››› Turkey has made much progress but remains highly vulnerable

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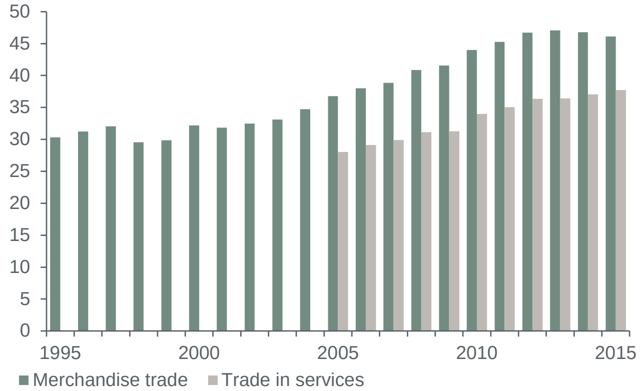
Turkey has evolved into an important trading hub between Europe and Asia. Particularly since the start of the millennium, and also in response to a serious economic crisis it suffered in 2001, the process of integrating the country into global trade has been accompanied by a series of reforms that enabled Turkey to make much progress along economic and social lines. However, economic problems and rising external vulnerability became increasingly apparent after the financial and economic crisis. Turkey's international competitiveness has deteriorated in the past years. This process has further accelerated since the summer of 2016 and is threatening the gains achieved through the modernisation and reforms undertaken in the past years.

Growing international integration

Turkey initiated a modernisation and reform process at the start of the millennium. It encompassed a number of reforms in the social security system and banking sector, among others, and it strengthened civil liberties. Some of these reform measures, especially in the banking sector, must be understood as a response to the crisis of 2001 when Turkey slid into a deep recession caused by a balance of payments and banking crisis that led to a GDP contraction of 5.7 %. That crisis can therefore also be seen as a turning point that triggered many positive developments, especially in the economic area.

Figure 1: Developing and emerging markets in global trade

Trade in goods and services (sum of nominal exports and imports) of DCs / EMEs as a percentage of global trade in goods and services



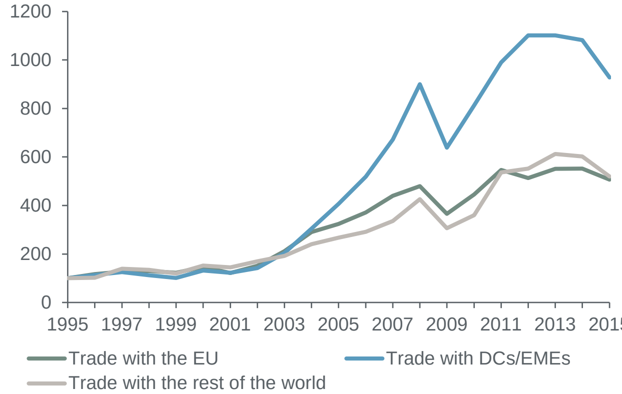
Source: UNCTAD, own calculations

While this Turkish reform process was getting underway, the pace of globalisation accelerated significantly. A primary feature of this development was the growing integration of the group of developing countries and emerging market economies (DCs/EMEs) into the global economy. The proportion of DCs/EMEs in global trade has grown from around 30 % in 2000 to over 45 % (Figure 1). This has brought great advantages for Turkey, which gradually opened up to external trade already in the 1980s. Turkey's exports and imports therefore have grown significantly since the start of the new millennium. At the same time, it is not surprising that Turkey's external trade with the DCs/EMEs has been particularly dynamic since then. The growing proportion of this group of countries in global trade has also been reflected in their trade relations with Turkey (Figure 2). But its trade with the rest of the world also gained momentum in the new millennium.

As a result, today Germany is Turkey’s most important trading partner. The country also maintains intensive trade relations with the USA and China. Russia is Turkey's third most important trading partner, Iraq the third most important destination for exports, while Iran and India are the eighth and ninth most important suppliers of the Turkish economy. Aggregated into country groups, the EU and the DCs/EMEs play a similarly important role with a volume of trade of some USD 160 billion each (a good 20 % of GDP). The rest of the world accounts for a trading volume of around USD 50 billion (as at 2015).

