*Josef Pöschl*

# Turkey's economy dipping its toe in troubled waters

On occasion, revisions of statistical data can give rise to good news. The GDP per capita figures for Turkey will be close to EUR 5170 in 2007 compared to 4370 in 2006 (or EUR 8440 compared to EUR 7370 in PPP terms). The application of a new census methodology introduced in 2007 was the main reason for the marked increase. According to the latest findings, the population currently stands at slightly below 70.6 million: significantly below previous estimates (close to 73 million). The new results confirm that Turkish society is predominantly urban, with over 70% of the population living in cities and towns – and close to 18% in Istanbul alone. The majority of citizens are under the age of 30; those of working age (15-64 year olds) make up two thirds of the total population.

A present, Turkey's GDP growth path appears less steep than it did up to mid-2006, when fears of overheating due to rapid credit expansion and accelerating inflation had strained investors' confidence. Our optimistic growth estimate for 2007, 4.2%, is based on the assumption that growth in the third quarter, 1.5%, was a deviant occurrence. As the Central Bank's business tendency survey of December 2007 suggests, a greater measure of optimism would hardly be justified. The real sector confidence index peaked at a value of 120 in April 2007, but had dropped to 101 by December. In that month for the first time in 2007, expectations were voiced of a possible decrease in output and employment over the coming three months confounding hopes of an increase. Domestic orders over the coming three months also gave rise to pessimism: fewer companies than before expected a year-on-year increase in their investments over the coming twelve months.

### Headwind blowing from the global energy and grain markets

In terms of oil and gas transmissions from the Caucasus and Middle East to Europe, Turkey holds a key position, yet has almost no production of its own. Reliance on energy imports is high; in 2007 energy accounted for 20% of total imports or about 6.4% of GDP. Based on annual averages (1.1% appreciation), parity between the Turkish lira and the euro remained almost unchanged over the period 2006-2007. This led to the lira appreciating against the USD (by 9.4%): a factor that helped to cushion the impact of rising prices denominated in USD. Nevertheless, the hike in energy prices was one of the reasons for inflation scarcely slowing down over the same period. Other major factors were the increase in food prices due to the sky-rocketing world market prices for cereals (wheat +80% December-on-December) and the low rate of domestic production. A dry and hot summer led to poor yields across large sectors of the agriculture industry. Summers had been consistently hot and dry in recent years; however, the summer of 2007 was even worse. Turkey is a major producer of unprocessed and processed agricultural products; as a rule, it achieves high export surpluses in this commodity segment.

## A teflon economy

As it stands now, the economy is much more crisis-proof than it was ten years ago. Market orientation is significantly more pronounced and economic activities benefit from a far more business-friendly environment. Two crises, one in 1999 and one in 2001, set in train a consolidation and acceleration of reform efforts. The general election results in 2002 were no less an important factor as they accorded a broad majority to a single party. The new government was able to push reforms through more easily. A major driving force for reform was the government's intention to pave the country's way into the EU in the foreseeable future.

In 2001, turmoil in the banking sector provoked a full-fledged crisis. Seven years later, however, the Turkish banking sector is far less likely to be destabilized, even in an environment characterized by adverse developments in global financial markets. Today, Turkey's banking sector is in much better shape. It comprises 50 banks, the largest five of which hold about 60% of the sector's assets (about EUR 300 billion in September 2007: equivalent to just over 80% of GDP in 2007). The asset share of foreign-owned banks is around 25%; however, the share of all banks with foreign shareholder participation is close to 50%. In September 2007, gross loans amounted to approximately EUR 144 billion (close to 40% of GDP and 80% compared to deposits). Almost half of the total was absorbed by Istanbul; two thirds were corporate loans; 30% were loans denominated or indexed in foreign currencies; and 42% were loans with a maturity of more than 24 months. Housing loans amounted to close on 11% of the loan total: a low proportion compared to the EU-25 average (35%) or the UK, the leader in this field (52%). As housing loans, unlike deposits, are long-term in nature, banks fund them through long-term loans from foreign currency resources that they then convert through SWAP operations. The banks' portfolios contain a high share of risk-free government debt securities, thus contributing to a very comfortable capital adequacy ratio (own funds in per cent of risk-weighted assets, 22% in December 2007).

