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Turkey: soft landing appreciated

In past decades, Turkey's economic development suffered from periodical crises, in particular after the liberalization of capital flows in 1989. Now, the crucial question is whether the crisis of 2001, the most recent and most severe one, was a turning point to the better, thanks to less vulnerability of the economy.

Still before 2001, the government had adopted a programme of fiscal consolidation. This programme gained absolute priority after 2001. Primary surpluses are high enough to bring the debt/GDP ratio down. In 2004, the high debt service burden generated a sharp contrast between a primary surplus of 5.1% of GDP and an overall deficit of 7%. The debt to GDP ratio was 74% at the end of 2004, but may reach Maastricht-standard by 2007.

In 2004, the performance of the real sector was characterized by GDP growth of at least 8% and industrial output growth of around 10%. Given that last December the EU decided to start accession negotiations on 3 October 2005, the year 2004 proved to be successful for Turkey. Consumer price inflation, year-on-year, was 9.3% at year-end and 10.6% on average. This was a new phenomenon after decades of two- and sometimes even three-digit annual inflation rates. 1 January 2005 appeared to be a well-chosen starting point for the New Turkish lira (YTL), with 1 unit worth 1 million units of the previous lira. IMF representatives have repeatedly expressed satisfaction about Turkey's economic progress; the latter seems to demonstrate that sticking to the Fund's conditionality is instrumental for stabilizing the internal and external value of money, and that it is at the same time also compatible with high GDP growth.

The sector of government-managed enterprises has entered a process of transformation. The state has privatized some of these enterprises, or parts of them; others have started a partnership with domestic or foreign private enterprises; and even the management style in some of the still completely state-administered enterprises has changed. Already before 2001, the government had laid the foundations for a reform of the banking sector. While this had come too late to prevent the sector from becoming the starting point of the crisis, a comprehensive reform gained high priority thereafter. Now, the country has an independent banking supervision, and the government's costly consolidation measures contributed substantially to the consolidation of the banking industry. The latter is still heavily dependent on the government's debt servicing ability – but this fact is not a matter of much concern at present.

Not only has the erosion of the internal value of the Turkish money decelerated, nominal depreciation has also come to an end for the time being. In January 2005 the lira showed an appreciation tendency against the euro, certainly not under the influence of recent foreign trade data. Exports of goods continue to exceed imports by far, and the surplus in services offsets only part of this deficit. The current account deficit may have climbed slightly over 5% of GDP in 2004. However, GDP-related figures are just in the pipeline for revision; the State Institute for Statistics has started adopting the EU methodology of national accounts calculation, and the outcome will be a marked upward shift in GDP.

The exchange rate is not primarily determined by current account flows. Given that confidence in the soundness of the Turkish economy is increasing, in the future high nominal interest rates will have the potential of generating massive capital inflow pushing the exchange rate towards appreciation. The result would be a development unsustainable in the longer run: nominal appreciation coupled with a widening deficit on the current account, the latter constituting a sign of shrinking competitiveness of Turkish producers of tradable goods and services. This is one point of vulnerability.

Another set of influences has also the potential of increasing, at least in the longer run, the economy's vulnerability. The present government has a strong prime minister and a comfortable absolute majority in the parliament. Its achievements are most impressive in economic and political terms. However, to be become fit for EU accession, the country needs to have reform-determined governments with a solid parliamentary backing for a decade or so. Meeting the reform requirements and at the same time upholding popularity will not always be an easy task.

To win the elections scheduled for 2007, the current government will try to keep its popularity as high as it is. However, to consolidate its economic success, the government has to continue with its reform programme, no matter that part of that programme will have painful consequences for its voters. To give a few examples from the economic sphere:

(1) Last years' high GDP growth was accompanied by a corresponding rise in labour productivity, but did not create jobs; unemployment may rise further, especially in the case of privatization of several large state-owned companies.

(2) The agricultural reform package contains not only the transition to a new support system, but also cuts in the total amount of support. The sector's output shows a slightly falling trend, and the rural population articulates signs of disappointment.

