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Parliamentary elections and Turkey's economy

On 3 May, parliamentary elections were fixed for 22 July 2007. The previous due date for these elections was 4 November 2007, but the ruling AKP party decided to call for an early election date in the wake of the outbreak of a political and constitutional conflict between the secular and the moderate Islamic forces in the previous weeks. Immediate cause was the tussle between the opposing forces over the election of a new President for which the AKP had nominated the current foreign minister Abdullah Gül. In the first round of the presidential vote in parliament Mr Gül had received 357 votes out of 361 present which were 10 votes short of the necessary 367 to be elected as president in the first two rounds of the election. Following this vote the main opposition party CHP applied to the Constitutional Court, arguing that it was unconstitutional to start voting with only 361 MPs present (the opposition parties had made a decision to leave the voting chamber). On 1 May the Constitutional Court ruled in favour of the CHP's demand, which meant that the first round of voting that had taken place on 27 April was illegitimate and would have to be repeated and that the presence of 367 MPs in the assembly was necessary before any voting could start. Furthermore, before that ruling, there had been an intervention by the military with the Turkish General Staff releasing a statement expressing their concerns regarding increasing threats to secularism. This statement was seen as an ominous sign of the military getting involved in the political dynamic of the country, and the European Commission reacted critically to this intervention.

Surrounding the elections for the Presidency there were also large street demonstrations organized by the secular forces objecting to an 'Islamic' candidate for president, which had also taken place previously when there was the possibility that the current prime minister Recep Tayyip Erdogan (whose right-hand man Abdullah Gül is) was a potential presidential candidate. With the strategy of an early parliamentary election, the AKP attempts to take over the initiative as current opinion polls indicate that they would win such an election and they would then attempt to pass in parliament a number of constitutional changes such as moving towards direct elections of the president of the Republic. In such a case, Mr Erdogan might become the official candidate of the AKP. Anybody familiar with the political scene in Turkey knows that behind the 'secular' vs. 'Islamic' divide are also economic interests which object to the way the economic reform process is going on. They resist the relinquishing of power over state-owned assets and fear a reduction of national control through the rapprochement with the EU and the eventual implementation of the *acquis communautaire*.

Current economic developments and the formulation of the economic policy agenda have to be seen against the background of these political developments and, as political stability might re-emerge in the wake of a decisive AKP election victory (which seems likely at the moment, but election forecasts have often proven wrong as was recently the case in the French parliamentary elections) there would again be a resumption of more predictable economic outcomes. Should the outcome of the elections not clear the situation, either through a decisive election win or through a non-acceptance of the losing side (backed by the military) of the election outcome, then the future path not only in economic terms but also in terms of the already complex Turkey–EU relationship will be much more difficult to evaluate. Given this rather complex context in which an economic assessment has to be attempted, we shall adopt the scenario in this article that political stability will be re-established after the July election.

Let us now move on to an assessment of the economic situation: In our February Report we pointed to the slowdown of economic growth in the last quarter of 2006 which was brought about by a tight monetary policy stance of the Turkish Central Bank. This had developed in the wake of the financial market turbulence of April/May 2006 and led to a high interest rate regime (with interest rates remaining at close to 20%) as the Central Bank perceived the economy drifting far away from the inflationary target (4% annual inflation) they had set themselves. The yearly GDP deflator had moved from 5.4% in 2005 to 11.5% in 2006 (average annual rates) and given that the deflationary strategy was an important pillar of the overall economic strategy (together with a – successful – reduction of public debt) the Central Bank reacted to this re-emergence of inflationary dangers with a succession of strong interest rate hikes. As was to be expected, high interest rates together with an expectation of a trend tendency of a nominally appreciating currency (typical of a of a catching-up economy) stimulated further capital inflows and hence reduced – as in many emerging market economies – control over liquidity. Furthermore, strong inflows of capital put further pressure on the exchange rate which, in Turkey's context of a large current account deficit, was not the direction in which external economic equilibrium could be achieved. In fact, some moderate success is starting to set in on the inflation front: annualized consumer price inflation (CPI) came down from 10.7% in April to 9.2% in May, and producer price inflation (PPI) fell from 9.7% to 7.1% over the same period. The estimation is that CPI inflation by end-of-year 2007 will come down to 6.5%. Commentators argue that the stickiness in inflation rates (in the context of an appreciating currency) in spite of a significant slowdown of consumer demand is due to asymmetric pass-through effects in the wake of exchange rate movements (i.e. not passing on the cost benefits of a currency appreciation to the consumers) as well as inertia in price setting behaviour in the services sector. Hence, the tough monetary policy stance is bringing inflation down, but only very gradually. Given the Central Bank's inflation target commitment, the high interest rate regime is likely to stay.

