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Turkey

Achievements and challenges

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Economic Research Department

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Management summary

Turkey: achievements and challenges

The last decade saw Turkey break with its turbulent past, at least in some areas. On account of a sharp increase in labour productivity, Turkey's economy expanded rapidly, growing by 6.8% on average between 2002-2007. Economic and export diversification helped strengthen the economy, while Turkey's growing role as a regional power has lowered its dependence on Europe as its single most important export market. Underlying this success were the fiscal and monetary reforms implemented after Turkey's currency and banking crisis in 2001, as well as a restructuring of the financial sector. Controlled public spending reduced the public debt from 75% of GDP in 2001, to 40% of GDP now, while inflation fell from 54% to (a still elevated) 6.4%, in the same period. Indeed, the government and central bank's commitment to macroeconomic stability are comforting, given Turkey's poor track record in this area. A complete restructuring of the banking sector helped build a healthy and stable financial system, as underscored by the banks' solid performance during the recent global crisis. Increased stability facilitated the development of a healthy business environment, which was further aided by an improved regulatory environment. Nonetheless, Turkey's domestic political and social tensions present an operating risk, deterring investors.

Unfortunately, a number of structural issues cast a shadow over the many achievements of the past decade, while inciting concern over the future stability of Turkey's economy. Especially Turkey's large external imbalance is worrisome. The large and persisting current account deficits (CAD) are the result of a dependency on energy imports, a high propensity to consume (especially when GDP growth accelerates) and, even though labour productivity increased, a lack of competitiveness. The lack of competitiveness is explained by Turkey's rigid formal labour market and, consequently, its large informal economy, which employs roughly 50% of the population. Lowering the minimum wage, liberalizing the very strict labour protection laws and increasing education, should go a long way in strengthening competitiveness. However, these reforms will not be implemented in the medium term. Another weakness is the fact that the CAD is largely financed out of the short-term external debt and volatile portfolio inflows. This makes Turkey especially vulnerable to changes in investor sentiment.

<u>Outlook and opinion</u>: The global crisis revealed both Turkey's strengths and weaknesses. While the banking sector showed a strong performance, the country's vulnerability to external shocks became very apparent. Slowing exports and an outflow of net portfolio investments ate away at FX reserves and caused the economy to contract by 4.8% in 2009. However, Turkey's government responded adequately and led the economy to recovery. We expect that as the crisis cools, Turkey will resume to grow, with growth rates expected to average 5% between 2014-16. Nonetheless, downside risks remain, which include a protracted global crisis and the risk of overheating (as a result of credit driven growth).

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Management summary

Turkey's growth performance will further depend on the government's ability to tackle the challenges detailed above. Nonetheless, given the structural problems underlying these challenges we do not expect any major improvements in these areas in the medium term. This is worrisome. While Turkey's strengths carry with them significant downside risks, its weaknesses are unlikely to improve. Moreover, it is not unthinkable that these weaknesses (especially the external imbalance), combined with fragile external conditions could throw the economy into a crisis. In short, despite the many achievements, whether or not Turkey did indeed break with its turbulent past is still unproven.

Introduction

Turkey's history is fraught with episodes of economic, as well as political instability. Nonetheless, its growth performance since the crisis of 2001, the successful restructuring of the banking sector and the reform of macroeconomic framework suggest a break from this trend. As does its quick recovery from the global crisis. Even so, Turkey's large external balances and credit-driven growth of the past year are signs that Turkey's economy could still be economically volatile. Moreover, political instability, both within and outside Turkey remains a cause for concern.

This Special considers Turkey's recent performance, the achievements, as well as the challenges ahead, in an attempt to identify what will determine the country's performance in the medium term. We will commence with a short discussion of Turkey's role in the world and its emergence as a regional power.

1. Bridging east and west

- **Turkey's emergence as a regional power**
- **The role and treatment of ethnic minorities**
- **The power struggle between the military and the government**
- **The government's firm grip on power**

"There are more Bosnians in Turkey than in Bosnia-Herzegovina, more Albanians than in Kosovo, more Chechens than in Chechnya, more Abkhazians than in the Abkhaz region in Georgia, and a significant number of Azeris and Georgians, in addition to considerable other ethnicities from neighbouring regions. Thus, these conflicts and the effect they have on their populations have a direct impact on domestic politics in Turkey" (Ahmet Davutoglu, Minister of Foreign Affairs, 2011).

Located in both Europe and Asia, Turkey is often regarded as the bridge between east and west. However, how Turkey is viewed by the world and how it views itself is not merely dictated by location, but also by the county's cultural and demographic make-up. In addition to accommodating the many different ethnicities listed in the quote above (although this list suspiciously leaves out the large Kurdish minority), Turkey has long struggled to combine the liberal economic principles and a view of modernity mostly ascribed to the West, with its other, Islamic, identity. Meanwhile, the struggle to create a national identity has come at the expense of non-Muslim minorities (like the Kurdish and Alevi populations), which have been frequently terrorized by both elected governments and military regimes.

