The Effects of the European debt Crisis on the Economic Future of Turkey: A country study

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Abstract
This article will discuss a simple question: How has Turkey been affected by the European Debt Crisis? The article will discuss general economic conditions in Turkey and provide important economic indicators, describe the history of Turkey’s involvement with the European Union, and relate how Turkey avoided the worst negatives of the European crisis. The article argues that Turkish domestic demand has been the driving force behind Turkey’s economic growth, and describes the important role of Turkey’s Central Bank. The article concludes by discussing the relationship between the IMF and Turkey and the necessary structural reforms required for transforming the economy of Turkey, and the main strengths and weakness in the Turkish economy.

Key words
Turkish economy, European crisis, domestic demand, Central Bank

1. Introduction
The present unstable macro-economic environment of the European Union is steeped in much uncertainty. After the 2008-2009 financial crisis in the United States, the resulting contagion spread to the European Union, although some have argued that the economic crisis actually has its deeper roots within the financial system of European continent itself. The sovereign debt of many countries has been downgraded because of high fiscal deficits and international investors have been exposed to the real possibility of the risk of default. As a result, for example, European leaders recently pledged to enforce at least a “50% haircut” on the value of Greek bonds (Worstall, 2011) and moved to stabilize the economies of the so-called “PIIGS” countries of Portugal, Ireland, Italy, and Spain—in addition to Greece. Several European nations were simply “unable to employ independent monetary policy in order to help battle the economic downturn.” (Investopedia, 2013a). It is important to note that by May 10, 2010, European leaders had already approved a 750 billion euro stabilization package to support the economies of these nations. (Investopedia, 2013a).

The economic woes of the PIIGS have inflamed the debate about the future of the single European currency employed among the seventeen Eurozone nations. 2 Critics of the euro point out that continued economic disparities within Europe could lead to a breakup of the Eurozone itself, although it is interesting to note that at present there is neither any way for a nation to leave the Eurozone once admitted or to be

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1 The article is the result of a fall 2012 independent study-research project undertaken by Mehmet Kilic, a senior undergraduate student at Seton Hall University, under the supervision of Dr. Richard Hunter, Chair of the Department of Economics and Legal Studies. Mehmet is of Turkish background and Dr. Hunter, a specialist in emerging markets, has undertaken a similar study in relation to Poland. (Hunter & Ryan, 2012; Hunter & Ryan, 2013).
2 The Eurozone currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.
expelled from the arrangement. In response, European Union leaders proposed essentially a unique “peer review” or committee system for approval of national spending budgets in an effort to promote closer economic integration among European Union member states and save the system which has seemed to serve Europe well. (Investopedia, 2013a; generally, Choksi, 2010).

Because the European Union is Turkey’s largest exporting partner, Turkey has been exposed to the shocks or dysfunctions stemming from the ongoing European crisis in many unique ways. This issue is of importance to the health and long term sustainability of Turkey, as well as the stabilization of the macro-economy environment—goals sought by the Central Bank of the Republic of Turkey or CBT. What is clear is that Turkey’s status as an emerging market and a regional power lies in its economic performance. (The seven largest emerging and developing economies by either nominal GDP or GDP (PPP) are China, Brazil, Russia, India, Mexico, Indonesia, and Turkey). In geopolitical terms, Turkey also has the ability to be a powerful player in the mobilization of democracy in the region. Turkey is the first Islamic democracy in the region and it has the potential to influence, and perhaps lead, neighboring countries into a similar path to sustained prosperity and the recognition of democratic political and economic rights.

2. Brief history impacting on the political and economic environment

Turkey is frequently described as the “eye of the world” because of its strategic geographical location. It is literally a bi-continental country, located in Western Asia, and is bordered by eight countries: Bulgaria, Greece, Georgia, Armenia, Azerbaijan, Iran, Iraq, and Syria. Turkey is also the only Islamic democracy in the world. These distinctions are beneficial to Turkey because they have helped Turkey to integrate with the west and more fully developed countries, while still maintaining its unique character as an Islamic state. Turkey is a member of the Council of Europe, NATO, the OECD, a founding member of the WTO, the Organization for Security and Cooperation (OSCE), and the G-20 set of the world’s major economies. Turkey has long sought membership into the European Union but has been trapped in political gridlock. Turkey also has strong affiliations with the Middle East, Asia, and Africa. Reflecting its Islamic background, Turkey is a member of the Turkic Council, the Joint Administration of Turkic Arts and Culture, the Organization of Islamic Cooperation (OIC), and the Economic Cooperation Organization.

Most recently, Turkey has embarked on a sustained pattern of economic reform and development. From 2002 to 2007, GDP grew at an annual rate of 7%. After the financial crisis in 2008, Turkey found itself in a recession—but at a 5% rate—far less than many other European nations. By 2010, the economy rebounded and grew at a rate of 10%. In 2011, the economy grew by 8.2 %. [As of the first of the year in 2013, the Economist reports that Turkey experienced a slowed growth rate of +1.6% in Quarter 3; but projected an overall increase of GDP by 3.2% for the entire year. Industrial production showed an increase 11.3% in November 2012 as opposed to November 2011. (Economist, January 5, 2013, p. 72; Economist, January 12, 2013, p. 84)].

