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Why is Turkey's economy sliding again?

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Is Turkey's economy sliding into crisis? One indication is the fact that the Turkish lira tumbled to a new low of 2.35 to the dollar at the end of January 2014.Turks now need more than twice as many liras to buy a dollar than they did at the currency's peak six years ago. This devaluation will impose serious costs on an economy heavily dependent on imports and foreign borrowing, although it will also encourage exports. The central bank was reported to have sold around $3 billion in its first direct intervention in the foreign exchange market in two years, but the move did little to calm the market. In response, the central bank increased a series of short-term interest rates including the marginal funding rate, an overnight rate, from 7.75 percent to 12 percent. This strengthened the exchange rate but pushed up the cost of borrowing sharply, which, as a consequence, will reduce the level of activity in the economy.

There are two main causes of this crisis. The first is that Turkey, along with other so-called emerging economies, has been very reliant on capital imports. These have been very cheap because interest rates on the dollar have been so low. The possibility that they could increase led to a flood of funds out of the emerging economies back to the U.S. and this affected exchange rates internationally. The second factor was the series of corruption scandals affecting Prime Minister Recep Tayyip Erdoğan, his government, and its supporters. These two factors are connected because monetary policy in Turkey has been highly politicized: the prime minister opposed increasing interest rates and this delayed the central bank's recent decision on interest rates. Erdoğan criticized a "foreign interest rate lobby" that he accused of being determined to push up rates and thus stifle economic growth. He also faces increasing criticism both at home and abroad for his attempts to curb press freedoms, control the judiciary, censor the internet and enact other authoritarian policies. It should also be noted that there were elements of a cyclical slowdown in 2012-2013 after years of fast growth.

The economic background to these events is provided in Table 1. Between 2002 and 2012, the gross domestic product (GDP) or national income in Turkey rose by 63 percent in real terms and per capita GDP rose by 43 percent. In current dollars GDP per capita tripled, partly due to the strengthening of the lira against the dollar. The government has claimed that GDP expanded by more than three-fold between 2002 and 2012 but this is misleading, as it is based on the dollar valuation of Turkish GDP at current prices, and hence puts both dollar inflation and the real appreciation of the Turkish lira on top of real growth.

The actual record is impressive enough: an increase of 43 percent in income per capita over a decade implies an annual growth rate of 3.6 percent. This is a performance that matches that of Turkey's previous high-growth period (1960-78) and exceeds anything experienced since.

In 2002, Turkey was just coming out of a severe financial crisis, so there is a case to be made that any growth calculation that takes 2002 as the base year confuses real growth with the bounce back from the crisis. More importantly there is the question of sustainability, as growth has been fueled by large current account deficits in the recent period. These are also detailed in Table 1. In the period 2002 to 2007, the balance of payments current account deficit averaged $19 billion a year; but, in the period 2008 to 2012, it jumped to $44 billion. The deficit was financed by borrowing, especially short term, and the stock of this debt rose over six-fold between 2002 and 2012. By November 2013, short term foreign debt had reached $130 billion.

Table 1

The Turkish Economy: Main indicators, 2002-2012

	Growth of GDP in constants prices %	Growth of GDP/capita constant prices %	GDP/capita Current $	Current Account $ bns	Short term foreign debt $ bns
2002	6.2	4.8	3492	-0.6	16.4
2003	5.3	3.9	4559	-7.6	23.0
2004	9.4	8.0	5764	-14.2	32.2
2005	8.4	7.1	7022	-21.4	38.9
2006	6.9	5.6	7586	-31.8	42.9
2007	4.7	3.4	9240	-37.8	43.1
2008	0.7	-0.6	10438	-40.4	52.5
2009	-4.8	-6.1	8559	-12.2	49.0
2010	9.2	7.7	10022	-45.4	77.3
2011	8.8	7.4	10466	-75.1	81.8
2012	2.2	0.9	10497	-48.5	100.6

Sources: Turkish Statistical Institute; Central Bank of Turkey

At the end of 2000, and at the beginning of 2001, Turkey suffered a severe economic and political crisis. In the spring of 2001 drastic steps were taken following the collapse of the exchange rate and a dramatic decline in the level of activity in the economy. The measures taken brought relief and provided the basis for recovery that has transformed the economy.

In 2002, the Justice and Development Party (AKP) founded by Recep Tayyip Erdoğan won a landslide victory in the general elections, gaining nearly two-thirds of the seats in parliament. This victory marked the end of Kemalist or secular rule in Turkey. Although the AKP followed orthodox economic policies, it moved the emphasis of government support from large companies in and outside the state sector to small and medium sized companies known as the Anatolian Tigers. These measures were very successful in generating exports and economic growth, but they did little to help Turkey develop high-tech.