Given that domestic demand has been slowing down, there has been some success in switching demand towards net exports (in spite of currency appreciation; see below). Hence industrial production growth was a respectable 7.9% in the first quarter of 2007, with particularly strong growth in the manufacture of other transport equipment, electrical machinery and metals, while the production of transport equipment (more domestic market-oriented) slowed down considerably. In view of the conscious policy-stance of maintaining a deflationary stance, we predict a further mild slowing down of industrial production in the coming months, and recent reports regarding a very dry summer do not bode well with regard to agricultural harvests; tourism income is, however, expected to be well above last year's relatively low returns. Nonetheless, the general view is that GDP growth in 2007 as a whole will lie in a respectable range between 5.5% and 6.0%. As a successful anti-inflation drive benefits consumers' real income expectations, domestic spending can pick up again and Turkey is projected to move back on its 6-7% per annum growth path in 2008.

On the fiscal side, there has been the long-run success story of bringing down the gross public debt to GDP ratio from 93% in 2002 to 60.5% in 2006 and the expectation is that it will further decline to 56.6% in 2007. Declines in real tax revenues in the first four months (declines in corporate tax rates, declining VAT revenues from slower domestic consumer demand) were more than compensated by whopping privatization revenues. The high interest rates impose a high burden on interest expenditure on public debt and these have increased by 12% over the first four months of 2007. Given also the higher non-interest spending in an election year, the primary surplus (which cannot include income from privatization) is projected to amount to about 5.5% of GDP in 2007 (down from

6.1% in 2006) and the overall budget deficit to GDP ratio is expected to rise to 2.6% in 2007 (there was a surplus of 0.4% in 2006).

Regarding external trade, the first quarter of 2007 brought dynamic developments in exports for the Turkish economy. The depreciation episode of the Turkish lira in mid-2006 favoured exports of goods, which rose by 14% (in euro terms) compared to the first quarter of 2006. Imports expanded by about 7% over the same period. The moderate growth in imports is caused by falling consumer and restrained capital imports, especially in the automobile sector which has lost momentum, while demand for imported intermediates – triggered by strong export growth – remained roughly constant. Strong export growth and sluggish import demand have led to an improvement in the goods trade deficit in the first four month of 2007 with a corresponding positive effect on the current account. Also, the export to import ratio (in goods trade) rose considerably and reached about 66% in the first four months of 2007 (from 61% in the same period last year).

The strong demand for exports arises not only from the exchange rate developments but also from good fundamentals, such as high labour productivity growth in manufacturing and the qualitative upgrading of the products produced. Motor vehicles, iron and steel, mineral fuels and oils and also clothing have contributed most strongly to the dynamism in exports. In particular the textile and clothing sector has recovered well, implying that the Turkish textiles and especially clothing industry – due to improvements in quality and complying with the importance of time-to-market – is able to withstand the strongly increased competition from China following the quota removal in 2005. Another important factor behind the strong export performance is to be found in the recovery of demand in the EU members, particularly in Germany. Germany is Turkey's largest single trading partner with a share of around 14%. Recent changes in the geographical composition also show that exports to the Middle East and Western Balkans were growing strongest, reinforcing Turkey's position as a hub for the region. On the import side, Russia's share is still increasing due to strong energy prices, however again, imports from partners within Southeast Europe and the Middle East evolve most dynamically.