Turkey remains eager to join the European Union and is pushing the kinds of economic reforms that are necessary preconditions to EU membership. Several reasons have been offered to bolster Turkey’s claim to EU membership. “The nation also boasts a younger workforce than most of nearby Eastern Europe. The country is home to a thriving manufacturing base serving both Western Europe and the Middle East. Turkey’s banks are profiting handsomely from an explosion of corporate and consumer lending.” (Bloomberg Business Week, 2005; generally, cnnTurk.com, 2012). This issue will be discussed later in the article.

3. The Turkish economy

Turkey’s economy is driven by three predominant sectors: industry, agricultural, and most recently, service. The agriculture sector accounts for 30% of employment. An overview of major import partners and categories of imports and exports include:

Turkey’s major exports: include: clothes, electronics, automobile, agricultural products, iron, steel, mineral fuels, oil, precious stones, tobacco, olives, hazelnuts.

Turkey Imports: electrical equipment, mechanical appliances, optical instruments, iron and steel, pharmaceuticals.

Major Import Partners Include: United States, Russia, Germany, Italy, France, Switzerland, UK, OIC Members.
According to information found on Turkey Economy 2012 (CIA, 2012), based upon data gleaned from the CIA World Fact Book Database, Turkey’s positive performance has been achieved as a result of decisive political action. “An aggressive privatization program (Guran, 2011) has reduced state involvement in basic industry, banking, transport, and communication, and an emerging cadre of middle-class entrepreneurs is adding dynamism to the economy.” Turkey's traditional textiles and clothing sectors still account for one-third of industrial employment, despite what has been described as “stiff competition” from international markets and from a fundamental change in the global trading system, characterized by the end of the global quota system which formerly protected many Turkish products from international competition. (Generally, Bhala, 2007).

In recent years, Turkey has experienced a growth in the manufacture of goods and in other sectors. Most notably, the automotive, construction, and electronics industries are gaining importance and have surpassed textiles within Turkey's export mix. Plans for the construction of both oil and natural gas pipeline from Central Asia to Europe through Turkey are in progress and will benefit Turkey in the long run by cutting Turkey's dependence on foreign oil and by establishing Turkey as an important player in the “global oil” scenario. (CIA, 2012).

**Economic indicators**

We shall first take a look at some leading economic indicators in the Turkish market (CIA, 2012):

**GDP** (purchasing power parity):
$1.053 trillion (2011 est.)
country comparison to the world: 17
$988 billion (2010 est.)
$906.9 billion (2009 est.)
note: data are in 2011 US dollars

**GDP (official exchange rate):**
$763.1 billion (2011 est.)

**GDP - real growth rate:**
6.6% (2011 est.)
country comparison to the world: 29
8.9% (2010 est.)
-4.8% (2009 est.)

**GDP - per capita:**
$14,600 (2011 est.)
country comparison to the world: 86
$13,800 (2010 est.)
$12,900 (2009 est.)
note: data are in 2011 US dollars

**GDP - composition by sector:**
agriculture: 9.2%
industry: 26.9%
services: 63.9% (2011 est.)

**Labor force:**
26.46 million
country comparison to the world: 23
note: about 1.2 million Turks work abroad (2011 est.)

**Labor force - by occupation:**
agriculture: 25.5%
industry: 26.2%
services: 48.4% (2010)
Unemployment rate:
10.3% (2011 est.)
country comparison to the world: 112
12% (2010 est.)
note: underemployment amounted to 4% in 2008

Population below poverty line:
16.9% (2010)

Household income or consumption by percentage share:
lowest 10%: 2.1%
highest 10%: 30.3% (2008)

Distribution of family income - Gini index:
40.2 (2010)
country comparison to the world: 62
43.6 (2003)

Investment (gross fixed):
21.8% of GDP (2011 est.)
country comparison to the world: 95

Budget:
revenues: $176.8 billion
expenditures: $189.2 billion (2011 est.)

Taxes and other revenues:
23.2% of GDP (2011 est.)
country comparison to the world: 130

Budget surplus (+) or deficit (-):
-1.6% of GDP (2011 est.)
country comparison to the world: 66

Public debt:
42.4% of GDP (2011 est.)
country comparison to the world: 71
43% of GDP (2010 est.)

Note: “Data cover central Government Debt, and excludes debt instruments issued (or owned) by Government entities other than the treasury; the data include treasury debt held by foreign entities; the data exclude debt issued by subnational entities, as well as intra-governmental debt; intra-governmental debt consists of treasury borrowings from surpluses in the social funds, such as for retirement, medical care, and unemployment. Debt instruments for the social funds are sold at public auctions.”

Inflation rate (consumer prices):
7.8% (2011 est.)
country comparison to the world: 166
8.6% (2010 est.)