Figure 2: Turkey's trading volume

Sum of nominal exports and imports (goods only, index 1995=100)



Source: UNCTAD, own calculations

As part of this internationalisation, the degree of openness of Turkey's economy rose as well. Before the financial and economic crisis, this rise was rather moderate at times because the increasing momentum of external trade was accompanied by significant GDP growth rates (see following section). After the degree of openness dropped as a result of the crisis, it subsequently increased more noticeably because external trade grew tangibly after the crisis despite declining growth rates – unlike the average of the DCs/EMEs, which became less open after 2006 (Figure 3). This is an additional indication of the enormous importance of external trade for Turkey.

Figure 3: Degree of openness

Sum of nominal exports and imports (goods and services) as a percentage of GDP

Source: World Bank, own calculations

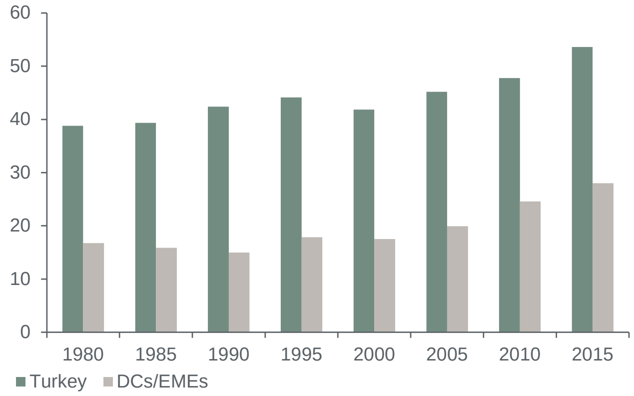
Flourishing domestic economy from 2000 to 2007

Turkey's opening brought the country a visible economic upswing. This was evident especially in investments, which usually grew at double-digit rates in the 2000s (up to the crisis). The investment ratio rose from nearly 19 % in 1999 to 21½ % in 2007 (in real terms, based on 1987 prices, that increase was even around 6 percentage points), while the consumption ratio remained relatively steady during this period at just under 70 %. As a result of this investment boom, Turkey exhibited high productivity growth (average labour productivity growth of roughly 4½ % in the years 2000–2007), eclipsing that of the euro area (1 %) and the OECD countries (close to 2 %).[1] Overall economic growth during this period averaged around 5 % (or nearly 7 % if one disregards the crisis year 2001).

Generally, these processes also had positive welfare effects for the Turkish population and improved social conditions which endure until today (beyond the period treated in this section). Per capita GDP in Turkey grew from around USD 13,300 in 2000 to just over USD 20,000 in 2015 (USD adjusted for purchasing power). During this period Turkey was also able to catch up in relative terms. At the turn of the millennium, per capita GDP was roughly 40 % of the EU level but rose to nearly 55 % by 2015 (Figure 4). Significant socio-economic improvements also took place, including in healthcare, education levels and per capita social expenditure.

Figure 4: Per capita income

Real per capita income in Turkey and in the DCs/EMEs in proportion to real EU per capita income (each adjusted for PPP), in per cent



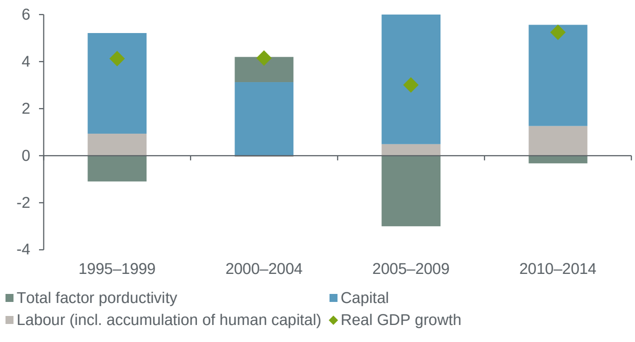
Source: Conference Board, own calculations

Problems have been growing since the financial crisis

The global financial and economic crisis has not left Turkey unscathed either. Its economy contracted by 4.8 % in 2009. After the crisis the country was able to achieve growth rates of around 9 % in 2010 and 2011, but after that it did not succeed in regaining its old growth momentum. The main reason for this was Turkey's declining productivity, which has been falling by an average 0.1 % annually since 2012. Total factor productivity, which explains the portion of growth generated by efficiency improvements, still contributed significantly to growth in the first half of the 2000s but has had no effect since then.[2] Productivity losses were increasingly offset through increased formation of capital stock and a (renewed) increase in labour participation (Figure 5).