The election of the Justice and Development Party (AKP) in 2002 (and again in 2007 and 2011), drastically altered both domestic and foreign politics. The success of the (moderately Islamic) AKP government, led by prime minister Erdogan, meant the intensification of the ongoing power struggle between the elected government and the (secular-oriented) military, which had long held a strong grip on power. In 2008, for the first time in Turkey's history, a coup attempt by the military failed. Instead, it became the target of a long series of trials, which signaled the first step of its demise. At the same time, Erdogan has strengthened his grip on power, becoming ever more authoritarian and intolerant of criticism. Especially the media is censored, while journalists are frequently jailed.

These events hold enormous importance for the future of Turkey. Most notably, without the military's fierce protection of secularism, the role of the Islam within Turkey's cultural group identity gained importance, which also influenced Turkey's role and involvement in the region.

In 2009, with the appointment of Ahmet Davutoglu as Turkey's new minister of foreign affairs, Turkey further consolidated its role as a regional power. Davutoglu recognized that as the global balance of power is shifting towards the east, Turkey too should broaden its focus. In order to do so, Davutoglu established a policy of ' zero problems with neighbours', while simultaneously increasing Turkey's involvement in both east and west, and by increasing focus on trade relations. It has strengthened relations with the US and NATO, while also partaking in the Organization of the Islamic Conference (OIC), an institution representing countries with a Muslim majority. Turkey's relations with Russia have also intensified, as Russia became a main trade partner. Moreover, it improved relations with most of its southern neighbours, especially boosting border trade with Iraq. Finally, the new regimes in North Africa have frequently cited Turkey as the example for a democratic yet Islamist state.

Unfortunately, Turkey's zero problems strategy has proven problematic in a region that is prone to conflict and instability. Since 2009, Turkey's relations with Israel (a former ally) deteriorated, as Israel refused to accept blame for the shooting of Turkish civilians. Furthermore, after strengthening relations with Syria in 2009 and 2010, Turkey saw itself forced to condemn the violence perpetrated by Syria's leader Assad. Meanwhile, the conflict with Greece and Cyprus has not been resolved, while Turkey also continues to find itself in a power struggle with Iran, which is seeking to establish itself as a regional power as well.

Relations with the EU were long defined by Turkey's desire to become an EU member. However, after a series of stalled negotiations, it became apparent that the road to EU membership would be long and cumbersome, while the current crisis in the eurozone has made accession to the EU a lot less desirable.

<u>Outlook</u>

In the future, we expect Turkey to consolidate its role as a regional power, by further improving diplomatic relations and strengthening trade relations, with both east and west. Nonetheless, ongoing regional instability will continue to challenge Turkey's ability to maintain its zero problems with neighbours policy. Domestically, we expect tensions between the Kurdish minority and the government to persist and continue to present a major risk to Turkey's political stability. In addition, with the declining role of the military, Erdogan will become only more authoritarian and especially his control over the media and jailing of journalists is likely to fuel social dissent.

In the medium term, we do not expect any major changes in Turkey's internal and external political risk profile. However, this also means that we do not expect any improvements in the government's treatment of minorities and journalists.

2. Achievements

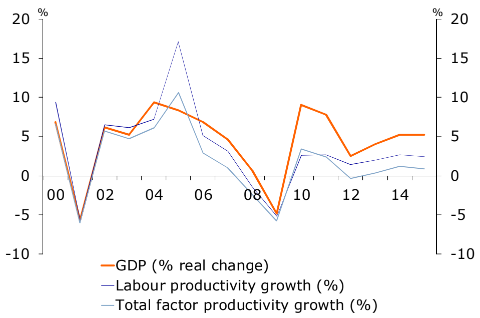
2.1 Productivity and growth

- **High GDP and labour productivity growth**
- **Diversification of the economy**
- **Export-driven growth**
- **Drivers of future growth**

Over the past decade, Turkey has seen high growth rates, thanks to a rapid increase in labour productivity (see chart 1). After a decade of overspending, hyperinflation and a series of booms and busts, which culminated in the banking and currency crisis of 2001, a regime change and several far-reaching policy and institutional reforms have led some to believe that Turkey has finally embarked on a road to economic stability. In addition to the enhanced macroeconomic framework and restructured financial system (see below), the government also began to actively (and successfully) promote Turkey as a destination for foreign direct investments (FDI), while increasing the competitiveness and importance of the export sector (see chart 3). As a result of these sound and timely policy measures, the economy recovered quickly from the 2001-crisis. Between 2002 and 2007, it grew by 6.8% on average.

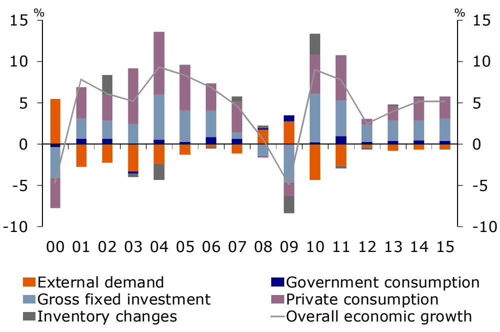
As said, growth was driven by an increase in labour productivity. In addition, a further opening to the global economy, helped increase exports. Meanwhile, the Turkish economy, as well as its export base, have become more diversified. Over the past decades, we witnessed a shift away from agriculture, towards manufacturing, industrial production and services. During the last years, especially the services sector gained in importance (see chart 4).
In 2007 and 2008, growth began to slow on account of the global crisis. Turkey's dependence on foreign capital inflows and exports to Europe made (and still make) it especially vulnerable to external shocks. Consequently, the crisis caused the Turkish economy to contract by 4.8% in 2009. Since then, Turkey has made a strong recovery, which underscores its strength and flexibility.