Central bank discount rate:
5.25% (31 December 2011)
country comparison to the world: 13
15% (22 December 2009)
Commercial bank prime lending rate:
16% (31 December 2011 est.)
country comparison to the world: 23
19% (31 December 2010 est.)

Market value of publicly traded shares:
$306.7 billion (31 December 2010)
country comparison to the world: 28
$225.7 billion (31 December 2009)
$117.9 billion (31 December 2008)

Agriculture - products:
tobacco, cotton, grain, olives, sugar beets, hazelnuts, pulse, citrus; livestock

Industries:
textiles, food processing, autos, electronics, mining (coal, chromate, copper, boron), steel, petroleum,
construction, lumber, paper

Industrial production growth rate:
8.5% (2011 est.)
country comparison to the world: 18

In general terms, Turkey escaped the worst effects of the crisis in Europe without major damage to its economy. “However, unlike developed countries and other emerging markets, Turkey survived the financial downturn in 2008 without relying on external emergency bailout packages.” (Sirkeci, 2012). This situation holds much promise for potential investors into the Turkish economy.

4. Turkey and the EU
As might be expected, Turkey’s largest trading partner is the European Union. Despite thus far failing in its bid to join the European, “The EU and Turkey are linked by a Customs Union agreement, which came in force on 31 December 1995, pursuant to the 1963 EU-Turkey Association Agreement, which aims at promoting trade and economic relations.” The Customs Union is ambitious but does not cover essential economic areas, such as agriculture, to which bilateral trade concessions apply, services or public procurement.” (Dimereva, 2009). The European Trade Commission (ETC) reports that the EU ranks as number one in terms of Turkish exports and imports; Turkey ranks 7th in the EU’s import and 5th in the EU’s export market. As of 2010, Turkey’s percentage of exports to the EU was 46.3 %. Turkey exports roughly 38% of its machinery production to the EU.

Another factor in the Turkish economy is the growing importance of Foreign Direct Investment (FDI) in the relationship between Turkey and EU. In the period between 2008 and 2010, FDI inflows from Turkey to the EU amounted to €2.1bn, whereas EU FDI flows into Turkey were €14.7bn in the same period. In 2011, FDI inflows were $15.904. The website, Invest in Turkey (2013), notes the following:

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3 It should be noted that if Turkey were successful in its attempt to join the EU, it would be required to meet the so-called “Maastricht convergence criteria.” These criteria include:
• Maintaining an inflation rate of no more than 2.3 percent; Maintaining a budget deficit at or below three percent of GDP; and
• Maintaining the level of government debt at no more than 60 percent of GDP. (Generally, Afxentiou, 2000).

4 Decision No. 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union (96/142/EC).

5 The website, Invest in Turkey, provides the following information:
• FDI inflows 2005-2011;
• FDI inflows by sector;
• Geographic breakdown of FDI in the Turkish economy; and
• Number of companies with international capital.
10 Reasons to Invest in Turkey

1. Successful economy
2. Population
3. Qualified and competitive labor force
4. Liberal and reformist investment climate
5. Infrastructure
6. Centrally located
7. Energy corridor and terminal of Europe
8. Low taxes and incentives
9. Customs union with the EU since 1996
10. Large domestic market

(Invest in Turkey, 2013)

Avoiding the European crisis

As indicated by data found in the January 5, 2013 Economist, economic dysfunctions in Europe have posed a clear threat to Turkey’s growth, as demand for Turkish products fell and Turkey experienced a decrease in Turkish exports. An upsurge in available credit and a growing current accounts deficit (-$53.1 billion) has created some concern over long-term financial stability, as foreign investors have continued to flood Turkey with capital. As indicated, statistics show that the EU is Turkey’s largest and most important trading partner. This symbiosis exposes Turkey to recurring economic shocks from Europe, as Europe attempts to right its economic ship. [As of January 2013, the Eurozone is still experiencing a negative growth of -0.6%; and an unemployment rate of 11.7%. (Economist, January 5, 2013, p. 72)]

Should the European debt crisis persist or even worsen, Turkey will have to rethink its export strategy and take further steps to diversify its export market. Reflecting a historical perspective as well as a modern application, two researchers noted: “If a country’s exports decline because its trading partners are facing a crisis, then it hurts that country’s trade balance and can lead to an unsustainable current account position. Similarly, a country could face a crisis through contagion capital outflows from neighboring countries. This is a crucial issue for an emerging market economy like Turkey.” (Binatli & Sohrabji, 2008, p. 174).