The internationalization of the Turkish economy through trade is progressing, the trade-to-GDP ratio has reached 56% in 2006 (up from 50% in 2001). In contrast to these favourable developments in goods trade, trade in services developed more sluggishly with exports being subject to strong fluctuations arising from tourism. The prospect for travel exports are positive for 2007, thus a recovery of this sector is expected. A possible drain on the current account may arise from the deterioration of the income balance following profit repatriation and interest payments for investments.

Nevertheless, the favourable developments in external trade together with the exchange rate dynamics have resulted in a slight reduction in the current account deficit, which had reached an unsustainably high level in 2006. For 2007, we expect a moderate improvement in the current account, even though the deficit is expected to remain at a high level for the next few years.

The most striking point to note from the capital account is the surge in FDI inflows in the first quarter of 2007. Net FDI made up 49% of total net capital inflows in the first quarter of 2007. With EUR 7 billion, half of the 2006 volume of FDI inflows was already reached by end of March 2007. Following mega-deals in the communication sector in 2006 (takeovers of Türk Telekom and Teksim, a Turkish mobile phone provider) the investment boom is driven more recently by record purchases of real estate by non-residents. Despite the dampening of the housing boom in mid-2006, the demand for real estate especially in Istanbul has recovered strongly, leading to fast rising property prices. Another sector responsible for the strong interest in Turkey as a location for FDI is the banking sector. The interest of foreign banks in local establishments is driven by cost-saving motives (saving on brokerage costs) as well as by market-seeking behaviour. The Turkish market, with its fast growing, young, relatively qualified labour force is an attractive destination for foreign investors. The increased presence of foreign (especially Western European) banks and brokerage offices in Turkey is expected to accelerate the ongoing consolidation and restructuring process in the highly fragmented Turkish finance and insurance market. Another driving force behind increased interest in investment in Turkey – apart from the attractions of the local market – is posed by the geopolitical situation, with investments from the Middle East and by Middle Eastern – especially Saudi Arabian – firms being redirected to Turkey, which is perceived as a safer destination in the short to medium run.

