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An Overview of the Turkish Economy: Outlook and Current Perspectives

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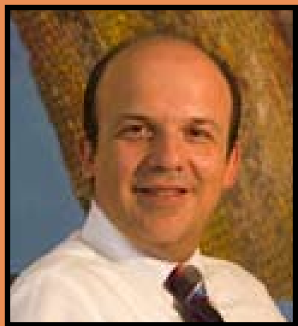
Contents

Executive Summary

This Policy Brief *provides a summary of recent developments in Turkey, which is becoming an attractive investment destination. The Turkish economy's growth potential is not only limited to internal dynamics, but Turkey is also a critical country as an engine for economic stability in the Middle East, as an energy route for Central Asian economic independence, and as a source of dynamism for the EU.*

About the Author



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Turkey is at the center of an economic and political area known as "Eurasia," where three regions of the world — Europe, the former Soviet Union, and the Middle East — intersect. Turkey's proximity to the Balkans and the rest of Europe as well as to the growing emerging markets in Central Asia, the Middle East, and North Africa creates unique business opportunities. The experience of numerous global firms confirms Turkey as a predominant investment location and export platform. Companies like Microsoft, Coca-Cola, GE, Procter & Gamble, and Phillip Morris, as well as international investment institutions like the World Bank Group's International Finance Corporation have already selected Turkey as a regional base. Turkey is fast becoming a production center for Europe in diverse industries, particularly in automotives.

Turkey is the leading investor in the Caucasian and Central Asian Turkic Republics. Due to her strong cultural and historic ties, Turkey provides privileged access and a perfect base to develop business with these countries.

The international image of Turkey in terms of a destination for investment is generally shaped by the diverse market opportunities, both domestic and export-oriented, that Turkey offers. These markets have a potential reach of over one billion consumers, including:

- a huge and growing domestic market (approximately 72 million);
- high-income European markets (approximately 600 million);
- emerging Russian, Caucasian, and Central Asian markets (approximately 250 million);
- diverse and expanding Middle Eastern and North African markets (approximately 160 million).

Turkey's potential has long been recognized by the international community, but its star has not easily risen due to a number of reasons. Political conflicts and instability created a sense of immobility, limiting the potential of the economy. Structural problems such as high inflation and real interest rates, high unemployment, unstable exchange rates, and income inequality that needed urgent attention were not adequately addressed, delaying long awaited economic and political reforms.

Turkish history is marked with great successes that follow important crises. For example, the decimation of the Ottoman Empire after World War I was followed by the formation of the secular, democratic republic of Turkey by Atatürk. The serious economic crisis of the second half of the 1970s was followed by the economic reforms of Turgut Özal that liberalized the Turkish economy. Similarly, the 2001 financial crisis turned out to be a blessing in disguise, despite the fact that Turkey had to pay the cost of such a shock for many years afterwards. In fact, the aftershock of the crisis was so strong that political choices were radically reviewed and politicians were forced to address a number of politically difficult structural reforms.

Such hardship eventually paid off. After more than 40 years of struggle towards integration with the EU and 25 years of struggle towards integration with the rest of the world, Turkey has now embarked on a new level of development. Not only are the aftershocks of the 2001 economic crisis fading away, but also the country's full potential has been brought to the attention of foreign investors, mainly thanks to the commencement of full membership negotiations with the EU and the success of an economic program that has so far been yielding positive results.

Such a blessing in disguise also triggered a serious change in the mentality of politicians and businessmen alike. Although the former had no other alternative but to address politically difficult choices, the latter had to improvise in the face of an increasingly open and competitive economy. Producing cheaply was no longer sufficient. The business community also had to improve quality and create world brands, and in such tasks they are proving to be successful. Recently, Turkey has become one of the top countries to host European Quality Award winners, and Turkish brands are becoming household names in a wide range of countries.

Other lessons were also learned. Until 2001, the Turkish business community generally preferred to maintain their interests within Turkey. After the crisis, they learned the hard way that diversifying their interest outside Turkey would not only be acceptable, but was also a necessity if they really preferred to integrate with the global economy. For example, many Turkish companies are gaining ground against global companies in high growth markets such as Russia.

In this setting, an important question still remains to be answered: has Turkey done enough to ensure that growth and stability are here to stay? To address such matters is almost always tricky. However, when one considers the current economic climate as well as the potential Turkey has to offer for investors, it is fairly safe to argue that the usual concerns of the past do not fit into the picture of the future.