Turkey plans to hedge its exposure to Europe by diversifying its exports to different trade partners. What is the nature of Turkey’s strategy? According to Econowatch.com (2010), exports to countries in Africa and Central Asia have increased tremendously. Trade with the Organization of Islamic Countries (OIC) jumped by more than 50% in 2008. FDI inflows from the Middle East countries increased to almost $2 billion in 2008. Exports to Iraq increased by 75% in Quarter 1 of 2009, and trade relations with Africa were expected to strengthen in the period 2010-2012. Statistics developed by the Oxford Business Group (2011) indicated that the Middle Eastern share of Turkish exports increased from 14% in 2007 to 19% in 2011, and exports to Asia have grown from 4.8% to 7.2%. The authors noted: “A renewal of stability in Libya, where Turkish businesses have historically thrived, would further diversify Turkish foreign trade. Turkey would still suffer in the face of European stagnation, but it is finding alternate markets for its goods.” (Oxford Business Group, 2011). Likewise, Forbes International (2009) reported that exports to the United Arab Emirates increased by 6% since 2009. The new mix created as a result of diversification in trade partners and patterns certainly has lessened the negative impact of a European recession.

Domestic demand driving growth

In a piece entitled, “Turkey: Sustaining Growth,” the Oxford Business Group (2011) noted: “Domestic demand continues to drive the Turkish economy, with 28% y-o-y growth in private consumption responsible for 6.3 percentage points of GDP growth in the second quarter. This increase has been cited as a threat that may overheat the economy, leading many to call for Turkey’s central bank to raise interest rates. Now, with a slowdown likely, continued low rates may be what are necessary to keep the economy chugging along.” (Oxford Business Group, 2011). There is, however, a potential negative. The increase in GDP as a result of a growth in the demand for exports has resulted in a persistent and growing current account deficit. Turkey’s current account deficit is currently $53.1 billion. (Economist, January 5, 2013, p. 72). While this is relatively low compared to several developed economies (most notably the United States, Britain, Canada, Australia), it nevertheless exposes the threat of a potential “credit crunch” if external financing is interrupted or becomes unavailable.
What is unusual, however, is that Turkey’s growth in GDP appears to be driven by real growth – namely, a burgeoning middle class hungry for consumption – rather than a short-term bubble created by meeting some limited or unusual consumption need. Writes Dilek Karal in the Journal of Turkish Weekly (May 2012), “Today, the middle class in Turkey is beginning to be described as a group which has a tendency to consume not only basic goods, but also luxury ones. In this context, the research by Ipsos KMG describes the models of cars, features of relatively luxurious consumption goods like TV and so on, shopping habits, frequency of foreign travels and consumption of branded goods as significant indicators of middle class tendencies. According to these criteria, 59% of Turkey’s population is considered middle class.” An additional positive factor for Turkey’s future is that half the population is under the age of twenty-nine.

It is apparent that unless another major shock develops that is wholly unanticipated, Turkey has the tools of both monetary and fiscal policy available to avert another major recession—at least in the short term. This assertion is borne out by the UBS forecast of 3% growth for 2012 and an actual increase in GDP of 3.2% for the same period. (Economist, January 5, 2013, p. 72).

5. Monetary and fiscal policy mix: The role of Turkey’s Central Bank

As noted in its website, the Central Bank of Turkey (CBT) has two main responsibilities in the area of monetary policy: “The first is to achieve price and financial stability, thus contributing to the enhancement of the prosperity of individuals and society, and to the sound and functioning and improvement of money, credit, capital, goods, and service markets.”

“The second mission is to support growth and employment policies of the government provided that they shall not be in conflict with the objective of achieving and maintaining price stability.” (Central Bank of the Republic of Turkey, 2011).

The CBT embraced what has been termed as an “unorthodox approach” in loosening reserve requirements, which has allowed Turkish banks to meet up to 10% of their requirements in either dollars or euros. The CBT was also expected to lower reserve requirement ratios to further expand the volume of available credit. If successful, these measures were intended to bolster short-term growth, although they carried a risk of inflation. [The inflation rate stood at 9.1% for 2012, but has slowed to a projected 6.4% in the latest figures. (Economist, January 5, 2013, p. 72)]. As noted by the Oxford Business Group (2011) in its annual report, “Sustaining growth through a slowdown will require a careful balancing act from Turkey’s monetary policymakers.”

The annual report states that in order to counter any negative external shocks, the CBT has adopted a policy mix that has effectively combined policies relating to short term interest rates, with alternative policy instruments such as liquidity management, and reserve requirements. By implementing this three-prong strategy, the CBT aims to enhance the effectiveness of monetary policy and contain macro-financial risk.

The 2008-2009 crisis in Europe caused the Turkish Lira to depreciate and market indices to tumble. Turkey was required to tighten its monetary policy using a combination of required reserve rations, reserve accumulation, and capital controls.