Figure 1: Productivty and growth



Source: EcoWin

Figure 2: Real GDP growth

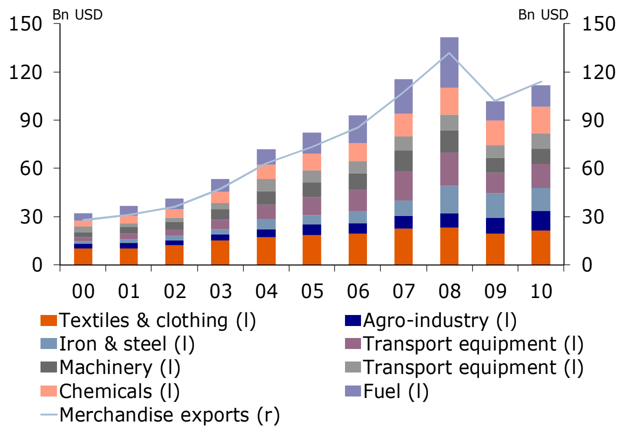


Source: EIU

2. Achievements

Nonetheless, the recovery has so far been driven by credit-growth and consumption, rather than production. With the economy growing by 8.5% in 2011, fears of overheating, and thereby a return to the boom and busts cycles of the past, have re-emerged. Fiscal austerity and sound monetary policy will help to reduce these fears (see below).
For the coming years, we expect growth to come from the tourism sector, which is increasingly proving to be a major earner of foreign exchange (FX), the automobile industry (another source of FX), as well as financial and insurance sectors. In addition, Turkey is increasingly proving itself as an exporter of construction services to countries like Afghanistan and Iraq, but also to Eastern European neighbours. Given its strengthening relations with both east and west, we expect this trend to continue. Finally, low productivity in the agricultural sector, combined with Turkey's abundance of fertile ground, suggest that there is potential for agricultural growth as well, although not without significant investments in the sector.

Figure 3: Exports



Source: Economist Intelligence Unit

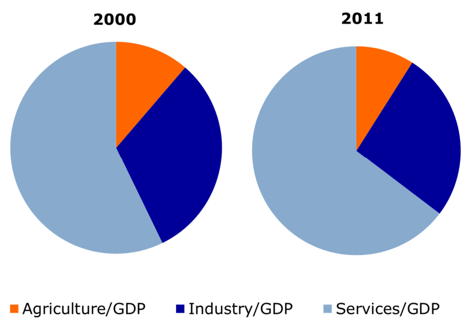
For the medium to long term, Turkey's growth track will come to depend on its ability to exploit its young demographic. This will be contingent on the government's willingness to address the many labour market rigidities that are currently hindering the utilization of labour. Moreover, a reduction of the minimum wage should help Turkey exploit its potentially large reservoir of cheap labour, which would allow it to compete with other emerging markets, such as China and India, where labour costs are lower. Its failure to do so would likely result in persisting unemployment, a growing informal economy, a further contraction of the textile industry (which is currently unable to compete with Chinese imports) and an increased focus on capital intensive production, which will only further reduce the availability of low-skill jobs.

Another prerequisite for continued growth is a high level of investment. The World Bank estimates that in order to maintain similar growth rates as seen between 2002 and 2007, Turkey needs to increase its investments rate from 20% of GDP between 2002 and 2007, to 30% of GDP. This will require either an increase in the domestic savings rate, an increase in foreign investments or, preferably, both. However, given the population's propensity to consume, rather than save, continued promotion of Turkey as a destination for FDI seems vital. The medium-term outlook is further determined by the government's ability to further strengthen and stabilize the economy. Although the fiscal balance has been brought under control, the external balance remains a source of risk and continues to deter investors. The last section of this report will discuss both challenges in more detail.

<u>Outlook</u>

In the coming years, Turkey will continue to catch up with the European Union and we expect GDP growth to average 5% between 2014-2016. In 2012 and 2013, GDP growth will be hampered by external conditions and we expect a 2.1% and a 4% growth rate respectively. And, large downside risks remain present. These include the risk of overheating (as a result of credit-driven growth) and thereby the return of boom and bust cycles, as well as the risk of a protracted global crisis, which will lower the demand for Turkey's exports, while increasing the volatility of portfolio investment inflows. In the long term, Turkey's growth performance will largely depend on its ability to create jobs for the growing number of job market entrees, increase foreign and domestic investments, further establish itself as a regional power, while further stabilizing the economy.