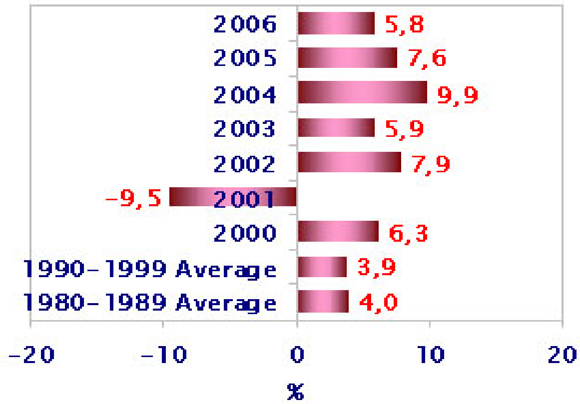
To substantiate our arguments, it may be useful to begin our analysis by addressing the general economic situation in Turkey from a historical perspective.

ECONOMIC GROWTH

Turkey has witnessed three major economic crises since 1994, and the last one in 2001 was one of the worst economic downturns Turkey has ever experienced. Although the average historical growth rates have been more than satisfactory, political instability, problems in foreign affairs, populist domestic policies, and a major earthquake at an industrial center have all contributed to these crises.

On the other hand, growth rates since 2001 have been the highest in the Organization for Economic Cooperation and Development (OECD) area (see Figure 1 and Table 1). What is different from the past is the fact that in the period since 2001, Turkey has carried out some of the most impressive and long-awaited structural reforms, which were recognized by the international community: the EU has agreed to open full membership negotiations with Turkey and the IMF declared Turkey a success story. It would not be an exaggeration to suggest that in the absence of a *force majeur*, Turkey is set on the right track for economic growth of satisfactory levels. According to the economic program, it is expected that the Turkish economy will continue to grow at an average of 5% annually for the next two years.

Figure 1: Economic Growth, 1980 to 2006 (%)



Source: State Planning Organization (SPO)

Table 1: GDP, 1980 to 2006

	GDP Growth (%)	GDP Nominal (billion US$)
1980-89	4.0	-
1990-99	3.9	-
2000	6.3	200
2001	-9.5	146
2002	7.9	184
2003	5.8	241
2004	8.9	301
2005	7.6	361
2006	6.0	390

Source: Turkstat, Treasury

Furthermore, the long-term perspectives look even more promising. With Turkey's population growth rate falling from over 2% to roughly 1.5%, it is on the verge of entering a "golden demographic period" similar to what East Asia experienced in the 1980s, where the productive working population is the largest relative to children and retirees, providing the potential for even more rapid income growth.

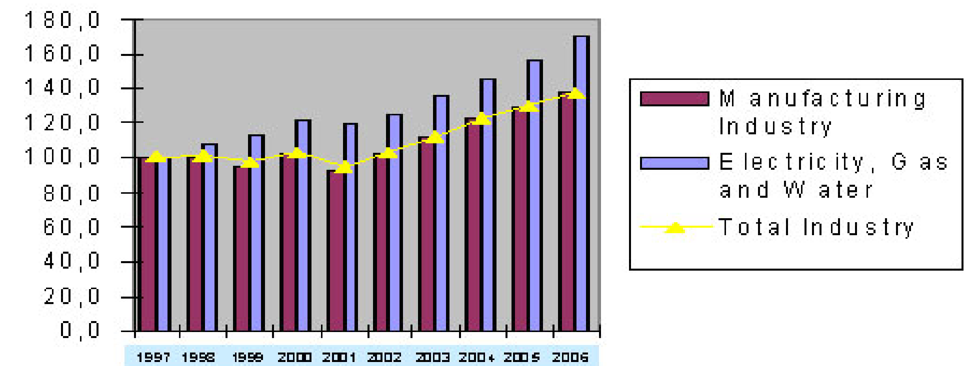
This situation is likely to be a panacea for improving the competitiveness of Europe as well as Turkey. The continuation of reforms to bring Turkey into full EU membership will not only increase the confidence in the Turkish potential and investments in Turkey, but also is likely to make Turkey indispensable to the EU. For example, with her renowned hospitality, quality of medical care, and pleasant climate, Turkey is likely to become the Florida of the EU in terms of caring for the elderly.