The Economic Policy Research Foundation of Turkey, in its May 2011 report, encourages a cut in the budget deficit to ease the current account deficit. With that perspective in mind, Turkey has introduced a number of measures to deal with the current account deficit. These measures predominantly targeted the private sector savings gap. For example, the Central Bank has moved to prevent rapid credit expansion. However, experts note that even if these efforts proved completely successful and savings and investments of the private sector attain the proper balance, this can solve only one fourth of the current account deficit problem. What is clear is that the current account deficit must immediately be reduced to manageable levels. To this end, fiscal policy must also be significantly tightened. The three elements of a successful fiscal policy would certainly would include a balanced budget, significant improvement in addressing the private savings gap (close to the 2010 level), and reaching an acceptable and realistic balance in trade. Achieving these fiscal goals would bolster the possibility of both an ideal and sustainable outlook for Turkey. (Kalkan, 2011).
Relationship to domestic demand: The key

Turkey’s economy has clearly grown on the basis of an increase in domestic demand. The Economic Policy Research Foundation Report of May of 2011 (reported in Kalkan, 2011), referenced above, urges both the private and public sectors to avoid excessive borrowing. It also states a policy preference for longer maturities in all financial-borrowing vehicles, using the option of borrowing in the Turkish Lira as much as possible, and managing risk appropriately in order to increase the effectiveness of the measures taken by the CBT. These actions were intended to help strengthen the Turkish economy in the face of “exogenous shocks” occurring outside of the Turkish economy. What were some of the tentative observations made in the Report?

Europe’s relatively weak demand for Turkish exports has thus far not caused any fundamental instability in the Turkish economy. The European debt crisis did expedite the amount of investment flowing into Turkey. The surge in available credit and GDP driven by domestic demand has increased the current account deficit (currently at $53.1 billion) which can have a destabilizing impact on the economy. However, a surge in short term capital inflows because of the relative attractiveness of the Turkish economy can also make the economy vulnerable to sudden changes in capital outflows. The CBT will have to control fluctuations in credit that will support long-term sustainable growth by decreasing volatility in the Turkish capital market.

6. IMF outlook

Article 6 of the IMF Consultation Preliminary Conclusions (CPC) (2011) reported that the CBT engaged in several activities designed to fight the growing imbalance of trade. An increase in reserve requirement was designed to slow the flow of credit by raising intermediation costs associated with placement of money with third parties. The outcome of these policies resulted in a nominal depreciation of the Lira and a slowdown in credit growth, as planned.

Because of the interworking of international and domestic economic decision-making, the IMF outlook on Turkey is closely correlated to macroeconomic conditions experienced globally. The Turkish economy, by comparison to the Eurozone, may be considered to be robust (Eurozone growth still negative at -0.4%; Turkey, +3.2%) and its fiscal balance continues to improve. In terms of its long-range prospects, what is clear is that so long as Turkey can withstand exposure to major fluctuations or “shocks” in global liquidity cycles and swings in risk adjustments, Turkey’s economy can remain stable and thus can continue to attract significant amounts of FDI.

The IMF’s policy recommendations for Turkey

The IMF provided several policy recommendations for improving future prospects in the Turkish economy. (IMF Consultation Preliminary Conclusions (CPC), 2011). These include the following:

- Redesigning the policy framework to reduce the possibility for volatile capital flow driven cycles. This step would require more effective use of “fiscal, prudential, and structural policies”;
- Tightening financial policies geared toward reducing macro-prudential risks, which would enhance monetary policy when fighting inflation; (Investopedia, 2013b)
- Reducing attractiveness to short term “carry trades” associated with buying currencies that pay interest;
- Introducing structural reform in order to enhance labor market efficiency;

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6 Investopedia (2013b) provides this definition of Macro-Prudential Analysis: “A method of economic analysis that evaluates the health, soundness and vulnerabilities of a financial system. Macroprudential analysis looks at the health of the underlying financial institutions in the system and performs stress tests and scenario analysis to help determine the system’s sensitivity to economic shocks. Macroeconomic and market data are also reviewed to determine the health of the current system. The analysis also focuses on qualitative data related to financial institutions’ frameworks and the regulatory environment to get an additional sense of the strength and vulnerabilities in the system.” See Investopedia, “Macro-Prudential Analysis,” at http://www.investopedia.com/terms/m/macroprudential-analysis.asp#ixzz2HlyFiYPv (last visited January 10, 2013; generally, Kenc, Turhan & Yildiri, 2011).

7 Investopedia (2013c) provides the following definition of a currency carry trade: “A strategy in which an investor sells a certain currency with a relatively low interest rate and uses the funds to purchase a different currency yielding a higher interest rate. A trader using this strategy attempts to capture the difference between the rates, which can often be substantial, depending on the amount of leverage used.” http://www.investopedia.com/terms/c/currencycarrytrade.asp#ixzz2l972pjP1
- Regularizing the shadow or the underground economy; and
- Improving the investing climate, which would help stimulate domestic production and reduce dependence on imports.

The IMF commented: “These policy adjustments would deliver a balanced, less volatile output and bring greater confidence in Turkey’s growth prospects.” (IMF Consultation Preliminary Conclusions, 2011, p. 3).

**IMF on monetary policy**

The IMF CPC report asserts that monetary policy should reframe its focus on price stability within a transparent and consistent operating framework. The Turkish banking sector needs to remain adequately capitalized because the growing dependence on short term external funding is likely to spread liquidity shocks to the real economy. The reliance (some might say dependence) on short term financing is unfavorable in an already strained financial market and may have been a major cause of the larger European debt crisis itself.

