a close relation between political development and economic development.

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