

Elections and the Economy

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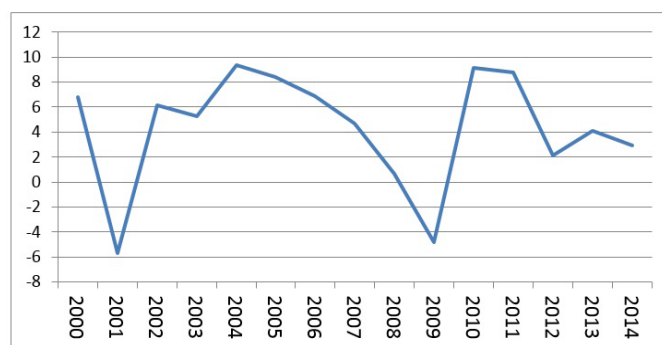
The growth rate of the Turkish economy reached remarkable levels in the early 2000s (see Figure 1). Following a severe financial crisis in 2000-2001, the economy picked up quickly and grew above 4 percent per year from 2002-2007. This was the only period in which the economy grew above 5 percent in 5 consecutive years in the last five-and-a-half decades.

What were the characteristics of this growth? High growth in GDP was accompanied by high growth in GDP per capita and high growth in total factor productivity, even in international comparison. It was accompanied by reductions in poverty and improvements in income equality. There is evidence that growth was somewhat “shared” in that productivity in new growth centers – the so-called Anatolian Tigers – grew faster than in traditional industrial centers such as Istanbul, Ankara, Kocaeli and Bursa, even though this catch-up is still incomplete. Growth was supported by the solid economic programme that was put together after the crisis but which was nevertheless followed by the incoming AKP governments. Macroeconomic stability was attained and interest rates and inflation were reduced – developments that led the banking sector away from its traditional task of financing government deficits towards extending credit to the private sector.

Evidence has shown that at least half of the increase in overall labor productivity in Turkey was due to structural change, that is, due to labor being re-allocated from low-productivity agriculture to higher-productivity services and industry. Indeed, the share of agriculture in total

employment was reduced from above 8 million in 2001 to 5 million by 2008. On the one hand, this was good news because it showed that industry and services could generate substantial employment that contributed to the growth of overall productivity. At the same time, it showed the limitations of the Turkish growth miracle, in the sense that the contribution of productivity growth *within* sectors to overall productivity growth was somewhat limited.¹ In other words, growth in the Turkish economy was mainly due to collecting the “low hanging fruits,” and Turkey eventually would have to enter a new growth regime, one that was more dependent on technology and innovation, if growth was to be sustained.

• **Figure 1 | GDP growth rate, 2001-2014 (%)**



Source: World Bank, World Development Indicators.

¹ Based on a nine-sector classification of the economy. For details, see Izak Atiyas and Ozan Bakış, “Structural Change and Industrial Policy in Turkey”, in *TUSIAD-Sabancı University Competitiveness Forum Working Papers*, No. 3/2013 (31 July 2013), http://www.tusiad.org.tr/_rsc/shared/file/str-ch-refwp.pdf.

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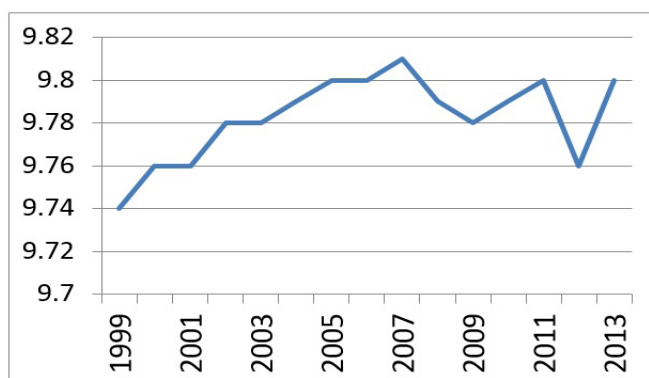
Another very important characteristic of economic growth in the early 2000s was the existence of the European Union (EU) institutional anchor. Turkey undertook several important legal and institutional initiatives, including the independence of the Central Bank, increased transparency and control of the budget, effective competition law, and the delegation of substantial authority to independent regulatory authorities. By and large, regulatory interventions were carried out in a non-discriminatory and impartial manner in order to create a level playing field, possibly encouraging the entry and growth of new businesses.



