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Turkey at the Crossroads

At the beginning of October, the European Commission puts forward its official position about opening up membership negotiations between the European Union and Turkey. In December, the European Council will announce its decision. For months, the press and experts have been examining the political dimension of membership, both at the domestic and at the regional level. Similarly, the consequences of Turkish membership for Europe's institutions and economy have been much discussed. This article looks at the Turkish economy, as the choice to be made places Turkey at a decisive crossroads. The opening up of negotiations will extend the remarkable stabilisation process which has taken hold since the customs union treaty of 1996, and which has accelerated since 2002. Negotiations will contribute to defining a new growth model, based on a dynamic manufacturing sector, but which will draw in more foreign direct investment and facilitate technological transfers. From this point of view, European membership and the adoption of the Union's acquis *may be seen as an instrument for both modernising Turkey's institutional framework and accelerating its economic transformation. Nevertheless, the risks associated with such a strategy, in a country that remains relatively poor, need to be assessed.*

The End of Chronic Instability?

During the 1980s and 1990s, the Turkish economy presented a real challenge to economists' common sense. In contrast to Latin America or Eastern Europe, Turkey managed to combine strong growth (on average 4% per year) with significant macroeconomic instability, especially a chronically high rate of inflation brought about by public finance disorders. By 1999, however, the miracle seemed to have petered out as the economy was dominated by inflation, debt and an insolvent banking system. After an initial stabilisation package based on a crawling peg[1] collapsed in February 2001, some headway in consolidating the economy was finally made, based on a floating exchange rate and hence a domestic policy anchor. In this case, the main risk to the economy is that exorbitant real interest rates snuff out growth, while driving all indebted agents into ruin. The challenge was therefore to set out a sufficiently credible policy to bring down real interest rates and inflationary expectations almost at the same time as the slowdown in prices themselves. Turkey managed to achieve this thanks to a clear hierarchy in conditionality, negotiated in exchange for massive support by the IMF (more than $13 billion over two years). Two criteria have dominated the pursuit of economic policy:

. The primary budget surplus (before interest payments) was pushed up to the very high level of 6.2% of GDP, compared to 3% of GDP in 2000, and in spite of the major recession in 2001 (a 9.5% collapse of GDP, see Table 1). The pursuit of this objective reflects the direct interaction observed between fiscal policy and the control of the money supply. A very unstable public debt market and very short repayment periods mean that there is a major risk that even temporary problems in financing debt lead to its monetisation, and hence to a violent surge in prices. For this reason, the real anchor of Turkey's second stabilisation programme lies not in controlling the money supply, but in managing primary financing of the State, which is watched closely, on a bimonthly basis.[2]

. At the same time, Turkey's banks have been subject to restructuring and massive recapitalisation, aimed at bringing them rapidly back to solvency, in the wake of the 2000-2001 crisis. Any new crisis of confidence on behalf of depositors would likely trigger a major, systemic crisis within a very short period of time.[3] Such an event has been avoided, but at a great cost which will bear down on the economy for a long time: $47 billion, or the equivalent of 20% of GDP in 2003.

1. See "Turkey Letter of Intent", 9 December 1999, at <http://www.imf.org>.
2. See the Letter of Intent, 3 May 2001. Targets were nevertheless made for monetary and fiscal variables. For information about the impact of fiscal variables on inflationary expectations, see O. Celasun & A. Prati (2003), "Would Cold Turkey' Work in Turkey?", IMF, Working Paper 03/49.
3. The IMF had already tried to use a strategy for containing insolvency during the Asian crisis (1997-1998), as a short term instrument for re-establishing banks' liquidity, by shoring up confidence. In Turkey, this is the first time that such a policy has worked, even though the results were mitigated in Thailand and catastrophic in Indonesia.