The Central Bank's financial stability report of November 2007 analysed the banking sector's asset quality, liquidity, exchange rate and interest rate risks, profitability and capital adequacy. It concluded that the banking sector created a sound impression. Vulnerabilities included the large current account deficit, fragile confidence of savers and investors, a risk of sustained credit expansion, interest rate risks rooted in maturity mismatches between government securities and housing loans and deposits, sovereign risk due to large holdings of public sector debt and, finally, loans in foreign currency amounting to almost one third of all bank loans. Credit expansion slowed down after June 2006 displaying symptoms of a looming crisis whereupon the Central Bank injected a dose of monetary austerity. In real terms, loans grew by 40% in June 2006 (compared to June 2005), but only by about 12% in June 2007.

**An economy with an Achilles heel**

Most concern is expressed over the large deficit in the current account. In recent years, capital inflows did more than simply fill gap; they also nudged the Central Bank's foreign currency reserves up to EUR 49 billion. Over the period January-August 2007 reserves increased by EUR 7 billion only to slump by EUR 2 billion in the period September-November. Two major factors governed capital inflows in the period January-November 2007: foreign direct investment (close to EUR 11 billion) and inflows of 'other' investments (non FDI and non-portfolio) that were absorbed by the non-financial corporate sector (slightly over EUR 20 billion). Exposure to liquidity-driven flows is high. Thanks to substantial reforms in recent years, Turkey has acquired the image of having joined the club of successful catching-up countries. As a result, it has attracted all kinds of investment – including carry trade – thanks to its high interest rate differential compared to the Japanese yen, for example. In recent months, global liquidity conditions have been changing. Two outcomes are conceivable: either market liquidity suddenly being withdrawn or catching-up economies, including Turkey, becoming still more attractive. In the latter case, the country must present a convincing case in terms of economic fundamentals. In that context, the slowdown in growth coupled with disinflation lower than targeted by the Central Bank might prove awkward. Concerns also focus on the high trade deficit, which is mainly responsible for the large gap in the current account. Price levels in Turkey have clambered up to two thirds of the EU average. For Turkish producers of tradables, it is not easy to compete with foreign suppliers. Wages are much lower than in the EU, yet low productivity in large segments of the Turkish economy more or less offsets that advantage. As a result, within the production of tradables, a wide gap yawns between highly competitive sectors and companies and those performing poorly. Whereas Turkey has proven very successful in the production of machinery, electrical equipment and motor vehicles, part of the textile sector, a traditional lead sector in the Turkish economy, suffers from a lack of competitiveness. It is no surprise, therefore, that the trade deficit is high.

Turkish producers of tradables would lead a much easier life, were the exchange rate, for example, TRL 2.0 or 2.5 per EUR (up from the current rate of about TRL 1.8). The current account deficit would be lower, thus reducing dependence on capital inflows. Marked depreciation, on the other hand, would have an adverse impact on the international perception of the Turkish economy. It would be perceived as a return to instability, and confidence in the currency would suffer a blow. This, in turn, would support further dollarization/euroization. What we expect is a minor depreciation against the euro in 2008, but no lasting trend in that direction. Over the past few years, we have observed a firm Turkish response to US developments, especially where financial markets are concerned. The ups and downs of the Istanbul stock market in terms of the euro-based IMKB-100 Index reflect this: it stood at a value of approximately 1.8 during the financial turmoil in mid-2006, close to 3.5 in the first half of October 2007 and somewhat below 2.5 by mid-February 2008. By way of contrast, bond values did not fluctuate widely between late 2006 and mid-February 2008. In any event, we cannot exclude situations that encourage efforts to 'buy' stability through higher interest rates.