Figure 5: Contributions to real economic growth

Average contributions to growth, in percentage points



Source: Conference Board, own calculations

This raises the question about future sources of growth. Although Turkey's labour participation rate of 55 % is quite low in international comparison, that rate is hardly expected to grow in the years ahead, according to the ILO. The reasons for this are demographic. In the case of Turkey specifically, another reason is that women's labour participation is very low and will probably remain low in the current political climate. The potential for generating growth by mobilising more male workers is low as their participation rate is already close to 80 % and free access to the labour market looks set to become increasingly difficult, for instance for minorities and supporters of the opposition.

Growth potential on the capital side is also limited. The lively investment activity of the past years has created over-capacity that can no longer be utilised today and in the future. Although the average (negative) output gap of the post-crisis period (2010–2015) is only a good 1½ % of potential GDP and thus lower than the OECD average of around 2 %, the OECD expects the output gap to narrow to 1 % for its entire territory this year and next year, while it expects it to expand to around 4½ % for Turkey. Against this backdrop, the weak investment activity since 2012 is not surprising either.

In summary: Unless it makes higher productivity advances in the coming years, Turkey will continue to lose growth potential. One way of improving this prospect is to invest in human capital, because despite major progress the country still has a need for catching up in the education sector, particularly by improving access to tertiary education. Turkey ranks only 73rd out of 130 on the Human Capital Index[3], scoring 67.6 points out of a maximum of 100, which puts it clearly behind the EU, where the average is 78.5.

Loss of competitiveness

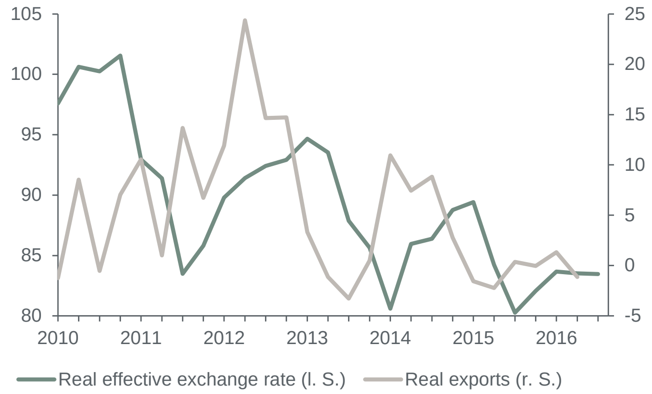
These kinds of structural factors play a major role also because they are crucial to an economy's international competitive position. When it achieves high productivity gains and provides a good investment environment, when its markets function efficiently and when it has well-developed human capital, an economy generally is attractive for foreign direct and financial investment, and this in turn helps to strengthen its own domestic economy and export industry.

As described, Turkey is closely integrated into global trade, but it exports less than it imports, so it has an external deficit. Turkey's current account was almost balanced on average during the 1990s, but as the country became increasingly interwoven with the global economy and global trade, it became increasingly unsuccessful in reasonably balancing its external trade. At the end of 2011 its current account deficit peaked at around 10 % of GDP before falling again to a good 4 % by mid-2016. But that is not an expression of increasing competitiveness and, hence, flourishing exports. The opposite is the case. Turkey's export momentum is trending downward (Figure 6) and the only reason its current account balance has improved since 2011 is because imports have decreased even further. Turkey's competitiveness has trended downward noticeably for several years now. The lost ground is reflected in the Global Competitive Index of the World Economic Forum (down from rank 43 out of 138 in 2012 to rank 55 in 2016) and in the World Bank's Doing Business Index, dropping from rank 51 out of 190 in 2013 to rank 69 today). Risk premiums on government bonds have roughly doubled since mid-2013.

A further indication is that the Turkish lira depreciated (in nominal and real terms) after the financial crisis as its export momentum dropped (see Figure 6). This in itself gradually increased Turkey's price competitiveness, which (theoretically) should have improved its export momentum. However, although a currency depreciation can help an economy regain competitiveness, above all else it is an expression of economic problems. In the case of Turkey the problems set out above and the resulting drop in competitiveness have led to reduced investor interest and falling demand for Turkish goods, leading to a drop in demand for the lira.