Table 1 – Turkey's Main Macroeconomic Indicators

	1999	2000	2001	2002	2003	2004p
GNP growth (%)	-6.1	6.3	-9.5	7.8	5.0	5.0
Inflation (consumer prices)	68.8	39.0	68.5	29.7	18.4	12.0
Government bond interest rate (%)	106.2	38.0	99.1	63.5	44.1	23.0
Private sector credit*. real change (%)	-10.7	24.5	-27.5	-16.5	16.9	6.9
Primary balance (consolidated public sector. % GNP)	-0.2	3.0	5.5	4.1	6.2	6.5
Public sector financial requirement (% GNP)	22.3	18.9	21.1	12.1	10.0	6.6
Net public debt (% GNP)	61.0	57.4	93.9	79.2	70.9	66.5
Current account balance (% GNP)	-0.7	-4.9	2.4	-0.8	-2.9	-3.0

* Deflated by the consumer price index; p projection.
Source: IMF, "Seventh Review under the Stand-by Arrangement", April 2004.

As of mid-2004, this strategy was deemed to be successful. For a start, healthy growth was back at a high level (6.9% per year, on average in 2002-2003). More importantly, the annual rate of inflation has fallen to 12% (as opposed to 68.5% in 2001), with market expectations being identical to the authorities's objectives, since the end of 2003. Lastly, the consolidation of public finances seems well underway: the overall weight of public debt in GDP was brought down to 71% of GDP at the end of 2003, as opposed to 94% in 2001,[4] thanks to the combination of budgetary discipline, growth and the effect of exchange rate appreciation on the real value of debt denominated in dollars.

Taken together, these trends do not of course rule out all future risks. First, the current account deficit could exceed 4% of GDP this year, due notably to the domestic investment boom. This source of weakness is aggravated by the fact that such investment is largely financed by short-term capital. Beyond this, sustainability tests carried out recently by the IMF indicate that the present stabilisation of public finances is not safe from all danger: a return to historical trends in the primary budget deficit and in real interest rates would push public debt rapidly back on an explosive path.[5]

In short, though no relaxation in the policy mix is yet on the horizon, the exercise in walking the public-policy tight-rope since the crisis in 2001 has indeed brought real advances. In fact, the political economy of Turkey's instability has, to a certain extent, been dismantled: i.e. the former regime which was characterised by the incapacity to arbitrate between simultaneous demands on public spending, by clientelist regional policies and by the constant use of the banking system as a substitute of the national budget. The challenge to such practices cannot but reinforce the credibility of the new direction taken by public economic policy.

The New Issues at Stake

Such a summary of present policy corroborates the view that Turkey has entered a new era. Holding the ground gained is crucial, but new priorities are also emerging. Such priorities demand special attention, and could be decisive should negotiations start with Brussels.

To begin with, renewed credit flows, in the wake of a major banking crisis that was followed by substantial restructuring, raise dilemmas which many developing countries are unable to solve. Banks tend to ration credit strongly for private companies, when they are concerned about limiting their exposure to risks and subjected to strict prudential rules. They prefer to buy government bonds and finance consumer credit. The renewed upswing in private sector credit in 2004 (starting at very low levels, 14.6% of GDP in 2003), should be judged from this point of view. Such difficulties are, *a priori*, aggravated by a disinflationary shock as numerous speculative and profitable activities no longer exist. It is also much more difficult to absorb possible losses through inflationary transfers, and lastly, the fall in yields on public stock impacts on bank earnings to the extent that such stock is included in their assets. These various factors likely explain the fall in banks' profitability which was observed at the beginning of the year.[6] Looking beyond the banking sector, the whole of the private sector faces a similar problem. Longer time horizons, the strengthening of solvency constraints, and tougher competition will all necessarily affect financial behaviour, investment or hiring. Little short of a new growth regime has to be invented.

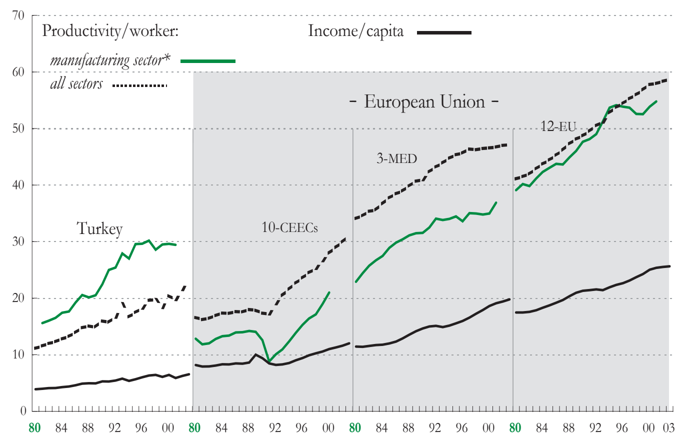
A second factor in the evolving rules of the economic game obviously concerns redefining the role of the State, which also affects agents' behaviour. While the State has so far been paternalist and clientelist, the reforms will lead to a clear structuring of its redistributory functions (social policies and regional transfers) and regulatory tasks. The latter have a direct impact on the country's growth strategy and its international integration. They call for the formulation of a regulatory and legal framework for Turkey's economic activity, which is to be at the heart of the development process, as has also been the case in Eastern Europe's transition (property rights and creditor safeguards, bankruptcy procedures, employees' protection *etc.*). It is here that the "European wager" underpins the reforms launched since the 1990s. The modernisation of Turkey's institutional framework has to a large extent been undertaken by adopting European regulations, with the aim of facilitating economic integration and eventual EU membership.