### Light at the end of the tunnel: a return to more growth and less inflation

Marked adaptability to new developments is a characteristic feature of the Turkish business sector – and society as a whole. A growth path with rates between five and ten percent is what Turkey could achieve in the absence of external shocks. Over the long term, the rate of growth should return to that path.

As for inflation, Turkey has moved far away from a state where governments and a government-controlled monetary sector fuelled growth in aggregate demand, while the supply side, dominated by state-controlled enterprises, was turgid and cocooned in the mantle of protection against competition. Repeated threats of inflation spiralling out of control had been the outcome. Current inflation is of a different ilk; it is similar to inflation patterns we have observed in the transition countries in Central and Eastern Europe. A disinflation process is under way, but it is susceptible to interruption through external shocks. Prices for electricity will increase. They are regulated, yet despite rising costs the government vetoed price increases to avoid a loss in popularity in the run-up to the elections. Estimates of growth in energy consumption in the years to come are high (5-10% per year); this suggests a need to build additional capacities. Currently, production is not profitable; moreover, money for investment is lacking. Current discussions focus on price hikes and comprehensive privatization as a prerequisite for investment in the sector: for example investment in a series of nuclear power stations.

### EU integration, westernization: going through a lean period

In the 2007 elections, the ruling party secured an even larger majority so that basically the same government was able to proceed with its reform and integration policy. Among the general public, however, support for integration policies has diminished since Turkey's membership aspirations have provoked many negative responses from within the EU. Turkey's relations with the USA, which had been excellent for decades, have deteriorated in the context of the Iraq war. The United States cooperates closely with the government of the autonomous region in northern Iraq, which PKK units have started to use as a base for their attacks on Turkish security forces. Turkey intervenes on a reduced scale in the region, while trying not to compromise Turkish business interests. In fact, Turkish companies have contributed a lot to the reconstruction of Iraq, especially the northern province. Whereas relations with the major western powers are not free of tension, Turkey has successfully strengthened its ties with neighbouring countries. Ties with Israel have always been good and still are, despite some differences of opinion on the region's main problems. This policy of good neighbourly relations is in the interest of the Turkish business community, which is dominated by a dozen or so successful major holdings. As a rule, the founders' families still hold controlling stakes. For the most part, they started out years or decades ago from a single core activity, only to branch out later into many different sectors (such as manufacturing, trade, construction, banking, research and education and the media). They have expanded their production, trading and investment activities westwards and northwards (Bulgaria, Romania, Russia and Ukraine), as well as eastwards (Central Asia, Iran, Syria and other Arab countries).

At the technical level, EU integration is progressing. Turkey has done much to reform the economy's regulatory framework and the economy itself, as can be seen from the country's openness to foreign investors. The stumbling blocks are at the political level and in the EU. The reunification of Cyprus remains a problem. The Greek Prime Minister Kostas Karamanlis paid a three-day visit to Turkey in January 2008, which may perhaps contribute to finding a viable solution. The Greek Cypriot voters' declared preference for a new president in mid-February could also help to release the logjam.

Another problem relates to the difficulty Turkey has in granting its citizens freedom of expression, and yet another revolves around guaranteeing equal rights to the various religious and ethnic groups. The concept of a homogenous nation state, which Article 301 of the Turkish Penal Code terms 'Turkishness', was a founding principle of the Republic of Turkey; it has been fiercely defended ever since. However, large segments of Turkish society regard it as violation of their human rights. It is this kind of problem that nurtures the animosity that some EU citizens harbour towards Turkey and its joining the EU.