Figure 4: Development per sector



Source: Economist Intelligence Unit

2.2 Fiscal and monetary policy

- **Fiscal reforms reduced fiscal deficits and public debt**
- **Increased independence of the central bank**
- **Monetary reforms including inflation targeting**
- **Move to a freely floating exchange rate**

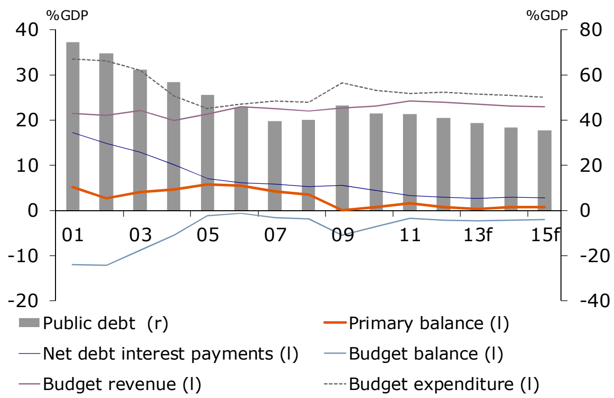
One of the main factors underlying the impressive growth rates of the last decade is the vast improvement in both monetary and fiscal policy. Already in 1999, when Turkey obtained its 17th stand-by agreement (SBA) from the IMF, the government took its first steps towards fiscal stability. However, it would take the 2001-crisis and a change of government to finally implement the much-needed reforms. These reforms were largely in line with the conditions traditionally imposed by the IMF, which include fiscal consolidation, inflation targeting, an independent central bank, privatization and financial sector reforms (discussed below).

In order to reduce the public debt, the government began to draft five year budget proposals and cut its consumption (leaving investments largely intact), while windfall revenues were allocated to a savings account. Consequently, we saw a large cut in expenditures, from 44% of the total budget in 2001, to 22%

of the total budget in 2008. Moreover, the government reduced its spending on public wages and the military, while increasing spending on more productive programs such as rural development, innovation, infrastructure and social development.

The results have been remarkable; between 2001 and 2008, the government reported an average primary surplus of 6% of GDP (or 3.8% of GDP, when excluding the gains from privatization), which was a vast improvement from the 5.6% of GDP and 12% of GDP deficits in 2000 and 2001, respectively. Lower interest costs, as a result of improved investor confidence, and the gains of privatization, which totalled USD 30bn, further helped reduce the public debt. Between 2001 and 2008, public debt fell from roughly 80% of GDP to 40% of GDP.

Figure 5: Fiscal Balance



Source: Economist Intelligence Unit

The measures and fiscal laws implemented in 2001 and 2002, combined with continued vigilance, provided the government with sufficient fiscal space to manoeuver its way out of the (ongoing) global crisis. And, after reporting a budget deficit of 5.8% of GDP in 2009, the government was able to curtail its spending in the following years, when GDP growth picked up.
Nonetheless, there is still room for improvement. Especially Turkey's small tax base, which is the result of a large informal economy (see below), remains a cause for concern. Formalizing the economy would allow the government to increase its spending on education, health and infrastructure, on which expenditure as a percentage of GDP remains below the OECD average.
Monetary policy also improved. Due to the combined effects of central bank independence, a policy of inflation targeting (introduced in 2006) and a freely floating exchange rate (which helps reduce imported inflation) the inflation rate decreased rapidly from over 54% in 2001, to 8.6% in 2004. Although inflation remains elevated, it is doubtful that monetary policy alone would be sufficient to structurally improve the inflation rate. The influx of portfolio investments makes a high interest rate undesirable, as this would only further increase the inflow of hot money, which in turn could destabilize the economy and possibly drive up inflation. Turkey's central bank recognized this problem and has instead chosen to increase the reserve requirement for short term deposits, while lowering the interest rate. This unorthodox policy appears to be working relatively well. However, reduced inflows of foreign capital as a result of the measure have put downward pressure on the exchange rate, which in turn adds to the costs of imports and thereby inflation. As strengthening the lira would undermine the

country's export competitiveness, the central bank finds itself in a difficult position. Given this difficulty of lowering inflation, while simultaneously stemming hot money flows and preventing a further deterioration of the current account balance, we do not expect Turkey's monetary policy to become more successful in the near future.

In 2008, the government completed its 19^{th} SBA. Even though there is a concern that the government may be less motivated to push through the necessary reforms without IMF monitoring, this fear should not be exaggerated. The government has shown a great willingness to guarantee macroeconomic stability, which cannot be explained by IMF involvement alone. In addition, the government is well aware that it needs to compensate for the poor track record of its predecessors, with respect to inflation and public spending, which means that it will have to do more to (re)assure foreign investors.

Outlook

For the medium term, we expect the government to maintain a tight budget, with budget deficits not surpassing 2% of GDP. As a result, public debt is expected come down from the current 41.3% of GDP to below 35% of GDP in 2016. The effectiveness of the central bank's monetary policy, and thereby its ability to curtail inflation, will continue to be undermined by the influx of hot money flows, as well as Turkey's external imbalance. Over the next years, strong domestic demand should keep inflation elevated.