The IMF concluded its evaluation by calling for the adoption of broad structural reforms in order to maintain Turkey’s robust growth. To this end, the International Investors Association of Turkey (2011) has proposed the following as any core components of Turkish reform (table 1):

**Table 1. Structural reforms in Turkey**

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<td>- Public Procurement Law</td>
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<td>- Rationalizations in financial management, employment, budget and investment in the public sector</td>
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<td>- Code of Ethical Conduct for Civil Servants</td>
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<td>- Law on Freedom of Information for Citizens</td>
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<th>Financial Sector</th>
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<td>- Regulation and Supervision in line with EU standards</td>
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<td>- Strengthening Private Banks (Capital Adequacy Ratio Improvement)</td>
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<td>- State Bank Reform</td>
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<td>- Resolution of Non-Viable Banks</td>
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<th>Social Security System</th>
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<td>- Social Security Administrative Reform Law</td>
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<td>- Pension and Universal Health Insurance Reform Law</td>
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<td>- Corporate Tax Law (effective from January 2006)</td>
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8 Underground economic activities: types of activity in the Turkish economy:

**Monetary Transactions, Nonmonetary Transactions, Illegal Activities:**

- Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling and fraud; Barter; drugs, stolen goods, smuggling etc.; Produce or growing drugs for own use; Theft for own use; Tax Evasion; Tax Avoidance.

**Legal But Unaccounted-For Activities:** Unreported income from self-employment; Wages, salaries and assets from unreported work related to legal services and goods; Employee discounts, fringe benefits; Barter of legal services and goods; All “do it yourself” work and neighbor help. (Ogunc & Yilmaz, 2000).
- Income Tax Law (amendments on rates – April 2006)
- Establishment of Large-Taxpayers Unit
- Establishment of Tax Policy Unit (February 2006)
Enhanced Role for Private Sector
- Deregulation in Key Markets (Energy, Banking, Telecommunications)
- Accelerated Privatization
- Improvements in the Investment Environment
Institutional Reform
- Investment Support and Promotion Agency of Turkey (ISPAT)
- Regional Development Agencies
(International Investors Association of Turkey, 2011).

How were these structural reforms to be accomplished? Reaching two specific policy objectives would involve reducing energy imports and promoting greater consumption efficiency. In this manner, Turkey could assure its long term growth. As Turkey’s market continues to mature and develop, other potential strategies would include the development of local capital markets and the introduction of new private savings vehicles that would reduce the risk inherent in swings in the global financial market.

7. Looking to the future: Turkey’s relative strengths and weaknesses

The Turkish economy exhibits several critical strengths. These include: GDP per capita is the second highest in the countries that exhibit a Moody’s rating of “BB” and above the “BBB” range. (Sezer, 2012). [At present, GDP per capita stands at $14,600.] The business climate, political and economic institutions, and corporate governance are relatively strong. It is important to remember that Turkey is a participant in a customs union with the EU, although not yet a member of the EU itself.

Debt tolerance has been enhanced by a strong banking sector, strong debt management capacities, and a good debt service record. The banking sector is well capitalized, with a balanced net external and foreign exchange position and a loan/deposit ratio of only 80%. Households have very low foreign debt and are “long” in foreign exchange indicating a strong position.

The floating exchange rate and inflation targeting regime are recognized as strong points in the economy. Turkey has established a track record of successful fiscal consolidation aimed at reducing government deficits and debt accumulation, most especially in the period 2001–06, that may be a strong indication of its willingness to take on difficult decisions in the current international environment.

Prior to the current downturn, GDP growth averaged 6.9% in the five years to 2007, above the “BB” range median growth rate of 5.8%. In 2010, the economy experienced a growth rate of 7.8%.

Because of the age of its population, demographics are favorable for future growth and public finances. There are, however, several weaknesses that are apparent and which must be addressed as well: EU defined “general government debt” rose to 45.5% of GDP at the end of 2009, above the “BB” range median of 41%. Yet, only about 35% of this debt is in foreign currency, compared with 66% for the “BB” range median.

Turkey faces large gross external financing requirements, projected at $115 billion for 2010 (including $48 billion of short–term debt). This amounts to 150% of official foreign exchange reserves for 2009, compared with the “BB” median of 82%.

The unemployment rate rose to an annual average of 14% in 2009, well above rating peers. However, the unemployment rate fell to 12% in 2011 and to 10.3% in 2011. Unemployment stands at 9.1% at the conclusion of 2012. (Economist, January 5, 2013, p. 72).
Fiscal transparency is still considered weak. Some problems that are apparent include the fact that standard general government data are not available; control and reporting of local authority budgets is poor; and the quality of the administrative infrastructure for fiscal policy has obvious weaknesses which are critical on these levels.

Political risk has a strong impact on Turkey’s overall rating. Turkey is ranked in the bottom 21st percentile in the World Bank’s political stability index, which indicates a level of instability below the “B” range (the group which is below Turkey’s present grade).\(^9\)

In terms of corruption, Turkey ranks 54 with a score of 49 in the 2012 Corruption Perceptions Index (World Bank, 2012), indicating moderate corruption. [The Corruption Perceptions Index scores countries on a scale from 0 (highly corrupt) to 100 (very clean). While no country has a perfect score, two-thirds of countries score below 50, indicating a serious corruption problem.]