Table TR

Republic of Turkey: Selected Economic Indicators

	2002	2003	2004	2005	2006 [1]	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year [2]	69302	70231	71152	72065	72974	.	.	.	.
Gross domestic product, TRY mn, nom.	277574	359763	430511	487202	576322	107769	.	653600	730900
annual change in % (real)	7.9	5.8	8.9	7.4	6.1	6.7	.	5.5	6.5
GDP/capita (EUR at exchange rate)	2782	3022	3405	4030	4370	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5650	5740	6140	6470	6910	.	.	.	.
Gross industrial production									
annual change in % (real)	9.5	8.7	9.8	5.5	5.8	2.8	7.9	6	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 mn, nom.	184420	239586	284631	328561	382757	79698	.	.	.
annual change in % (real)	2.1	6.6	10.1	8.8	5.2	8.1	.	5	6
Gross fixed capital form., TRY mn, nom.	46043	55618	76722	95307	121093	21371	.	.	.
annual change in % (real)	-1.1	10.0	32.4	24.0	14.0	32.1	.	8	15
LFS - employed persons, th, avg.	21354	21147	21791	22046	22330	20903	21574 [I-II]	.	.
LFS - employed pers. in agricult. th, avg.	7458	7165	7400	6493	6088	5304	5444 [I-II]	.	.
LFS - employed pers. in industry th, avg. [3]	4912	4811	5017	5456	5674	5248	5434 [I-II]	.	.
LFS - employed pers. in services th, avg.	8984	9171	9374	10097	10568	10351	10696 [I-II]	.	.
LFS - unemployed, th pers. average	2464	2493	2498	2520	2446	2735	2717.5 [I-II]	.	.
LFS - unemployment rate in %, average	10.3	10.5	10.3	10.3	9.9	11.5	11.4	9.5	9
Reg. unemployment rate in %, average	1.9	2.5	.	.	.			.	.
Average gross wages, manuf.industry (TRY/Hour)	2.68	3.30	3.74	4.20	4.68	.	.	.	.
annual change in % (real)	-5.4	-1.9	2.5	1.9	0.9	1.0	.	1	.
Consumer prices, % p.a. [4]	45.0	25.3	8.6	8.2	9.6	8.1	10.3	7.5	5
Producer prices in manufacturing, % p.a. [4]	48.3	23.8	13.1	7.6	9.3	4.9	11.2	7.5	5
General governm. budget, EU-def., % GDP [5]									
Revenues	.	.	15.9	27.0	27.1	.	.	26.1	25.3
Expenditures	.	.	21.6	27.4	26.7	.	.	28.7	27.4
Deficit (-) / surplus (+)	.	-11.3	-5.8	-0.3	0.4	.	.	-2.6	-2.1
Public debt, EU-def., in % of GDP [5]	93.0	85.1	76.9	69.6	60.5	.	.	57.0	55.0
Discount rate % p.a., end of period [6]	51.0	31.0	22.0	17.5	22.5	16.5	22.5	18	15
Current account, EUR mn	-1667	-7083	-12484	-18522	-25297	-7246 [7]	-6909 [7]	-25000	-27000
Current account in % of GDP	-0.9	-3.3	-5.2	-6.4	-7.9	-10.8	.	-6.9	-6.3
Gross reserves of CB, excl. gold, EUR mn	25562	26616	26436	42823	46200	48152	50682	.	.
Gross external debt, EUR mn	123678	114220	118045	143094	156774	152041	.	.	.
Gross external debt in % of GDP	64.1	53.8	48.7	49.3	49.2	.	.	.	.
FDI inflow, EUR mn	1203	1537	2326	8080	16027	947 [7]	7003 [7]	.	.
FDI outflow, EUR mn	177	439	693	875	744	-150 [7]	939 [7]	.	.
Exports of goods, BOP, EUR mn	42380	45183	53889	62017	73180	16262 [7]	18608 [7]	89000	109000
annual change in %	10.3	6.6	19.3	15.1	18.0	19	14.4	22	22
Imports of goods, BOP, EUR mn	49983	57504	73102	88953	105184	23496 [7]	25216 [7]	121000	143000
annual change in %	17.5	15.0	27.1	21.7	18.2	27	7.3	15	18
Exports of services, BOP, EUR mn	15113	15881	18519	21113	19443	2888 [7]	3007 [7]	22000	24000
annual growth rate in %	-13.9	5.1	16.6	14.0	-7.9	4	4.1	14	10
Imports of services, BOP, EUR mn	6923	6617	8165	9268	8806	1917 [7]	2103 [7]	10000	11000
annual growth rate in %	-5.3	-4.4	23.4	13.5	-5.0	4	9.7	8	10
Average exchange rate TRY/USD	1.5236	1.4987	1.4293	1.3480	1.4407	1.3330	1.4110	1.4	1.3
Average exchange rate TRY/EUR (ECU)	1.4397	1.6949	1.7771	1.6771	1.8090	1.6026	1.8492	1.8	1.7
Purchasing power parity TRY/USD	0.6115	0.7549	0.8315	0.8768	0.9424	.	.	.	.
Purchasing power parity TRY/EUR	0.7084	0.8920	0.9861	1.0452	1.1434	.	.	.	.

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

1) Preliminary. - 2) SIS projections. - 3) Industry including construction. - 4) From 2004 new methodology. - 5) According to ESA'95, excessive deficit procedure. - 6) CBRT interest rate - overnight, lending. - 7) Converted from USD with the average exchange rate.

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 forecasts and European Commission (Spring Report 2007).