(3) In spite of the population's low average age and low average life expectancy, the pension system generates high deficits, which have to be covered by the government; so a reform of the pension system is on the agenda.

(4) The tax system needs a comprehensive reform. At present, government revenues stem predominantly from indirect taxation and direct taxation of employees. The degree of tax evasion, combined with corruption, is immense.

These are sensitive issues, and reform initiatives can easily trigger a popularity loss without provoking a solid victory of an opposition party. The outcome would be weak governments such as Turkey had in the past. To maintain its popularity, the current government will most probably schedule reforms in a way that postpones painful consequences to the post-election period. Temptations to fuel popularity through more generosity will be there, but it will be possible to maintain a relatively high degree of budgetary discipline, should growth remain high, as seems likely.

In other words, Turkey is on the way towards fulfilling the Maastricht criteria; the main risks in the macroeconomic sphere are (1) weak governments in the future, which would prove incapable of maintaining budgetary discipline and (2) a central bank unable or unwilling to control nominal appreciation. Nevertheless, the Turkish economy is in better shape than several years ago, and the economy's vulnerability has diminished.

In both 2005 and 2006, GDP growth will reach around 6% and thus be somewhat weaker than in 2004. The fear of overheating has vanished. It had been triggered by year-on-year growth of 13.1% in the second quarter of 2004, which, however, originated from special conditions speeding up purchases of durable consumer goods. Both employment and real wages will continue to stagnate and thus again not contribute to consumption growth. Inflation will come down to about 7% in 2005 and to about 5% in 2006. In 2004, the main source of inflation was an increase in prices of non-tradables. Foreign trade will continue to expand faster than GDP, turning Turkey finally into a more open economy. Still, the volume of exports is below that of Poland's, a country whose economy is of similar size. Foreign direct investment inflows may rise, depending on the realization of larger privatization projects.