The current account deficit in 2002 was almost $600 million and easy to manage. By 2012, it reached nearly $49 billion (6.3 percent of GDP), after peaking at $75 billion

(9.5 percent of GDP) in 2011. These deficits were made possible by a heavy reliance on foreign capital inflows, creating significant exchange rate risk. The volume of short foreign debt rose from $28 billion in 2000 to $130 billion at the end of November 2013, although the foreign exchange reserves of the central bank also increased from $20 billion to $131 billion over the same period. This is in part the legacy of the 1980s when the liberalization of the foreign account preceded the stabilization of the economy and left Turkey over-exposed to international financial fluctuations.

One reason for the large trade and current account deficits was the high import content of Turkish exports. The rapid growth of exports of goods since 2002 was one of the causes of import growth: the import content of exports was high. Exports rose from $35 billion in 2002 to $162 billion in 2012, but imports increased from $47 billion to $221 billion.

Another reason for the high level of imports in recent years was the high cost of imported fuels which account for more than 70 percent of Turkish energy needs. In 2011, Turkey imported more than 90 percent of its total liquid fuel consumption and 50 percent was supplied by Iran. The fuel import bill rose from $8.5 billion in 2002 to $26.6 billion in 2007 and $60.1 billion in 2012.

In recent years borrowing to finance the current account deficit has been easy and cheap because of the international recession, and very low interest rates, especially on the dollar. The fact that so little could be earned on U.S. government bonds meant that there were huge volumes of funds moving around the world looking for investment opportunities. The so-called BRICS (Brazil, Russia, India, China and South Africa) and Turkey attracted these funds, but in 2013 the economic performance of the BRICS and Turkey slowed as the possibility of higher U.S. interest rates was seen on the horizon.

Encouraged by the inflow of cheap funds, a boom in infrastructure development and construction developed in Turkey. The country’s highway network has been expanded by more than 10,000 miles and the number of airports has doubled. New, luxury housing complexes and shopping malls have sprung up in every major city. The planned construction of yet another mall in Istanbul's Gezi Park was the cause of major disturbances in May-June 2013 that posed a serious political challenge for the government. A $30 billion project to build a third airport for Istanbul and a canal costing at least $10 billion to relieve the congested Bosphorus are also now threatened by financial clouds.

Beyond these developments, Turkey faces another set of challenges related to demography. Although the annual population growth rate is 1.24 percent according to the U.N., this still means an addition of 900,000 people a year. The Turkish population is young: there are over 20 million children aged 0-14, accounting for more than 28 percent of the population. There are 13.4 million 15 to 24 year-olds constituting almost 19 percent of the population.

Closely related to this is the problem of unemployment. This rose from 8.4 percent in 2002 to 10.3 percent in 2004, despite the acceleration of growth. It then declined slightly despite the slowdown in growth to reach a low of 9.9 percent in 2006 and 2007 and then rose in 2008, finishing the year at 13.6 perhaps, according to official figures. It seems that the economic recovery of 2002 to 2007 did not have a major impact on employment. Unemployment would be much higher if the labor participation rate was higher: Only about 50 percent of working-age adults were employed in 2012, compared with an average of 68 percent in the Organization for Economic Cooperation and Development (OECD). Part of the reason for this is gender inequality. Turkey ranks 120th out of 136 countries in terms of gender equality, and women constitute only 23 percent of the nonagricultural work force. Turkey still lags behind the developed world in terms of educational levels, as well. In 2011, two-thirds of Turkey’s working-age population had received only primary education or less, and, according to the EU, some 30 percent of Turkey’s young people are not receiving education or training nor securing jobs. This also has implications for the distribution of income which is very unequal.

In 2011, when Turkey had the fastest growing economy in Europe, the richest 20 percent of the population accounted for almost half of national income, while poorest 20 percent had just 6 percent. Turkey ranked third highest among 34 countries in the Organisation for Economic Cooperation and Development on a scale of income inequality.

Income inequality is also a regional issue. Nearly 80 percent of GDP is generated in the west of Turkey, accounting for about 35 percent of land area. In 2011, average GDP per capita the richest city, Istanbul, was $15,674 while in the eastern and poorest province of Van, it averaged $3,826.

What are the prospects for 2014? Both the OECD and the International Monetary Fund have forecast a difficult year ahead, with the risk of serious financial problems. Economic growth in 2013 was relatively slow and the same is forecast for 2014. The volume of borrowing required to finance the current account deficit and service foreign debt in 2014 is estimated at $94 billion, equal to about 25 percent of GDP. (The non-financial corporate sector's net debt rose from $78 billion in mid-2008 to $164 billion in mid-2013 leaving it more exposed to interest rate and exchange rate changes). This huge sum will have to be imported, largely because savings in Turkey are not high enough to finance investment and consumption needs. Foreign direct investment has slumped and inflation remains at about 7 percent and investors' confidence has declined. Turkey faces local elections in Spring 2014, presidential elections in Summer 2014, and parliamentary elections in 2015. This is not a political environment that will encourage politicians to make difficult economic decisions.