2.3 Financial system

- **Improved regulation and monitoring**
- **Restructuring and privatization of public banks**
- **Consolidation and recapitalization of private banks**
- **Stable performance of the banking sector during recent crisis**

Over the course of the past decade, Turkey's financial system, perceived as one of Turkey's main weaknesses only 11 years ago, has been transformed in one of the most stable systems in Europe. In the run-up to the 2001-crisis, banks functioned mostly as the government's private cash cows, leaving the private sector strapped for cash. However, as a result of the rehabilitation program adopted in the aftermath of the crisis, Turkey's financial system became the backbone of its economy.

First of all, Turkey adopted a series of measures that would ensure increased monitoring of both public and private banks. In addition, reporting standards were brought in line with European standards. This also meant that more weight was given to the Banking Regulation and Supervisory Agency (BRSA), which was already created in 1999 under the 17^{th} SBA.

Secondly, in order to nurse the financial sector back to health, the 22 bankrupt, or near-bankrupt, private sector banks were bought by the Savings and Deposit Insurance Fund (SDIF) and subsequently liquidized, or sold off. Private sector

banks were further strengthened through recapitalization and (forced) consolidation, which significantly reduced the number of banks.
Finally, public banks, which accounted for a large share of the Turkish financial sector, were restructured, or privatized.
All in all, the entire rehabilitation program cost the government roughly USD 47bn. Nonetheless, it was money well spent. As a result of the restructuring, Turkey's financial institutions became an attractive destination for foreign capital, which further helped banks recapitalize, while the involvement of foreign investors increased efficiency. The sector's robust performance throughout the recent global crisis further underscores the success of the rehabilitation program. Banks remained well capitalized, with an average capital ratio of 16%, while NPLs staid at a low 2% of all outstanding loans (relative to over 30% in 2001).

<u>Outlook</u>
The financial sector's strong performance is expected to be sustained, although growth of the sector will slow somewhat in the near future, as the government's focus on curbing bank lending (to slow domestic demand growth) will cut into margins. Nonetheless, in the medium turn we expect the high banking assets growth rates seen between 2003 and 2008 (when growth averaged 14%) and again in 2010 and 2011, will persist. Given that many households in Turkey do not have a bank account, there is still a large market to be won. Next to banking services we expect insurance and other financial services to households to increase. Also pension services are gaining importance and may prove another profitable market.

2.4 Business environment

- **Improved regulation and governance**
- **Bottlenecks: taxes, political stability, infrastructure**

Over the last decade, Turkey saw a sharp improvement of its business environment. For one, the many achievements listed above helped stabilize the economy. With public spending and inflation under control and with a sound financial system in place, the private sector flourished. Moreover, the government has been actively promoting foreign direct investment and, as a result, reduced red tape in almost all areas, thereby lowering the time it takes to set up a company, acquire licenses etc. Moreover, it brought its intellectual property law in line with WTO regulation. Turkey's high ranking relative to other emerging markets (71 out of 183) on the World Bank's Ease of Doing Business index further underscores this fact. In fact, Turkey outranks China, Brazil and India and ranks 22nd out 49, when only compared to other higher middle-income countries.

2. Achievements

Despite these improvements, some bottlenecks remain. The Ease of Doing Business report identifies labour taxes as a point for improvement. In addition, despite ongoing investments, infrastructural quality remains below the regional (European) average. Also, although power outages have decreased, businesses still reported an average of 4 outages per month in 2010, which is high. Finally, a frequently cited concern is the country's political stability. The ongoing tensions stemming from the Kurdish conflict, as well as an increasingly authoritarian regime are indeed worrisome and undermine Turkey's good performance.

Outlook

We expect the government to continue to promote an investor friendly business climate, by improving infrastructure, further reducing red tape and adjusting tax rates, while political instability will continue to divert investors. However, in the medium term, we do not expect any major changes in the business environment, although small improvements in regulations are expected.

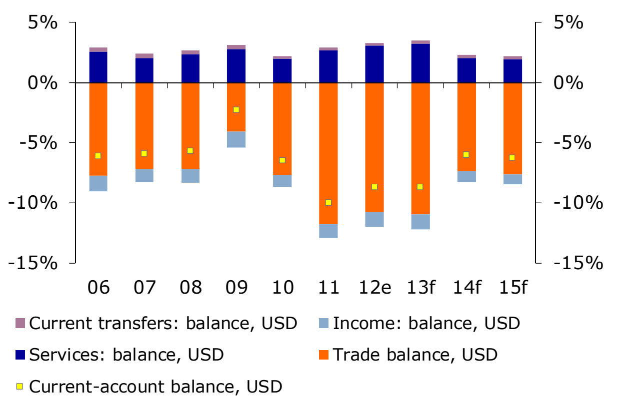
3. Challenges

3.1 External imbalances

- **Large current account deficit**
- **Large inflows of and dependency on portfolio investments**
- **Dependency on (short term) external debt**
- **Relatively low reserves**