Table TR

## Republic of Turkey: Selected economic indicators

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 [1] | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Forecast | |
| Population, th pers., mid-year [2] | 69,302 | 70,231 | 71,152 | 72,065 | 72,974 | 70,586 | . | . | . |
| Gross domestic product, TRY bn, nom. | 277.6 | 359.8 | 430.5 | 487.2 | 576.3 | 653 | 740 | 830 | 935 |
| annual change in % (real) | 7.9 | 5.8 | 8.9 | 7.4 | 6.1 | 4.2 | 4.0 | 5 | 6 |
| GDP/capita (EUR at exchange rate) | 2,782 | 3,022 | 3,405 | 4,030 | 4,370 | 5,170 | . | . | . |
| GDP/capita (EUR at PPP - wiiw) | 5,590 | 5,600 | 6,280 | 6,590 | 7,370 | 8,440 | . | . | . |
| Gross industrial production | | | | | | | | | |
| annual change in % (real) | 9.5 | 8.7 | 9.8 | 5.5 | 5.8 | 5.5 | 5.0 | 7 | 9 |
| Gross agricultural production | | | | | | | | | |
| annual change in % (real) | 6.9 | -2.5 | 2.0 | 5.6 | 2.9 | . | . | . | . |
| Construction industry | | | | | | | | | |
| annual change in % (real) | -5.6 | -9.0 | 4.6 | 21.5 | . | . | . | . | . |
| Consumption of households,TRY bn, nom. | 184.4 | 239.6 | 284.6 | 328.6 | 382.8 | 425 | . | | |
| annual change in % (real) | 2.1 | 6.6 | 10.1 | 8.8 | 5.2 | 2 | 1.5 | 2 | 4 |
| Gross fixed capital form., TRY bn, nom. | 46.0 | 55.6 | 76.7 | 95.3 | 121.1 | 136 | . | | |
| annual change in % (real) | -1.1 | 10.0 | 32.4 | 24.0 | 14.0 | 6.2 | 6.0 | 8 | 10 |
| LFS - employed persons, th, avg. | 21,354 | 21,147 | 21,791 | 22,046 | 22,330 | 22,700 | . | . | . |
| LFS - employed pers. in agricult. th, avg. | 7,458 | 7,165 | 7,400 | 6,493 | 6,088 | . | . | . | . |
| LFS - employed pers. in industry th, avg. [3] | 4,912 | 4,811 | 5,017 | 5,456 | 5,674 | . | . | . | . |
| LFS - employed pers. in services th, avg. | 8,984 | 9,171 | 9,374 | 10,097 | 10,568 | . | . | . | . |
| LFS - unemployed, th pers. average | 2,464 | 2,493 | 2,498 | 2,520 | 2,446 | 2,490 | . | . | . |
| LFS - unemployment rate in %, average | 10.3 | 10.5 | 10.3 | 10.3 | 9.9 | 9.9 | 11 | 10 | 9 |
| Reg. unemployment rate in %, average | 1.9 | 2.5 | . | . | . | . | . | . | . |
| Average gross monthly wages, manuf.ind., TRY [4] | . | . | 1,030 | 1,162 | 1,304 | 1,420 | . | . | . |
| annual change in % (real) [4] | -5.4 | -1.9 | . | 4.3 | 2.4 | 0.2 | . | . | . |
| Consumer prices, % p.a. [5] | 45.0 | 25.3 | 10.6 | 8.2 | 9.6 | 8.8 | 9.0 | 7 | 6 |
| Producer prices in manufacturing, % p.a. [5] | 48.3 | 23.8 | 13.1 | 7.6 | 9.3 | 5.6 | 6.0 | 5 | 3 |
| General governm. budget, EU-def., % GDP [6] | | | | | | | | | |
| Revenues | . | . | . | 21.0 | 30.9 | 30.4 | 30.2 | . | . |
| Expenditures | . | . | . | 21.4 | 30.5 | 31.1 | 29.9 | . | . |
| Deficit (-) / surplus (+) | . | -11.3 | -5.8 | -0.3 | 0.4 | -0.7 | 0.2 | -0.2 | -0.1 |