Table TR

Republic of Turkey: Selected Economic Indicators

Variables	1998	1999	2000	2001	2002	2003	2004 [1)]	2005 forecast	2006 forecast
Population, th pers., mid-year [2)]	65145	66304	67469	68618	69757	70885	72003	72003	73109
Gross domestic product, YTL mn, nom.	52225	77415	124583	178412	277574	359763	429730	487400	542500
annual change in % (real)	3.1	-4.7	7.4	-7.5	7.9	5.8	8.0	6	6
GDP/capita (EUR at exchange rate)	2660	2577	3171	2348	2776	3004	3369	.	.
GDP/capita (EUR at PPP)	5.820	5.573	6.260	5.570	5.949	6.254	.		
Gross industrial production									
annual change in % (real)	2.0	-5.0	6.0	-7.5	9.4	7.8	9.8	8	8
Gross agricultural production									
annual change in % (real)	8.4	-5.0	3.9	-6.5	6.9	-2.5	.	.	.
Construction industry									
annual change in % (real)	2.5	-9.4	0.2	-10.6	-6.1	-10.3	.	.	.
Consumption of households, YTL mn, nom.	36123	55928	89098	128513	184420	239586			
annual change in % (real)	0.6	-2.6	6.2	-9	2.1	6.6	8.3	7	7
Gross fixed capital form., YTL mn, nom. [3)]	12839	16931	27848	32409	46043	55618			
annual change in % (real)	-3.9	-15.7	16.9	-31.5	-1.1	10.0	35.0	25	15
LFS - employed persons, th, avg. [4)]	20872	21413	20557	20492	21463	21291	.	.	.
LFS - employed pers. in agricult. th, avg. [4)]	8461	8872	7176	8105	7623	7390	.	.	.
LFS - employed pers. in industry th, avg.[5)]	3638	3580	3731	3767	3913	3821	.	.	.
LFS - employed pers. in services th, avg.	8772	8962	9650	9647	9926	10080	.	.	.
LFS - unemployed, th pers. average [6)]	1527	1774	1449	1905	2473	2497	.	.	.
LFS - unemployment rate in %, average	6.8	7.6	6.6	8.5	10.4	10.5	10.5	10.8	11
Reg. unemployment rate in %, average	2.1	2.1	3.3	3.2	1.9	2.5	.	.	.
Average nom. wages (YTL/Hour)	0.52	0.95	1.48	1.95	2.68	3.30	.	.	.
annual change in % (real)	0.5	11.0	0.8	-14.6	-5.4	-1.8	.	.	.
Consumer prices, % p.a.	84.6	64.9	54.9	54.4	45.0	25.3	10.6	7	5
Wholesale prices in manufacturing, % p.a.	66.7	57.2	56.1	66.7	48.3	23.8	11.1	.	.
Government budget, % GDP									
Central government revenues	22.4	24.3	26.7	29.0	27.5	27.9	.	.	.
Central government expenditures	29.8	36.2	37.4	45.1	41.6	38.9	.	.	.
General governm. deficit (-) / surplus (+) [7)]	-9.6	-15.7	-11.9	-16.2	-12.6	-8.6	-7.0	.	.
Public debt in % of GDP	42.2	52.7	53.8	100.4	88.8	83.3	.	.	.
Discount rate % p.a., end of period	67.0	60.0	60.0	60.0	55.0	43.0	.	.	.
Current account, EUR mn	1751	-1267	-10670	3798	-1603	-7120	-12530	-14000	-17000
Current account in % of GDP	1.0	-0.7	-4.9	2.3	0.0	-3.3	-5.2	.	.
Gross reserves of CB, EUR mn	17404	21849	24095	21050	28233	29781	.	.	.
Gross external debt, EUR mn	85090	97121	129107	127620	138031	130263	.	.	.
FDI inflow, EUR mn	841	766	1855	3684	621	367	.	.	.
FDI outflow, EUR mn	11	28	788	25	5	7	.	.	.
Exports total, fob, EUR mn	27060	27189	33385	38484	42203	45365	53630	61700	71000
annual change in %	-4.5	0.5	22.8	15.3	9.7	7.5	18.2	15	15
Imports total, fob, EUR mn	38094	36040	55673	42495	49557	57777	72860	84000	96000
annual change in %	-5.4	-5.4	54.5	-23.7	16.6	16.6	26.1	15	14
Exports of services, BOP, EUR mn	20903	15837	22130	17961	15570	16855	19400	.	.
annual growth rate in %	19.0	-24.2	39.7	-18.8	-13.3	8.3	15.1	.	.
Imports of services, BOP, EUR mn	8984	8779	9776	7731	7271	7548	9050	.	.
annual growth rate in %	13.1	-2.3	11.4	-20.9	-6.0	3.8	19.9	.	.
Average exchange rate YTL/USD	0.2616	0.4211	0.6252	1.2284	1.5095	1.4967	1.4253	.	.
Average exchange rate YTL/EUR (ECU)	0.2964	0.4468	0.5753	1.0963	1.4332	1.6894	1.7714	.	.
Purchasing power parity YTL/USD, wiiw	0.1241	0.1917	0.2744	0.4301	0.6183	0.7451	0.7126	.	.
Purchasing power parity YTL/EUR, wiiw	0.1378	0.2095	0.2950	0.4668	0.6689	0.8116	0.8857	.	.

Notes: 1) Preliminary. - 2) 2004 to 2006 SIS projections. - 3) Private and public. - 4) For years prior to 2000 estimates based on biannual data. - 5) Mining and Quarrying, Manufacturing, Electricity, Gas and Water. - 6) Civilian Labour Force: unemployed; for years prior to 2000 estimates based on biannual data . - 7) Based on the Public Sector Borrowing Requirement (PSBR) methodology including local public administration, social security and enterprises under public administration.-

Source: CBRT-EDDS (Central Bank of Turkey, Electronic Data Distribution System), SIS (State Institute of Statistics), SPO (State Planning Organization), UT (Undersecretary of Treasury).