**Outlook for Growth**

Turkey continues to be a candidate country for EU membership. Accession negotiations began in October 2005, with the beginning of an official “screening process.” In order to accede to membership in the EU, Turkey must first successfully complete negotiations with the European Commission on each of the 35 chapters of the acquis communautaire, which consists of the total body of EU law. At that point, each of the member states must unanimously agree on granting Turkey membership. The EU has closed provisionally one chapter: Science and Research in June 2006. In addition the EU opened negotiations on seven chapters: Enterprise and Industry (March 2007) and Financial Control and Statistics (June 2007), Trans-European Networks and Consumer and health protection (December 2007), Intellectual property and Company law (June 2008). On 18 February 2008 the Council adopted a revised Accession Partnership with Turkey. At one point, the EU froze the opening of eight chapters (Free Movement of Goods, Right of Establishment and Freedom to Provide Services, Financial Services, Agriculture and Rural Development, Fisheries, Transport Policy, Customs Union and External Relations) when Turkey refused entry to its ports and airports to Cyprus in 2006; additional chapters were blocked directly by Cyprus and others have been blocked by France.

Even though Turkey has been unsuccessful thus far in attaining full EU membership (and doubts are growing about the eventual success of the process), Turkey has had a long history of involvement with Europe. This involvement has included the Ankara Association Agreement for the progressive establishment of a customs union, signed with the European Economic Community, signed in 1963. The Ankara Association was supplemented by an Additional Protocol signed in November 1970. As previously noted, the EU established a Customs Union with Turkey in 1995 covering trade in manufactured products between Turkey and the EU. The Custom Union requires alignment by Turkey with several core EU policies, such as technical regulations relating to products, competition (anti-monopoly), and Intellectual Property Law. In agriculture and steel product, trade is regulated by separate individually-negotiated “preferential agreements.”

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\(^9\) According to the World Bank, “Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.” The Worldwide Governance Indicators (WGI) project (World Bank, 2011) sponsored by the World Bank reports aggregate and individual governance indicators for 215 economies over the period 1996–2011, for six dimensions of governance:

- Voice and Accountability
- Political Stability and Absence of Violence
- Government Effectiveness
- Regulatory Quality
- Rule of Law
- Control of Corruption

Customs Union has been very successful and has significantly increased the volume of trade between Turkey and EU member states. As had been noted, more than half of Turkey’s trade is with the EU. Turkey’s trade with the EU has resulted in a rather modest trade deficit of less than €8.3 billion, which amounts to 13% in Turkey’s total trade deficit. 2011 was the biggest year ever for Turkish exports, with a total value of goods worth $134.6 billion being exported. In addition to setting a new record, this was also 18.2% higher than the 2010 figure.

The Turkish economy has shown consistent levels of performance with steady growth over the last eight years, as the economy experienced an average annual real GDP growth rate of 5.2 percent in the period 2002 to 2011. While many of the world’s economies have been unable to recover fully from the global financial recession, the Turkish economy bucked the trend and expanded by 9.2 percent in 2010, and 8.5 percent in 2011, although growth has slowed to 3.2 percent in 2012. Even with the recent slowdown, this level of performance ranks Turkey as the second fastest growing economy in Europe (behind Russia which recorded an increase of GDP by 3.7 percent in 2012), and one of the fastest growing economies in the world. (Economist, January 5, 2013, p. 72). In addition, according to the OECD, Turkey was expected to be the fastest growing economy among the OECD members during 2011-2017, with a projected annual average growth rate of 6.7 percent. (OECD, 2011-2012). Whether Turkey can meet this target will have to be seen. But the preconditions are certainly present.

In general terms, the nature of Turkey’s success may be the result of pursuing policies exhibiting a sound macroeconomic strategy, prudent fiscal policies, and major structural reforms. These policies were designed to increase the role of the private sector in the Turkish economy, to enhance the efficiency and resiliency of the financial sector to meet future economic shocks, and to reform the social security system. The Turkish economy has certainly seen its integration into the global economy, while pursuing a successful policy of attracting FDI. (IMF World Economic Outlook, April 2012; Turkish Statistical Institute (TurkStat), 2012).

On the financial side, Turkey has also successfully managed its public finances. As defined by the EU, general government (sovereign) nominal debt stock fell to 39.4 percent from 74 percent in the period 2002 to 2011. Turkey has also met “60 percent EU Maastricht criteria” for public debt stock since 2004. Similarly, during 2002-2011, the budget deficit decreased from more than 10 percent to less than 3 percent—again meaning that Turkey has met one of the important EU Maastricht criteria. (The most recent financial data indicates that deficit will be 2.7 percent as a percentage of GDP in 2012).