During the 2000s, the structure of exports in the Turkish economy also changed. The share of low technology industries in total exports decreased, and the share of medium technology exports (such as motor vehicles, automotive parts, steel and chemicals) increased. This was also a remarkable achievement. However, here as well the limitation was that the share of high technology products in total exports is still very low: below 5 percent. In fact, Turkey exports relatively unsophisticated products typical of middle-income countries. This compares to China, which exports more sophisticated products, and there is evidence that countries that export more sophisticated products grow faster in the future. In fact, there is evidence that the average sophistication of Turkish exports declined after the global crisis (see Figure 2), perhaps reflecting the re-orientation of exports to areas other than member states of the European Union, towards the Middle East and Africa.² In 2013, the export sophistication level of Turkey was below not only that of Poland and Hungary but also that of Thailand and Mexico.

the savings rate in Turkey is very low, making growth dependent on international capital flows. In fact, the development of medium technology industries also increased the import dependency of the manufacturing industry due to weak backward linkages and an inability to domestically produce important intermediate inputs of a more sophisticated nature. There is evidence that while large firms in Turkey are catching up in labor productivity with those in new member states of the EU, productivity in small firms is seriously lagging behind. The drive for economic reform, especially in areas such as labor markets, taxation, research and development, has slowed down significantly, and it is likely that small firms are especially hurt by the lack of reform.

• **Figure 2 | The sophistication of Turkish exports**



Source: World Bank, Trade Outcomes Indicators.

There were also additional constraints. Even though Turkey made significant progress in educational attainment, the quality of education is highly uneven and educational opportunity is very unequal. Furthermore,

² The export sophistication index InEXPY displayed in the figure measures the extent to which Turkey's export basket resembles those of rich countries. See Ricardo Hausmann, Jason Hwang and Dani Rodrik, "What You Export Matters", in *Journal of Economic Growth*, Vol. 12, No. 1 (2007), p. 1-25.

Economic growth after 2012 has slowed down. Productivity is almost stagnant. With the EU anchor weakened, there is fast deterioration of economic institutions. The independence of the Central Bank and regulatory institutions is being curtailed. There is increased polarisation of society, evidence of predatory treatment of politically un-favored businesses, and an overall weakening of rule of law. The weakening of trust has also weakened private investment.

After elections, Turkey faces a tough reform agenda. Turkey was already reaching the limits of a growth regime based on structural change, and the deterioration of the institutional environment makes growth prospects even weaker. For high growth (say close to or above 5 percent) to resume, it will be necessary to improve both rule of law and the quality of economic institutions more generally, and undertake important structural reforms. Yet at the moment there are enormous political uncertainties. It is yet not clear whether it will be possible to form a coalition government. Even if one is formed, the probability that it will be able to address the structural reforms that are necessary to put Turkey on a high-growth path is not very high. Presumably a coalition government most conducive to economic reform would consist of the Justice and Development Party (AKP) and the Republican People's Party (CHP). However, structural reforms require the adoption of at least a medium-term outlook and significant cooperation between partners, which will be difficult to achieve given the low level of trust between

the two parties. In particular, it would require that the AKP restructure its focus away from the centralisation of power within the state, a focus that has generated a significant amount of polarisation in society in recent years, towards a more inclusive political stance, and so far there are no signs of such a transformation. Furthermore, a coalition government will function under the shadow of a president – the most important driver of polarisation – who has been striving both to transcend his constitutionally-defined authority and intervene in the workings of the executive branch, and to maintain his grip on the AKP. So far there are no indications that the AKP is going to contain the president within constitutional boundaries or reclaim its autonomy from him. Without structural reforms, Turkey may be locked in mediocre growth rates that remain between 3-4 percent. If instead a coalition government is not formed and early elections are held, then political uncertainties will persist even longer, and even mediocre growth may turn out to be elusive.