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After a sustained boom Turkey is facing a difficult period

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The dominant theme in recent reports on Turkey has been the country's internal political situation. However, this does not mean that the country's economy is sailing in calm waters. Although Turkey's economy has grown strongly in recent years, structural weaknesses continue to exist, and the internal political crisis could exacerbate the economic problems, particularly because it unsettles investors. Since the beginning of the wave of protests against the government in May, the lira has depreciated significantly, share prices have fallen and there have been reports of capital outflows.

From the sick man of Europe to the OECD's growth champion

Until the early 2000s, the Turkish economy slid from one crisis to the next through government mismanagement. As a result, in 2000 per capita income was even lower than in Botswana, for example. The massive economic crisis in 2001 (GDP -6 %, crash of the lira) triggered fundamental economic policy changes. Supported by the IMF, the government introduced market reforms in the areas of taxes, foreign trade, and monetary policy as well as in the banking sector, and also forced through privatizations.

These economic reforms have visibly borne fruit, with growth since 2002 being impressive. Turkey has achieved an average annual GDP growth of 4.1 %, and no other OECD country has recorded higher growth. Since 2002, goods exports have increased by 270 %, while foreign direct investment has increased from less than USD 1 billion to USD 13 billion. The budget deficit and the national debt have both been reduced to a respectable 1.5 % / GDP and 36% / GDP respectively. The inflation rate has gone down from 45 to 7 %.

Persistent structural economic weaknesses

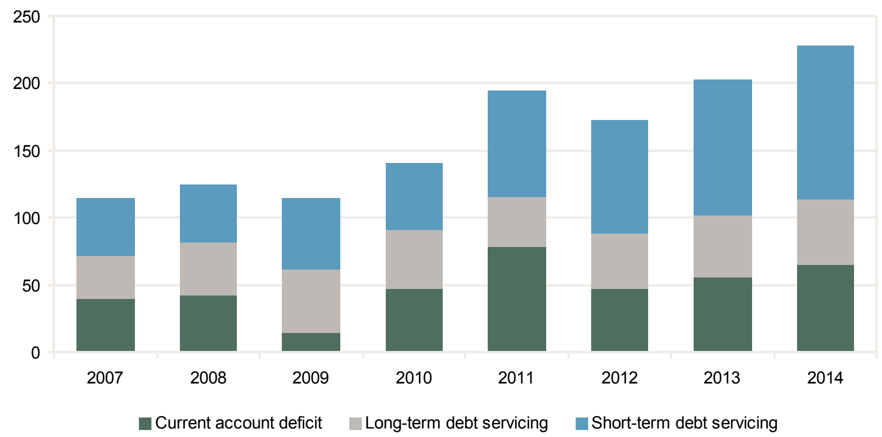
The economic reforms have significantly improved the investment climate. However, in order to achieve the government's longer-term goal of ranking among the world's ten largest economies, continued efforts in the area of *governance* are needed. To increase the country's growth potential, improvements in education and a higher employment rate for women (currently very low at 30 %) are also urgently needed. Another structural problem is the low savings rate (just 15 %), which adversely affects investment activity and exposes the dependence on volatile capital inflows from abroad.

The external imbalance involves significant risks. Since 2002, Turkey has consistently recorded a current account deficit of up to 10 % / GDP (2011). It currently stands at 7 %. Reasons include high energy imports as a structural factor, booming imports, the weak economic conditions in its principal markets (EU, Iraq, Iran), and the volatile exchange rate. The external financing needs (current account deficit and debt servicing) will this year be as high as USD 200 billion (= 24 % / GDP) and is rising (see figure). Foreign direct investment covers only 6 % of this; the rest has to come from portfolio investments and loans. So far, these capital inflows have not been in doubt, and have been facilitated not least by the upgrading of Turkey by rating agencies in recent months.

Risk factors – domestic politics and international environment

The current developments in the foreign exchange market and on the stock market against the backdrop of internal political tensions have already been mentioned. An end to the low interest-rate policy of the US and the EMU could increase capital outflows as well as the cost of borrowing. Although Turkey should be able to cope with these challenges, it has a tough time ahead. ■

Figure: External financing needs (USD billion)



Source: IMF, EIU