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Turkey's Economic Future and the AKP

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On April 30, 2007, the Turkish stock market slumped and the value of the lira dropped following a massive demonstration in Istanbul against the Justice and Development Party (AKP) government, coupled with a statement by the military voicing support for secularism. Previously, the comparatively healthy Turkish economy had boosted the chances that the AKP, rooted in the country's Islamist movement, would achieve further electoral victories this year. On April 24, Prime Minister Recep Tayyip Erdogan named Foreign Minister Abdullah Gul as his party's candidate for president -- a legislatively elected post. In the April 27 parliamentary session, however, the secular opposition boycotted the vote, and the AKP failed to muster the required two-thirds majority. The Turkish constitutional court subsequently annulled the vote, and the status of the presidential election is now uncertain. In the meantime, the parliament has moved legislative elections up from November to July 22.

These developments have blocked the AKP from unilaterally electing the country's next president and ushered in a period of overlapping presidential and legislative elections, exacerbating political tensions between the AKP and secular Turks.

So far, strong economic figures, attributed to International Monetary Fund (IMF) advice, have earned the AKP domestic support despite a slowdown in European Union (EU) accession talks and ongoing regional instability, both of which might otherwise affect the economy. Given increasing political tensions, however, economic stability, the linchpin of the AKP's success, is now at stake.

Recent Economic Gains

After coming to power in 2003, the AKP pursued an economic reform agenda inherited from the previous coalition government. Since late 2005, however, the party has postponed a privatization agenda and further economic reforms to avoid negatively affecting its supporters in advance of this year's crucial elections. Meanwhile, EU accession talks have been stalled since December 2006, when the union froze negotiations on eight policy areas due to issues such as Cyprus. In particular, the EU demanded that Turkey open its ports and airports to Greek Cypriot ships and aircraft.

In purely economic terms, however, Turkey is moving rapidly toward compliance with the EU's accession criteria. The country's budget deficit stands at 2 percent of its gross domestic product (GDP), well below the EU ceiling of 3 percent. At 61 percent of GDP in 2006, public debt was only slightly above the EU target of 60 percent, and the economy has grown by an average of nearly 8 percent in each of the past four years, well above the 2.1 percent average of the EU's twenty-five member states. Per capita income, calculated in terms of purchasing power parity, climbed to $8,400 in 2006 -- up from $6,700 in 2002. Erdogan has promised to boost this figure to $10,000 within the next five years.

Turkey's biggest success since 2003 has been its ability to attract foreign direct investment (FDI). Between 1980 and 2003, the country saw $18 billion in FDI. Between 2003 and 2006, however, FDI jumped from $1.7 billion to $20 billion. More than $30 billion is expected in 2007. Perhaps most important, FDI financed 60 percent of the nation's account deficit in 2006.

Ongoing Economic Challenges

Hot money. On April 3, the *Financial Times* reported that "the biggest threat to continued rapid expansion of the Turkish economy . . . is high interest rates." There is concern that some of the capital flows are "hot money," attracted by interest rates of nearly 20 percent and the appreciating Turkish lira, which the *Financial Times* described as "perhaps overvalued." (The new lira, instituted in January 2005, dropped six zeros from the old.) Such funds provide liquidity but hurt corporate profits and exports.

Deficit. The current account deficit is also problematic, growing from $22.7 billion to $31.4 billion in 2005-2006 and becoming a major economic risk. This expansion seems to be driven by an increase in the private sector's international debts, encouraged by the strong Turkish lira. The deficit reached 8 percent of GDP in early 2007.

Inflation. In 2006, Turkey's Central Bank failed to meet the inflation rate target of 5 percent. By year's end, inflation stood at 9.6 percent. In 2007, the country is aiming for a 5.8 percent average inflation rate, although the Economist Intelligence Unit forecasts a rate of about 6.5 percent by year's end.

Trade deficit. Turkey's exports, valued at $85 billion, are far from covering its imports, totaling $137 billion as of 2006. This year, the country is hoping for $95 billion in exports; a slowdown in domestic demand may facilitate improvements as well. The anticipated decrease in energy prices now seems overly optimistic, however.

Unemployment. The unemployment rate is difficult to measure in Turkey because of the size of the unregistered economy. Despite a small, recent drop, the official unemployment rate of 9.9 percent will continue to be a problem in 2007.

Income distribution and poverty. Income inequality is a key policy concern; the poverty rate was 20.5 percent in 2005 (according to the survey of a Turkish National Statistics Institute). At the same time, however, the number of billionaires in Turkey jumped from six in 2002 to twenty-six in 2006, generating support for the AKP among large businesses.

Comparable countries. Turkey's economic performance has improved to an impressive degree since 2002, but it has not surpassed that of new EU members such as Hungary and Poland, which Turkey sees as competitors. Ankara needs to accelerate reforms and provide research and development, employment, and education programs for small- and medium-size enterprises.

In March, the IMF began discussions on its 2007 Article IV consultation with Turkey. This is the sixth review in Turkey's stand-by agreement. At the conclusion of the talks, the IMF was broadly positive in its review of Turkey's performance. According to the Economist Intelligence Unit, however, the IMF emphasized the need to resume the counterinflation process, maintain the Central Bank's independence, keep fiscal policy tight, and implement delayed social security reforms as soon as possible.

Conclusion

The future of the AKP government is closely linked with Turkey's economic performance and with foreign and domestic political developments. There are two sets of domestic issues that might affect voter sentiment toward the AKP in the upcoming elections. On the one hand, any campaign-related tensions between the AKP and secular parties would likely stress the economy and reduce support for the ruling party -- especially among large businesses, which have greatly benefited from the recent economic stability. On the other hand, the Turkish economy is still fragile and open to international economic risk. Consequently, both Turkish economic stability and the AKP's political future could be affected by external factors such as global economic fluctuations or possible political crises in the Middle East.

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