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**THE ECONOMIC OUTLOOK OF TURKEY
STRUCTURAL STRENGTHS, WEAKNESSES
AND THE PERSPECTIVES FOR 1999**

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Paper presented at the international conference on
"US and EU common approaches to Turkey"
Rome, IAI, 20-21 November 1998

IAI9825

ISTITUTO AFFARI INTERNAZIONALI

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Ladies & Gentlemen,

Considering that this is the only section on economics, I will try to evaluate Turkey's economic outlook for 1999 from the perspective of structural weaknesses and strengths. Since the international crises still rises concerns about emerging markets, I will have to touch upon the recent crises when necessary.

My argument is that the recent Russian and East Asian crises proved that, unless the institutional framework of a market economy functions properly, integration to the world markets will not secure a sustainable growth process. In that sense, Turkey as an emerging market economy having established customs union with the EU, has important structural strengths and has achieved some progress towards establishing macroeconomic stability in the last one and a half year. However, there remain some structural weaknesses also, which should be acted upon immediately in order for Turkey to improve the economic conditions for 1999 and to take its deserved place in the world economy.

Recent Economic Developments in Turkey

Turkey is one of the crucial emerging markets, with a well-functioning market economy, where financial markets, foreign trade and foreign capital movements are liberalised, and has a Customs Union since 1996. Although Turkey has high public deficits, which result in high inflation and high real interest rates, it has a very dynamic private sector and a rapidly growing domestic demand.

Turkey enjoys high economic growth in the subsequent years since 1994 crisis, with an average rate of 7.8 %. In the first half of 1998, the Turkish economy grew by 6.3 %, which is in fact slower than the previous periods. The measures to restore macroeconomic balances can be identified as being responsible for this slowdown.

The inherited problems of the economy, such as high inflation and large fiscal deficits forced the government to take measures to restore macroeconomic balances. The measures against inflation dates back to July 1997. Beginning in 1998, the government had reinforced these measures with the quarterly programs of the Treasury, the Central Bank and the Ministry of Finance. Although it was far away from being a strict stabilization program, yet it reduced uncertainties and break inflationary expectations. The success of the government to obey these programs resulted in considerable improvement in economic variables with optimism in financial and reel sectors. Inflation began to decelerate since January, and in July inflation rate fell 20 points when compared with the beginning of the year. The yearly inflation rate is expected to fall further to 61% in December from 65.9% in September. This smooth and continues fall, brings the rate of inflation back to its level prior to 1994 crisis.

To support the program by more strict policies and gain further credibility, the so-called «Memorandum of Economic Policies» was declared and the 'Staff Monitoring Agreement' signed at the end of June '98 with IMF.

The decrease in the inflation rate, the speed up in the privatisation process, the increase

in tax revenues, the consensus in the parliament which gave way to the enactment of the tax reform, all of these factors increased positive expectations as to restoring macroeconomic balances in Turkey.

The effects of the Russian Crises

However, in August, the positive climate began to vanish. Nevertheless, the starting point of the dissolving optimism is certainly the Russian Crisis. This crisis came just one year later than the Asian crises and created suspect on all emerging economies including Turkey. Turkey is effected from the Russian crises because of trade relations, availability of foreign funds and foreign investors in the Turkish stock exchange market, which I will touch upon below.