Only a few emerging markets in the world have the potential of attracting investment both for export as well as for their domestic market. Turkey is in a privileged position to create a "virtuous investment cycle," with a more competitive domestic business environment further strengthening Turkey as a platform for exports, and exports in turn stimulating firms to upgrade and better serve the domestic market. This is true not only for products, but also for the young managers. Young Turks, with their professionalism and flexibility to deal with a wide range of circumstances, are being employed by global firms throughout the world. The Chairman of Pfizer has suggested that the most important export of their Turkish operation is qualified managers / leaders.

INDUSTRIAL PRODUCTION AND CAPACITY UTILIZATION

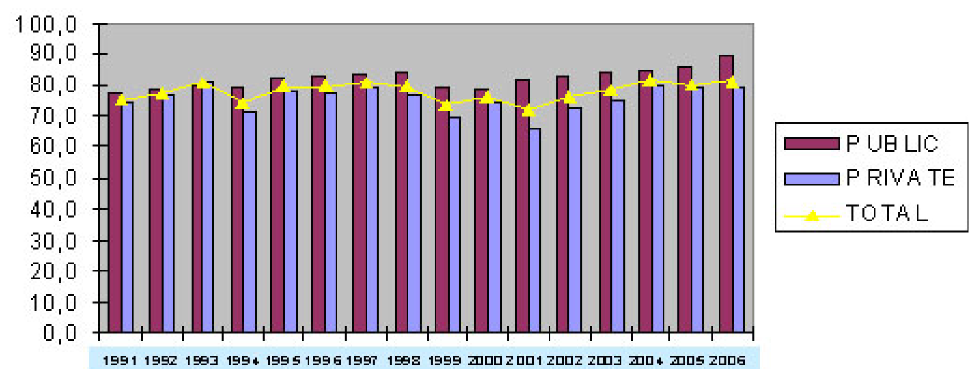
Industrial production has shown a steady increase since 2001 (see Figure 2) and reached its highest ever level of 138 at the end of 2006, based on the 1997 index. Capacity utilization rates have demonstrated a similar pattern and have been hovering around the 80% mark over the last year.

Figure 2: Industrial Production, 1997 to 2006



Source: Turkstat

Figure 3: Capacity Utilization, 1991 to 2006 (%)



Source: Turkstat

Figures 2 and 3, exhibiting the levels of industrial production and capacity utilization, demonstrate increased levels of confidence in the markets. Industrial production is on a steady increase since the 2001 financial crisis and capacity utilization rates demonstrate the characteristics of a booming economy, as was the case between

1991 and 1993 as well as between 1995 and 1998.

FOREIGN TRADE AND CURRENT ACCOUNT DEFICIT

Turkish foreign trade has increased tremendously over the past decade, growing almost 20% annually. According to WTO figures, Turkey ranks fifth in the world in terms of exports growth. In fact, Turkey's exports have more than tripled in the last six years, reaching an impressive US $85 billion for 2006. Its imports also have been growing at an impressive rate. The structure of imports remains concentrated in raw materials and other industrial inputs, suggesting that however high they may be at this stage, imports are merely supporting the export base.

Table 2: Foreign Trade, 1980 to 2006 (Billion US$)

	1980	1990	2000	2003	2004	2005	2006
Exports	3	13	28	47	63	75	85
Imports	8	22	55	69	97	116	137

Source: Turkstat, State Planning Organization (SPO)

The only serious concern in the major economic indicators relates to the current account deficit, which is high by any standards at its annual current level of US $18.9 billion as of end of 2006, down from US $22.8 billion in 2005. Historical data suggest that although the current account deficit has been high in recent years, the rate in which it is growing is slowing down and the possibility of financing it is definitely improving.

Any correction to such a high figure carries its risks. The general attitude of the government towards financing the deficit is to keep calm, carry on with the IMF program and the EU integration process and continue to improve the quality of financing over time.

EXCHANGE RATES AND INTRODUCTION OF THE NEW TURKISH LIRA

In order to create a psychological impact and to facilitate accounting, the present government introduced the New Turkish Lira (first YTL and then TL again since the beginning of 2007) by getting rid of six zeros off the currency. Such a change gave a boost to the positive expectations about the economy.

After a very strong devaluation in 2001, the TL has been left to float freely — with minor interventions — and has become overvalued against major currencies by some 49%, according to the exchange rate index at the end of 2006. Needless to say, such an overvaluation has its consequences in the exporting ability of the country. However, despite numerous outcries from the business community, the government insisted on freely floating the TL.

