

REVIEWING THE TURKISH ECONOMY AFTER OCTOBER 3

Dr. Baran Tuncer

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On October 11, 2005, the CSIS Turkey Project hosted the distinguished Turkish economist and columnist Dr. Baran Tuncer. Having spoken at CSIS in May 2003 on “The Turkish Economy: On the Road to Recovery,” Tuncer re-examined the economic prospects for Turkey following the start of accession negotiations with the European Union on October 3, 2005

In his previous presentation, Tuncer had said that it was too soon to conclude that the recovery had ensured that the Turkish economy had entered an era of stability and strong growth. He had also said that the future course of the economy would be determined by the performance of the Justice and Development (JDP) government, which had come into office a few months earlier.

While Tuncer was willing to express greater optimism on the durability of the recovery, he nevertheless cautioned that its continuation depended on the preservation of political stability.

After summarizing ‘the dramatic economic progress’ during the past three years, Tuncer said that “an average of 7 percent growth rate over three years is respectable by any standards and what is remarkable is that a decline of the inflation rate to single digits has been accompanying economic growth.” Identifying “the explosion in exports as the engine of economic growth” Tuncer observed that the increase in exports was due mostly to productivity gains and did not lead to a growth in employment.

Tuncer noted that despite the economic growth, the unemployment rate had actually increased and real wages had come down. Consequently, although the economic recovery had impressed the markets and international financial institutions, it had not made a positive impact on the life of the ‘man on the street.’ While small and medium-sized firms were complaining and asking for government support, big corporations and banks were, in contrast, experiencing an increase in their profits and supportive of the policies of the government. Consequently, Tuncer warned, the “social consequences of uneven development” could undermine support for the JDP government.

Moreover, Tuncer stated, it was not only exports but also imports which had “exploded,” leading to the highest GDP current account deficit in history. Having reached \$16 billion for the first 8 months of 2005 - with a significant proportion of the deficit listed under the ‘net errors and omissions’ section - the current account deficit was expected to reach \$21 billion and to constitute close to 7 percent of GDP by the end of this year.

Although the remarkable recovery of the Turkish economy from 2002 to 2005 had eased the overall debt burden while reducing the budget deficit from 17 percent to 6 percent of GDP, Tuncer said that “alarm signals were not out of question.” The economy needed a new engine to sustain growth, but did not have one. Since the output in manufacturing

sector was already on the decline and there was no substantial increase in domestic demand, the growth rate would inevitably fall.

Tuncer observed that overvalued Turkish lira was hurting production and exports. The exchange rate could not respond to the fluctuations in the level of imports and exports because capital inflows kept it high. According to Tuncer, the exchange rate was “tied to the needs of hot money.” While the current account deficit was already financed for 2005, in order to be able to continue financing the balance of payments in the future either imports had to come down or additional funds had to come in from Turkey’s own resources or from abroad.

Tuncer estimated that short-term capital inflows invested in the stock market, Turkish Lira accounts and government bonds probably amounted to as much as \$30 billion. High real interest rates were keeping Turkey attractive for investors and there was no immediate reason to panic. Commenting that the foreign lenders were “making big money,” Tuncer said that the government was borrowing at a high real interest rate of 17-18 percent.

Although there would have been a limited negative impact on the stock market if the accession negotiations had not started on October 3, Tuncer claimed, no positive reaction was observed as “markets had already bought the accession.” He said that even if EU accession talks had not started, there would not have been a significant capital flight.

Given the continuation of the economic recovery, Tuncer said he expected the requirements of the Maastricht Criteria regarding the budget deficit and public debt stock to GDP to be “easily fulfilled.” Turning to the likely impact of eventual EU membership, Tuncer referred to the experiences of the ten new EU members as well as Spain, Portugal and Greece, and said that although the economic effects varied from country to country, accession triggered economic growth. It increased the volume of foreign trade and foreign direct investment (FDI) and decreased inflation and interest rates, but also led to an increase in current account deficits. In the Turkish case, Tuncer said that the changes would probably not be that dramatic as Turkey had joined the Customs Union in 1995 and there had already been an increase in the level of trade between Turkey and the EU. Nevertheless, Turkey could expect more FDI, which had already risen this year to over \$2 billion unless there was a major political crisis. (In his 2003 speech, Tuncer had said that he expected more FDI because “the current government was inclined to be less bureaucratic and therefore more favorable to foreign investors.”)

Estimating the size of the informal sector in Turkey to be as high as 40-50 percent, Tuncer said that it was “not taxable” but “helped to reduce costs.” Although he did not foresee the abolition of what he termed “the underground economy in the near future, Tuncer said that it would be certainly affected by the adjustments necessary during the EU accession process. He said changes in tax laws and a social security reform could bring down the high costs for the manufacturers, smoothing the inevitable transition. Regarding relations with the IMF, Tuncer stated that the IMF and the government were “taking each other seriously” and neither “could give the other up.” Moreover, the EU was “not a substitute for the IMF at this point.”

Tuncer concluded by reiterating his concern over the possibility of “a non-economic shock” which might cause panic among investors and have a disastrous effect on the economy.