| Public debt, EU-def., in % of GDP [6] | 93.0 | 85.1 | 76.9 | 69.6 | 60.5 | 54.1 | 50.0 | . | . |
| Discount rate % p.a., end of period [7] | 51.0 | 31.0 | 22.0 | 17.5 | 22.5 | 18 | 22 | | |
| Current account, EUR mn | -1,667 | -7,083 | -12,482 | -18,167 | -26,168 | -29,000 | -26,500 | -28,000 | -29,000 |
| Current account in % of GDP | -0.9 | -3.3 | -5.2 | -6.3 | -8.2 | -7.9 | -6.9 | -6.5 | -5.9 |
| Gross reserves of CB, excl. gold, EUR mn | 25,562 | 26,616 | 26,436 | 42,823 | 46,251 | 49,200 | . | . | . |
| Gross external debt, EUR mn | 123,678 | 114,253 | 118,082 | 143,257 | 157,733 | 167,367 | . | . | . |
| Gross external debt in % of GDP | 77.4 | 56.3 | 50.4 | 46.8 | 51.0 | 44.0 | . | . | . |
| FDI inflow, EUR mn | 1,203 | 1,537 | 2,328 | 8,286 | 15,765 | 15,000 | 15,000 | . | . |
| FDI outflow, EUR mn | 177 | 439 | 693 | 875 | 722 | 1,400 | 1,500 | . | . |
| Exports of goods, BOP, EUR mn | 42,380 | 45,183 | 53,889 | 62,017 | 73,066 | 84,000 | 90,000 | 108,000 | 127,000 |
| annual change in % | 10.3 | 6.6 | 19.3 | 15.1 | 17.8 | 15 | 7 | 20 | 18 |
| Imports of goods, BOP, EUR mn | 49,983 | 57,504 | 73,102 | 89,115 | 105,882 | 117,000 | 120,000 | 140,000 | 160,000 |
| annual change in % | 17.5 | 15.0 | 27.1 | 21.9 | 18.8 | 11 | 3 | 17 | 14 |
| Exports of services, BOP, EUR mn | 15,113 | 15,881 | 18,531 | 21,597 | 19,443 | 20,000 | 19,500 | 22,000 | 24,000 |
| annual growth rate in % | -13.9 | 5.1 | 16.7 | 16.5 | -10.0 | 5 | -3 | 15 | 10 |
| Imports of services, BOP, EUR mn | 6,923 | 6,617 | 8,165 | 9,180 | 8,892 | 10,000 | 10,200 | 11,000 | 12,000 |
| annual growth rate in % | -5.3 | -4.4 | 23.4 | 12.4 | -3.1 | 10 | 2 | 10 | 8 |
| Average exchange rate TRY/USD | 1.5225 | 1.4983 | 1.4286 | 1.3480 | 1.4408 | 1.3054 | . | . | . |
| Average exchange rate TRY/EUR (ECU) | 1.4397 | 1.6949 | 1.7771 | 1.6771 | 1.8090 | 1.7891 | 1.93 | 1.93 | 1.91 |
| Purchasing power parity TRY/USD | 0.6126 | 0.7728 | 0.8109 | 0.8683 | 0.9009 | 0.8940 | . | . | . |
| Purchasing power parity TRY/EUR | 0.7169 | 0.9149 | 0.9639 | 1.0265 | 1.0716 | 1.0967 | . | . | . |

*Note:* The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) SIS projections. Figure for 2007 (end of year population) is based on new census methodology. - 3) Industry including construction. - 4) From 2004 including overtime payment. Real changes calculation until 2003 based on hourly wages. - 5) From 2004 new methodology. - 6) According to ESA'95, excessive deficit procedure. - 7) CBRT interest rate - overnight, lending.

*Source:* CBRT-EDDS (Central Bank of Turkey, Electronic Data Distribution System), SIS (State Institute of Statistics), SPO (State Planning Organization), UT (Undersecretary of Treasury), Eurostat; wiiw forescasts and European Commission (Autumn Report 2007).