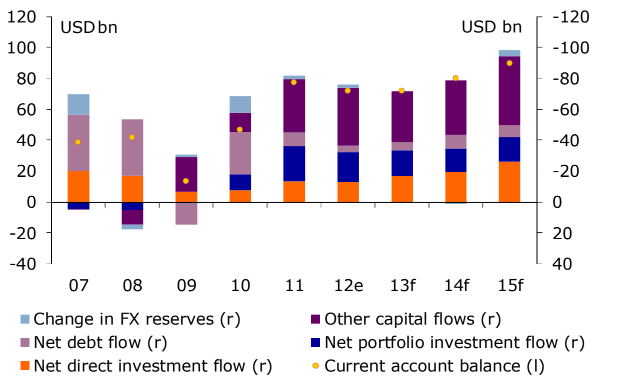
The most pronounced risks to Turkey's medium term outlook are the large and persistent current account deficits (CAD), see graph 6 and 7. These deficits are largely financed out of portfolio investment inflows and short term debt, both of which are considered volatile and highly dependent on changes in market sentiment. Given the relatively low level of FX reserves (currently covering 4.9 months of imports), a sudden drop in investor confidence could quickly lead the country into a crisis. In addition, the dependency on foreign investment creates an vicious circle: while inflows of portfolio investments are needed to finance the current account deficit, they simultaneously drive up the exchange rate of the lira vis-à-vis other currencies, which in turn reduces the competitiveness of Turkish exports (although also reducing the costs of imports).
The good news is that the CAD is considered very flexible, meaning that when GDP growth drops, the CAD tends to decline as well, as consumers quickly switch to local produce and producers require less fuel and capital goods. Still, despite this flexibility, the deficit points to more structural issues, such as Turkey's dependency on imported fuel, as well as a lack of competitiveness and the population's propensity to consume. Regarding the latter, it is often observed that as soon as growth picks up, domestic consumption (especially of imported goods) rapidly accelerates, causing the CAD to widen. In order to enhance the competitiveness of the economy, especially labour market reforms are considered vital (see below). Furthermore, the CA balance will benefit from a reduction of

Figure 6: Current account



Source: EIU

Figure 7: Financing the current account



Source: EIU

Turkey’s dependency on imported energy.

Apart from the external imbalance, the inflow of large quantities of portfolio investment have also resulted in credit-driven growth that further undermines Turkey’s long term stability. Stemming these inflows, while simultaneously increasing the domestic savings rate is therefore considered a prerequisite for future stability and growth.
On a more positive note, even though the current account deficit is partly financed out of debt, Turkey’s foreign debt level is considered sustainable. Foreign debt increased during the global crisis (2009), but has been declining ever since and we expect it to come down further in the coming years, from 40% of GDP in 2011, to 29% of GDP in 2015. Roughly 27% of all foreign debt consisted of short term debt, which was mostly related to trade finance.

<u>Outlook</u>
Given the structural nature of the causes underlying the CAD, we do not foresee any major improvements in the medium term. Although slowing growth in the coming two years should reduce the CAD somewhat, once growth accelerates, the CAD will widen again (see chart x). FDI inflows are expected to increase, as a large domestic market will continue to attract investors, but we do not expect this increase to be sufficient to lower Turkey’s dependency on short term debt and portfolio investments.

3.2 Competitiveness

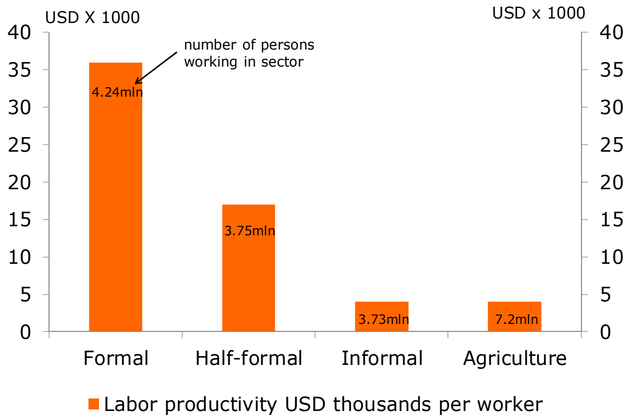
- **Large disparities between eastern and western regions**
- **Urbanization**
- **A large informal economy**
- **Young demographic: both opportunity and threat**
- **Labour market rigidities and jobless growth**
- **Skills mismatch**

In order for Turkey to increase its economic competitiveness, it needs to address the two dualities that continue to undermine it from reaping the fruits of a large and young labour force: the disparity between east and west, as well as the disparity between the formal and informal economy.
To this day, Turkey’s eastern regions remain highly underdeveloped. Whereas the economy in the west (including Istanbul and Ankara) is similar to the economies in Western Europe, the east still displays a level of human, infrastructural and economic development generally found in developing countries. In fact, Turkey’s wealthiest region, Istanbul, is 4.9 times richer than the country’s poorest region, Van (measured in GDP per capita). Moreover, while the west has developed thriving services and industrial sectors, the east continues to rely on agriculture and, more specifically, subsistence farming.