One indication of the success of financial management may be seen in Standard & Poor’s action in raising Turkey’s long-term rating from BB– to BB on 17 February 2010—keeping with a “positive outlook,” and implying that further upgrades would be possible in the future. (Hurriyet Daily News, 2011). In announcing the upgrade, Standard & Poor’s made the following points:

“The Turkish government’s policy flexibility has improved as a result of its track-record in steadily reducing the public debt burden.

Turkey’s regulatory institutions have been successful in preserving the solidity of the financial sector, despite external adversity. The banking sector is one of the strongest and least-leveraged in Eastern Europe.

Turkey’s local capital markets are continuing to develop, enabling the government to lengthen maturities of local currency debt.

The ratings on Turkey remain supported by the government’s overall track record of sound economic and fiscal management.

A further upgrade is likely over the next 12–24 months if the country returns to its prior rates of growth with less dependence on external funding. In contrast, the rating may be lowered if external pressures mount, if medium-term fiscal plans suggest fiscal loosening, or if the domestic political environment deteriorates significantly.”

8. Conclusions

After reviewing key reports initiated by major organizations and outside parties who have actively analyzed the health of the global financial economy, it is clear that Turkey has the potential to prosper in the wake of the financial crisis experienced in Europe. This conclusion is supported by many factors. The most important element to sustaining growth in Turkey is financial and political stability. A second factor results
from Turkey’s strategic geographical location in the center of the convergence of Europe, Asia, and the Middle East. Location gives Turkey a strategic advantage by integrating Turkey both into the developed western capital markets in Europe and the emerging economies on Turkey’s borders. Turkey is surrounded by countries that export natural resources, thus giving Turkey a competitive advantage in this regard as well. In addition, Turkey is surrounded by three bodies of water which can facilitate shipping traffic. It is in the interest of many countries to obtain goods and services through Turkey because Turkey can provide efficient transportation, logistics, supply chain management, and a developed infrastructure which can manage the flow of goods and services. As Turkey creates new partnerships abroad it is vital for Turkey to continue to use its location as an asset to capitalize on long term growth. The European debt crisis has thus far not deterred Turkey from conducting business in the larger region based on its strategic-geographic positioning.

Political stability is vital to assure a country’s prosperity and Turkey has certainly improved over the years in reaching a stable political environment. As a statement of historical perspective, note the following: “Turkey’s foundation as an economic force was forged nearly a century ago. In the 1920s, Mustafa Kemal Atatürk, the first president of Turkey and ‘The Father of All the Turks,’ dramatically changed the country’s political structure from a dictatorship to a democracy. Atatürk was instrumental in altering many aspects of the country: He chose a new capital, renamed Constantinople to Istanbul, pleaded with women to unveil, changed the Turkish alphabet to improve communication abroad and literacy at home, and moved the day of rest from Friday to Sunday.” (Holmes, 2011).

Turkish policy expert, Dr. Doga Eralp, noted in an interview with balkanalysis.com (reported in Nagy, 2012) that the Turkish government is currently experiencing a difficult time in balancing its desire to maintain political stability within the country with the need to liberalize aspects of the political regime. If Turkish politics completes its liberal transformation, Turkey has the potential to become the primary peacemaker and a major diplomatic player in the Eastern Mediterranean. Because Turkey has made great strides in fostering political stability, foreign investors should recognize that the ingredients necessary to develop a sound, stable, and non-corrupt economy within which to invest are clearly present. Political stability is also crucial in the present term because Turkey may be able to influence the creation of democracy within regimes of its Arab neighbors who are undergoing transformation of government structure and social and economic upheavals.

Policies undertaken by the CBT are promising indications of Turkey’s ability to avoid the slow or non-growth patterns from the EU. The mission of the CBT, designed to foster discipline on the fiscal level, is evidence that Turkey is determined to meet its core financial obligations over the long run. By diversifying the nature and mix of Turkey’s exports, it can replace the potential loss in demand from Europe. If Turkey can obtain new markets for its goods, it can provide ample evidence to developed markets that Turkey is a safe place to invest. Assuming that Turkey develops new trading partners before the loss of demand is reflected in a drop in GDP, this can provide much more stability in the current account balance of the country.

After analyzing the data that supports continued prospects for growth and development, it is clear that Turkey has the policy tools in place, and thus the ability, to overcome internal and external shocks that can affect growth and stability. Turkey may suffer in the short run from a decrease in demand caused by the continued crisis on the European continent, but that may not be enough to damage Turkey’s status as a growing emerging market. The careful and prudent mix of fiscal and monetary policy supports growth at sustainable levels, which is key to create the right environment to keep Turkey as an appealing destination for FDI. As indicated, FDI has increased at a substantial rate over the years leading to sustained growth. And, it is important to note that the dynamic population is very young and is a substantial force behind domestic growth. Political stability is vital to strong business relationships in both the domestic and international arenas. All of these factors support the premise that Turkey will be able to avoid the worst dysfunctions of the European crisis—perhaps experiencing minor shocks from time to time—if it continues its disciplined policy which has placed Turkey on a “glide path” to long term growth and success.

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