From this perspective, it needs to be stressed that the customs union which came into force between Turkey and the EU in 1996 is far more than what such an arrangement is usually

4. At least a third of public debt (or 22% of GDP) is made up of foreign debt. This external public debt stood at $53 billion in 2003, of which $16.2 billion were owed to the IMF.
5. See IMF, "Seventh Review Under the Stand-By Arrangement, Appendix 2", April 2004.
6. Returns on assets fell from 2.3% in 2003, to 0.4% during the first quarter of 2004, though without implying a worsening of solvency, which remains strong (the capitalisation ratio stood at 18.5% at the end of 2003).

held to be; a point often misunderstood. Apart from the adoption of a common tariff and the reduction of quantitative obstacles to trade, the arrangement covers a not insignificant share of the *acquis communautaire*: the 80 000 odd pages of European rules and directives which make up the legal foundations of the European Single Market and which ensure its unity (technical standards, consumer protection, requirements for goods to be put on the market, financial supervision etc.). In particular, Turkey had to adopt EU regulations concerning the free movement of goods, competition and intellectual property. Since the European Council in Helsinki (1999), which accepted Turkey among the countries that could join the European Union, the process of absorbing the *acquis* has been enlarged and henceforth receives technical and financial support from the Union.[7]

Graph – European Union: Income per capita and productivity per worker (1980-2003) in USD thousands



* Poland, Hungary and Czech Republic only
Source : Author' calculations, CEPII: Productivity Comparison Database (http://www.cepii.fr); GGDC & The Conference Board : Total Economy Database ; GGDC-ICOP : Industry Database (http://www.ggdc.net).

The Real Economy

With the major decision on membership coming up, how can the Turkish economy be compared to those of the other new and future members of the EU? Is it possible to judge the credibility of Turkey's candidature on this basis?

The first point to be observed is that Turkey is considerably poorer than the ten new central European members which joined in spring 2004. This is borne out by per capita GDP levels measured at PPP (Table 2). This gap obviously has consequences for investment volumes, public spending and the level of education. That said, Turkey's relative level of resources is hardly different from that of the Balkan economies which have been promised membership. From a retrospective point of view, it is also close to that of the ten new members, when they were *de facto* promised membership in 1990.

Table 2 – Turkey – European Union*: income level and population

	Turkey	European Union		
		10-CEECs	3-MED	Eu-12
Population and income in 2002				
Population (millions)	70	73	62	315
Gross national income (USD billions at PPP)	438	886	1 249	8 571
Gross national income per capita (USD PPP)	6 300	12 113	20 145	27 170
Employment by sector, in %, in 2000				
Agriculture	35	13	10	3
Industry	25	34	30	29
Services	40	53	60	68

* The 10 CEECs which joined in May 2004; 3-MED: Spain, Greece and Portugal; the rest of the EU: the EU-12.
** Only Poland, Hungary, the Czech Republic and Slovakia are taken into account here as CEECs.
Source: Authors'calculations, World Bank WDI-2004; OECD Historical Statistics, 1970-2000.

A far more surprising picture emerges, however, when looking at output per employed worker in the manufacturing sector, rather than income. In this case, Turkey's performance is close to that of the "Club Med" countries (Spain, Greece and Portugal) when they joined the EU, and is far better than the most competitive central European economies today.