3. Challenges

Over the past decades, the large disparity between east and west has motivated many to move from the eastern hinterlands to the urban west. As a result, in 2010, the urban population accounted for 70% of Turkey's total population, a sharp increase from the 50% 25 years earlier.
However, the influx of rural workers could not be absorbed by the formal economy. As a result, urbanization furthered the creation of a large informal economy. Although estimates on the size of the informal economy differ and are highly unreliable, guesstimates suggest that the informal economy employs roughly half of Turkey's labour force, while the formal economy employs 40% of the working population, leaving roughly 10% of the population unemployed. However, this data does not include the large group of low-skilled women, many of whom, as a result of the lack of jobs, have removed themselves from the labour force. In fact, Turkey holds the lowest female participation rate, with only 20% of all women participating in the work force.

Figure 8: Labour productivity



Source: OECD

There are two main reasons why the informal economy has absorbed such a large share of Turkey's labour force. First of all, Turkey's formal labour market is far from optimal. Turkey has a high minimum wage that is considered higher than labour productivity would allow for, while it lies far above the minimum wage in the informal economy (OECD, 2010). In addition, Turkey's employment protection laws are more far more strict than in any other OECD country, thus adding to the costs of firing an employee. Other obstacles include the additional taxes paid by companies that employ more than 39 people and the fact that temporary employment is not considered legal. As a result of these and other rigidities, companies in the formal economy are incentivized to hire (temporary) employees in the informal economy. Furthermore, high labour costs motivate companies to move to capital intensive, rather than labour intensive production. The consequent lack of job creation in the formal economy then forces workers into the informal economy.
The second reason for the large size of the informal economy is a skills mismatch. While Istanbul and Ankara are home to large groups of highly skilled workers, education levels in the rural east remain low. In fact, the average number of years of education per person in Turkey is only seven years, far below the European average. And, with the process of urbanization, the number of unskilled labourers in urban areas increased rapidly. Meanwhile, the demand for low-skilled workers in the formal economy is low.

Finding a solution to both problems is crucial, now more than ever. As shown in chart 8, productivity in the informal economy lies far below that in the formal economy. This result is partly explained by the fact that the informal economy enjoys less access to financing and legal protection. Consequently, formalizing the economy should help boost productivity. In addition, a young demographic means that the labour supply is expanding. In fact, we expect the labour force to expand by 2.22% per year, between 2011 and 2020. Although a young demographic is generally thought of as a strength and opportunity for growth, the inability to employ new entrees could quickly turn this strength into a weakness, as an largely unemployed young population increases chances of social unrest (which became painfully clear during the Arab spring). Finally, by bringing down the minimum wage, Turkey could reap the benefits of a potentially large pool of cheap labour, which would allow it to compete with other emerging markets.

<u>Outlook</u>
We do not expect the labour market reforms and investments in education, which are necessary to formalize the economy and improve Turkey's competitiveness, to come about in the medium term. Although the government has made some small steps towards liberalizing the labour market, the political power of labour unions and other interest groups has so far blocked any chance of real progress. The government itself has been hesitant to reduce the minimum wage as this would likely cost it political support. With respect to education, even though the government has implemented many programs to improve education levels, as well as access to education in rural areas, it will take time to see results.

3.3 Resource dependency

- **Increasing domestic energy production**
- **Making more efficient use of available resources**

One major cause of Turkey's CAD is its dependency on energy imports. At this moment, Turkey imports roughly 70% of its energy needs. At the same time, high GDP growth has increased the consumption of energy from 1643 KwH per capita in 2000 to 2298 KwH per capita in 2009. Reducing Turkey's dependency on imports, while simultaneously improving its use of available energy sources should therefore be considered a priority. Government plans to build nuclear power plants and increase its production of energy from renewable sources (by 2023) should go a long way in achieving this goal. If all targets are met, Turkey would be producing roughly 60% of its energy consumption. In addition to investments in production, investments in energy infrastructure should help reduce spoilage and lower the persisting security risks.

Outlook

We expect the government to indeed follow through on its plan to increase energy production. However, increasing the national production share to 60% by 2023 may prove overly ambitious. And, even if it succeeds, Turkey will still have to import 40% of its energy needs. So, both in the medium and the long term, Turkey will remain dependent on imports of energy.

3.4 Savings and FDI

- **The low savings rate**

Increasing the domestic savings rate is vital if Turkey is to increase its investment rate. Although Turkey's savings rate of 18% of GDP is comparable to those seen in developed countries, it is low as compared to other emerging markets. Increasing the domestic savings rate will allow Turkey to reduce its dependency on hot money and debt flows, while simultaneously allowing it to increase the share of FDI in total foreign investment. The latter follows from the fact that to increase FDI inflows is hard to accomplish with a low domestic savings rate, as it reduces the possibility for shared ownership between foreign and domestic investors, which is often seen as desired by foreign investors. Improving citizens' propensity to save is traditionally done through the implementation of tax incentives. Given Turkey's small tax base, however, this would likely prove futile. A more successful route would be to increase the number of people that hold a deposits account. As mentioned above, Turkey remains relatively underbanked, which suggests that there may be valuable resources hidden under people's matrasses. Increasing the number of deposit accounts, and thereby the aggregate value of deposits, may thus prove to be a meaningful alternative.

Outlook

Given the credit-driven growth seen in the last year and the population's high propensity to consume, we do not expect the savings rate to increase. However, increasing the number of households with bank account could also help generate the funds needed to spur investments (at least in the medium term).