INFLATION

The level inflation has reached in recent years is another success story in the economic program (see Table 3). Despite numerous domestic and international pressures such as high oil prices, the steady decrease in inflation levels has not only boosted confidence in the domestic market, but also has allowed all the players in the economy to be able to plan ahead, perhaps for the first time in 30 years.

Table 3: Inflation, 2001 to 2006 (%)

	2001	2002	2003	2004	2005	2006
CPI	68	30	18	9	8	10
WPI	89	31	14	14	3	12

Source: Turkstat

Turkish businesspeople are very happy to have the high inflation nightmare out of their sight. However, working in an unstable economic environment for such a long time has strengthened their financial skills and sensitivity. For example, many global businesses chose to utilize their Turkish managers' skills to deal with the Asian crises.

INTEREST RATES

Having suffered from substantial real interest rates and having dealt with the financial crises under such unfavorable conditions, the Turkish economy is now getting accustomed to the idea of relatively lower interest rates, another manifestation of confidence in the markets.

Despite skepticism regarding its current level (some experts argue that they are very high compared to the inflation level), the risk elements are slowly disappearing. This suggests that in time, real interest rates too will reach a more comfortable level, reflecting the potential of the country (see Table 4).

Table 4: Interest Rates, 2003-2006 (%)

	2003	2004	2005	2006
Government Bonds	28	20	14	22
O/N Borrowing	30	20	14	19

Source: Treasury

BUDGETARY DATA

For the first time in its modern history, the Turkish government prepared and declared a three-year budget in line with the IMF targets (see Table 5). This development has definitely contributed to positive expectations in the market.

Table 5: Consolidated Budget, 2004 to 2006 (In Billion YTL)

	2004	2005	2006
Expenditure	141	145	175
Interest Payments	56	46	46
Excluding Interest Payments	85	99	129
Revenues	111	131	171
Taxes	90	113	137
Deficit	30	15	4

Source: Treasury

It is important to underline a few facts about fiscal discipline. Since the beginning of the economic program, budgetary discipline has been maintained vigorously. Governments have been committed to fiscal discipline and did not seek solutions in populist policies, which in the past have turned Turkey's budget into a black hole. Secondly, and again in line with the discipline issue, targets always have been set at acceptable levels.

It can be argued that expenditures have been kept under control, with interest payments beginning to stabilize at the very least. Tax collection is increasing and stabilizing at around 80% of total revenues. Most importantly, the deficit is narrowing thanks to the positive economic outlook, reducing interest rates and thus risks.

RECENT DEVELOPMENTS AND TARGETS FOR THE FUTURE

As part of the economic reform program, the Turkish government began a series of privatizations, some of which are in strategic industries. Out of the privatization program, three transactions — namely Türk Telekom's sale to Saudi Oger, Tüpras' (petroleum refinery) sale to the Koç and Shell Consortium, and Erdemir's (steel) sale to OYAK group of Turkey — attracted a great deal of attention from international investors, and this has been a milestone for growing confidence in the government's economic program. The privatization program raised US $9.65 billion in 2005 and US $19.79 billion in 2006.

It seems that persistent attempts in the privatization program will continue in the future, creating further and profitable opportunities in the energy, telecoms, agribusiness, transport, and real estate industries.

As for relations with the IMF and other major financing institutions, Turkey has implemented most of the important structural reforms required, giving the impression to the outside world that economic and monetary discipline are very important in order to maintain credibility, and that a stable economy and political system free of unnecessary turbulence are key to success.

A similar portrait was depicted in relations with the EU. To the surprise of many supporters and skeptics alike, Turkey has successfully completed a series of political reforms and secured a new beginning with the EU by initiating full membership negotiations. This prospect has placed Turkey in a highly desirable position in the eyes of foreign investors.

CONCLUDING REMARKS

In short, with her high growth potential, qualified workforce and managers, and entrepreneurial spirit, Turkey provides an important potential market for global businesses. Furthermore, regional political stability can only be established on a sustainable basis if this economic development spreads throughout the region. The engine for growth in the Balkans, Caucasus, Central Asia, and the Middle East is likely to be Turkey. Perhaps most importantly, as an observer of the Turkish economy has put it, "Turkey will be the 'viagra' for Europe" by becoming the key agent to helping improve European competitiveness.