Figure 6: Turkey's competitiveness

Real effective exchange rate: index (2010=100); exports: variation on previous year in per cent



Sources: Turkish Statistical Institute, Bloomberg, own calculations

Financing side may become a bottleneck

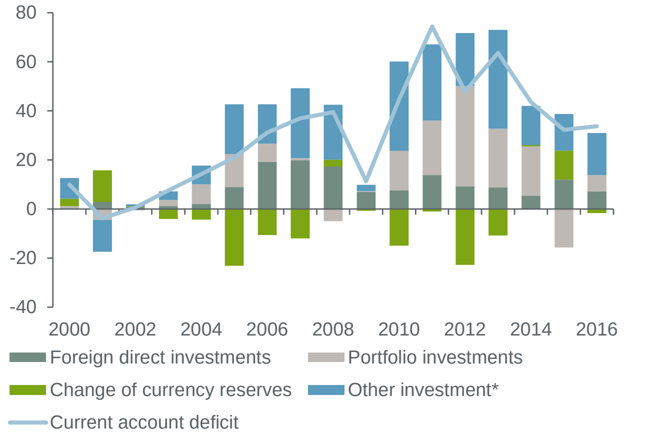
An external deficit needs to be financed. That is why Turkey (like any other deficit country) continuously depends on capital flowing into the country.[4] Turkey's capital inflow totalled some USD 450 billion net from 2000 to 2015. Thereby, the indebtedness of the non-financial private sector reached extremely high levels from just under 25 % of GDP at the turn of the millennium to almost 80 % at the end of 2015. Consistent with the reduced current account deficit after 2011, the volume of capital entering from abroad dropped from around USD 65 billion in 2011 to less than USD 25 billion in 2015 (see Figure 7).

However, because the reduced inflow of external funds is a reflection of reduced competitiveness and waning international investor confidence, the question arises what structure these capital inflows have. The more short-term and the more easily reversible capital inflows and their resulting claims are, the higher the danger of further forced current account adjustments. The situation becomes part-icularly dangerous when falling investor confidence leads not just to reduced capital inflows but, on balance, to a capital drain.

The nature of capital inflows to Turkey has changed significantly over time. Before the financial crisis, inflows were mostly composed of so called other investment (mostly loans, deposits, cash, business loans; on average around 40 % of all net inflows from 2000) and direct investments (roughly one quarter). Portfolio investments made up only around 15 %. After the financial crisis, portfolio investments became significantly more important (average share around 30 % from 2010), and funding through other investment transactions was further expanded (around 45 %), while direct investments on average remained below 20 %. At the same time the short-term nature of external debt increased. The outstanding amounts of portfolio investments (which are regarded as easily reversible) and short-term loans together made up around 35 % of GDP in 2014, whereas that share was only around 20 % at the start of the millennium and only a good 10 % in the mid-1990s. Thus, the potential for fast capital withdrawals has increased stepwise and Turkey's external vulnerability has grown.

Figure 7: Financial account balance and current account deficit

In USD billions (+ sign means capital inflow; figure for 2016: up to and including October)



* Comprises mainly loans, cash and deposits, trade loans

Source: CBRT, own calculations

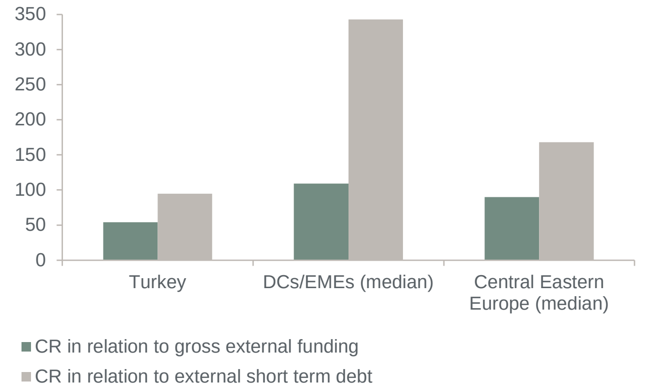
External vulnerability remains high despite improvements

The decline in capital inflows since 2011 and the associated balance of payments adjustment, however, have not yet led to any major distortions, even though in 2015 portfolio investments were even reversed, that is, withdrawn from Turkey. The economy is evidently strong enough to handle this capital outflow and the associated reduced import growth (which offset the reduced export growth). In the course of this adjustment, the above stock of portfolio investments and short-term loans dropped to nearly 30 % of GDP in 2015.

But it is still too early to give the all-clear. Turkey's external vulnerability remains high, especially since the risk is growing that an environment of rising interest rates in the industrialised countries – originating in the USA – may end up making Turkey a less attractive investment location. Thus, fast capital outflows continue to jeopardise the financing of Turkey's economy. Its currency reserves are much too low to mitigate such outflows. Although reserves did rise continuously since the start of the millennium up to around 2013, since that year a sideways trend in the stock of currency reserves has been discernible. In relation to its accrued external short-term debt and in relation to its external funding requirements, Turkey' stock of currency reserves is far below average (Figure 8).