4. Datatable

Turkey

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Key country risk indicators									
GDP (% real change pa)	4.7	0.7	-4.8	9.2	8.5	3.5	4.0	5.1	5.3
Consumer prices (average % change pa)	8.8	10.4	6.3	8.6	6.5	9.5	7.6	5.5	4.4
Current account balance (% of GDP)	-6.0	-5.7	-2.2	-6.4	-10.0	-8.8	-7.7	-7.3	-7.4
Total foreign exchange reserves (mln USD)	73384	70428	70874	80713	78322	80828	80429	81021	84752
Economic growth									
GDP (% real change pa)	4.7	0.7	-4.8	9.2	8.5	3.5	4.0	5.1	5.3
Gross fixed investment (real % change pa)	3.0	-5.8	-19.4	30.1	18.8	5.0	7.5	8.5	9.0
Private consumption (real % change pa)	5.4	-0.3	-2.4	6.7	7.8	3.0	3.5	4.0	4.0
Government consumption (real % change pa)	6.7	1.7	7.0	1.9	5.4	3.0	3.5	4.5	5.0
Exports of G&S (real % change pa)	7.4	2.8	-5.5	3.5	6.5	2.6	3.4	7.2	7.5
Economic policy									
Budget balance (% of GDP)	-1.6	-1.8	-5.5	-3.6	-1.3	-1.9	-2.2	-2.1	-2.2
Public debt (% of GDP)	40	40	46	43	40	39	37	34	33
Money market interest rate (%)	17.2	16.0	9.2	5.8	3.0	5.0	5.3	5.3	5.8
M2 growth (% change pa)	22	27	11	24	11	15	17	13	21
Consumer prices (average % change pa)	8.8	10.4	6.3	8.6	6.5	9.5	7.6	5.5	4.4
Exchange rate LCU to USD (average)	1.3	1.3	1.5	1.5	1.7	1.8	1.8	1.7	1.7
Recorded unemployment (%)	10.3	11.0	14.1	12.0	9.8	9.8	9.6	8.9	8.3
Balance of payments (mln USD)									
Current account balance	-38434	-41524	-13370	-46643	-77157	-71890	-72027	-80139	-89790
Trade balance	-46852	-53021	-24850	-56445	-89406	-86144	-89351	-98129	-110931
Export value of goods	115361	140800	109647	120902	143491	141855	148765	161695	178483
Import value of goods	162213	193821	134497	177347	232897	227999	238117	259824	289414
Services balance	13283	17748	17316	15493	18241	19787	22433	23615	26570
Income balance	-7108	-8364	-8191	-7139	-7726	-7362	-7206	-8070	-8155
Transfer balance	2243	2113	2355	1448	1734	1828	2097	2445	2725
Net direct investment flows	19941	16955	6858	7574	13440	13000	16750	19500	26000
Net portfolio investment flows	-4582	-5262	-926	10133	22632	19326	16785	15206	15876
Net debt flows	36646	36464	-13589	27712	8881	4133	5121	8748	7864
Other capital flows (negative is flight)	-329	-9483	22365	12201	34443	37549	32973	35277	44282
Change in international reserves	13242	-2850	1338	10976	2239	2118	-399	-1408	4231
External position (mln USD)									
Total foreign debt	252950	284080	271225	293872	306628	306493	310396	317713	323936
Short-term debt	43135	53104	49711	78123	82827	78637	75172	76243	77851
Total debt service due, incl. short-term debt	91433	98662	115131	108411	132118	139138	137758	135881	139900
Total foreign exchange reserves	73384	70428	70874	80713	78322	80828	80429	81021	84752
International investment position	-314920	-201460	-274333	-357142	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	167366	184168	178048	179974	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	482286	385628	452381	537116	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity									
Trade balance (% of GDP)	-7.3	-7.3	-4.0	-7.7	-11.5	-10.5	-9.5	-9.0	-9.1
Current account balance (% of GDP)	-6.0	-5.7	-2.2	-6.4	-10.0	-8.8	-7.7	-7.3	-7.4
Inward FDI (% of GDP)	3.4	2.7	1.4	1.2	2.1	1.8	2.0	2.0	2.3
Foreign debt (% of GDP)	39	39	44	40	40	38	33	29	27
Foreign debt (% of XGSIT)	165	153	179	181	162	162	154	145	134
International investment position (% of GDP)	-48.8	-27.6	-44.6	-48.9	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	60	53	76	67	70	74	68	62	58
Interest service ratio incl. arrears (% of XGSIT)	8	7	8	7	5	5	4	4	4
FX-reserves import cover (months)	4.9	4.0	5.6	4.9	3.7	3.9	3.7	3.4	3.2
FX-reserves debt service cover (%)	80	71	62	74	59	58	58	60	61
Liquidity ratio	100	99	100	91	79	79	80	80	80

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Colophon

This Special is a publication of the Economic Research Department (ERD) of Rabobank Nederland. The view presented in this publication has been based on data from sources we consider to be reliable. Among others, these include Reuters EcoWin, the Central Bank of Turkey, IMF and OECD.

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