How is this contrast to be explained? Part of the answer lies in the Turkish economy's profound dualism, which is sharpened by an agricultural sector that still employs 35% of the population, even though it only accounts for 14% of value added. This underlines the contrast with the main strength of the Turkish economy, namely its manufacturing sector and services (tourism in particular) which are not just highly productive but also remarkably flexible, adaptable and very open to exports. These activities are led by a few key industrial and financial companies, which are well structured and modern, and often access international capital markets. At the same time, a dense fabric of small-and medium-sized enterprises has emerged, which are often sub-contractors to large firms. Their dynamic growth stems from high profitability and a very flexible labour market. These companies have been key actors in Turkey's growth in recent decades and in the take-up of labour that is quitting agriculture, which is far from complete.

A last point concerns Turkey's high level of foreign debt, which contrasts with low FDI inflows and stocks. The latter stems partly from regulation that was long unfavourable to FDI, as well as the fact that Turkey's large firms are often family companies, while SMEs are little-attractive to foreign investors. From this point of view, Turkey stands out in opposition to Ireland and Hungary, along with much of

7. A Partnership for membership was set up in February 2001 and a National Programme for Adopting the *Acquis Communautaire* was submitted by the Turkish government to the Commission in March 2001.

Eastern Europe: its international integration is led mainly by local firms and not much by multinationals. In other words, Turkey benefits from a form a "national capitalism" which is healthy and dynamic, and this is an undoubted advantage.

Why Join the EU?

This economic structure also reached its limits during the 1990s. Search for a new growth model now requires greater openness to foreign investments, which bring with them stronger international integration and greater technology transfers. Overall, entry into the European Union is seen both as an instrument for restructuring Turkey's productive industries and as accelerating the modernisation of its institutions. This ultimately is where the interests of the political and economic elites converge, and around which the present mobilisation concerning the issue of Europe focuses.

The wager is that the credibility resulting from the membership process, together with the active support of the EU, will favour the coordination of expectations and hence the strategies of various actors (companies, public administrations, politicians etc.). As a result, the necessary institutional and microeconomic adjustments should be easier to achieve. A virtuous circle of integration could then emerge, similar to that experienced by the Union, in the years leading up to the launching of the Single Market, or by that experienced by central Europe in recent years. Democratic reforms should also be consolidated in this case.

But there is also a downside risk. While Turkey's dynamic private sector and its undeniable political credibility are prime assets, it remains a developing country, which is very dualist, with insufficient public infrastructure and administrations that are often weak. Its adherence to highly constraining rules and regulations, written by some of the world's most developed countries, may also have negative effects. As in Central Europe, it may be feared that such complex regulations will turn out to be very difficult to implement, and hence will push certain SMEs into the informal economy. More generally, it is not possible to rule out that Turkey may suffer from "peripheral Eurosclerosis", as occurred in Greece, for example, for a long time.[8] To be sure, the progress made since 1996 in applying the *acquis communautaire* has reduced uncertainty to some extent. It should make it possible to evaluate in detail to what extent European rules and standards have been adopted by companies and public administrations.[9]

That said, a key enigma which has already featured in the EU enlargement debate remains largely unanswered: is the level of development an objective (rather than a political) constraint on successful EU membership or not? This holds for Poland, Bulgaria as well as Turkey. If the Copenhagen criterion about having a market economy is used, then Turkey passes the test with no problem. But is this a sufficient guarantee? Nobody can really say. It is still difficult to establish to what extent the "European attraction", which is based on a strong political contract, may from a distance modify economic rules, modernise infrastructure and reinforce growth. In other words, how far down the development ladder can the European contract act as an accelerator for convergence, much more than was the case of the World Bank and its peers during the 1950s? In fact, it should be asked whether the Single Market is an economic rule linked specifically to the economic and institutional framework of western Europe. Or can it be effective in the face of the issues which are at stake in globalisation and development?

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8. Such worries obviously also still apply to the countries which have recently joined the Union, see "Eastward Enlargement of the European Union: Can Failure Be Avoided?", *La Lettre du CEPII*, July-August 2000, available at <www.cepii.fr>.
9. In its *Regular Report on Turkey's progress towards accession in the EU* for 2003, the European Commission stressed how much Turkey's institutions and resources available concerning the implementation of technical standards and consumer safety were wanting.
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