Figure 8: Currency reserves (CR)

In per cent



Source: EIU

Increasing structural problems have thus begun to appear in Turkey in the past years, leading to declining competitiveness and higher external vulnerability. This is currently being exacerbated by the fallout of the failed coup attempt of July 2016.

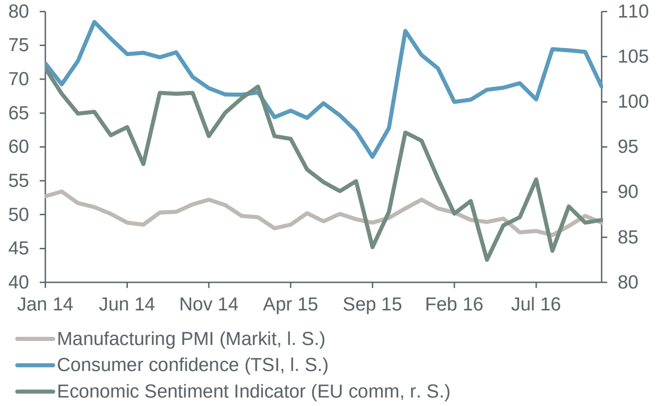
The coup attempt and its possible consequences

Turkey's response to the failed coup attempt has included radical measures such as massive restrictions on civil rights. From an economic viewpoint that has increased the danger of triggering a massive brain drain. As a consequence of the response to the coup attempt, several thousand people are already no longer in the workforce. Administrations, universities, schools and other public domains are facing increasing skills shortages.

This will result in undesirable economic consequences. A climate of uncertainty and cautiousness is emerging that is discouraging people from making decisions. The confidence of domestic and international investors as well as consumers will decline noticeably and private investment plans and consumption decisions will be deferred or abandoned altogether. The competitiveness and macroeconomic performance capability of Turkey's economy will generally be weakened in the medium term. In this context, the GDP decline of 1.8 % in the third quarter on the third quarter of 2015 should be taken seriously, but not overrated either because the actual coup attempt took place in the third quarter. The relatively quickly available sentiment indicators do not yet really show a drop in confidence (Figure 9). The stock market was characterised by losses, but these were partly recovered later. However, significant losses occurred again in late October. The monetary, fiscal and structural policy mix of the coming years will be crucial in determining whether the positive mood will translate into hard economic facts.

Figure 9: Sentiment indicators

Left scale: Diffusion index (50=neutral), right scale: index points



Source: Bloomberg

Conclusion

At the start of the millennium, Turkey created excellent conditions for a fast-growing, internationally integrated and structurally sound economy that also offers a modern socio-economic and social environment. Structural policy failures, especially with a view to productivity growth and further development of human capital, are beginning to limit production potential. The response to the failed coup of July 2016 and its investigation are threatening to reduce the underlying strength of Turkey's economy even more. This is a risk factor because Turkey will remain dependent on the inflow of foreign capital in the future as well. ■

[1] Source: OECD Statistical Annex to the Economic Outlook, June 2016. Depending on the source, the calculation of productivity advances is subject to a number of differences in methodology, such as the currency conversion factors applied. Using other sources therefore may also lead to different figures. However, these differences do not affect general statements made in this paper.

[2] The reason for this could be that Turkey's innovative capacity has declined. Commonly used indicators such as expenditure on research and development (R&D) or the number of patents are unsuitable for confirming this hypothesis. What is rather more likely is that Turkey's ability to ultimately transform R&D, patents and other measures into actual innovation that enables total factor productivity to grow has fallen.

[3] The Human Capital Index is computed and published by the World Economic Forum. It presents a condensed measure of how well the surveyed countries develop and employ human capital.

[4] An external deficit and the associated need to finance it externally is not problematic in itself. Other countries such as Germany are equally incapable of balancing their foreign trade, but here the sign is reversed. Surplus countries by definition are forced to build up claims against the rest of the world so that, in purely arithmetic terms, there always needs to be another country that provides the funds to finance the deficit of a deficit country such as Turkey. Nonetheless, for individual countries there may be situations in which foreign capital providers withdraw on short notice. This can lead to balance of payments crises.