- ❖ The foreign trade, the luggage trade and the invisible revenues of Turkey will definitely be negatively effected by the Russian crisis. Russia is one of the main counterparts of Turkey when the 2 billion USD registered export, and 5 billion USD unregistered export volumes are concerned. Including the tourism and entrepreneur revenues which amounts nearly 1.5 billion USD, the gain resulted from the Russian foreign trade constitutes almost 14 % of total foreign exchange revenues of Turkey. Consequently, the Russian Crisis may induce reductions in FX revenues. On the other hand, devaluation of Rubble will certainly cause a decline in import prices of Turkey, especially cheaper raw materials prices will promote the competition power of exports.
- ❖ In the international market the reluctance of international investors to lend to emerging economies may make it difficult for Turkey to raise the necessary amounts to rollover its foreign debt. In this case, foreign debt repayments should be financed from the domestic market which will soar up inflationary pressures and interest rates.
- ❖ The recent financial crises around the world in emerging market economies caused international investors to change their portfolio allocations, moving away from not only a specific country that is no longer perceived as profitable, but from all countries having similar characteristics. As a result of the foreign investors' attitude of shifting away from all the emerging markets, the Istanbul Stock Exchange experienced one of its sharpest falling trends. However, the trend is over and the index has increased by 21% since then. However, since advanced economies will begin to be interested in real sector investment and production, instead of short-term capital investments, which become more risky with global crisis, the struggle on foreign funds among emerging markets will be harder and the well-performers will be those which attains progress on macroeconomic structure. Considering the measures that Turkey has taken, there was considerable success on short-term measures but macroeconomic reforms are still to be realised. The bureaucrats have so far managed the crisis successfully by using international reserves, interest rates and corrections in tax legislation. The government introduced a number of measures designed to substantially ease the tax burden on financial markets, which had an immediate positive effect on financial markets. On the other hand, the rise in interest rates, coupled with Central Bank's foreign exchange sales helped to reduce the capital inflow. The Central Bank which has forced to sell over 4 billion \$ in three weeks to meet the demand, has began to rebuilt its reserves, which increased by 1.2 billion \$ since then. The interest rates which climbed sharply from 109 % to 157 %, which had been an indicator that market mechanism functions properly, decreased to 139% recently.

Turkey's structural strengths

In order to assess Turkey's outlook in the near future, I would like to draw your attention

to **Turkey's structural strengths.**

Considering the crises in emerging markets, Turkey's historical achievements in the last 20 years should not be overlooked. Besides, setting up and operating market economy institutions, Turkey integrated its economy to world economy in this period.

- ❖ Turkey, reformed its legal structure and enacted new legislation to regulate markets within the market economy perspective. Turkey has liberal financial and goods markets, liberal foreign trade and capital movements. Turkey has enacted all multilateral agreements on environment. Turkish Competition Law was enacted, the Competition Board started to operate Turkish Patent Institute was founded and intellectual property legislation was modernised. State-aid regulation and incentive regime was reformed
- ❖ Furthermore, the Customs Union with the European Community is an important step for Turkey not only for integrating its economy into the biggest regional bloc in the world but also bringing a discipline to reforming its legal structure.
- ❖ The other important achievement is the Free Trade Agreements (FTAs). To be in conformity with the Common Commercial Policy of the EU and to be included in the Pan-European Cumulation of Origin System, Turkey has signed FTAs with the countries having FTAs with the EU. Turkey, in this way, further deepened its export markets.
- ❖ Being a raw materials importer (65 % total imports) and manufactured goods exporter (58 % of total exports) Turkey, is favourably effected from the slow down in international prices of raw materials, and of course likewise the EU benefiting of low oil prices.
- ❖ Having stable export markets (59.7 % of total export go to OECD countries), Turkey is less vulnerable to global recession.
- ❖ Has large and very dynamic domestic consumer market where consumer durable demand has been growing more than 28% in real terms in the last three years.
- ❖ Total international reserves of 34 billion \$ can finance eight months imports.

The outlook for 1999

Under the assumption that there won't be a change in the direction of economic policies and meagre stability attempts will continue in 1999, it is estimated that the economy will slowdown but the inflation rate and public deficits will increase.

However, the government is more optimistic. According to the budget proposal in the Parliament, the growth rate and the average inflation rate are targeted as 3% and 44.4%, respectively. While the budget deficit to GNP ratio will fall to 7%. The foreign trade deficit and the current account deficit are estimated as \$23 billion and \$3.6 billion, respectively.

The expectation surveys and projections utilizing past trends indicate a different picture than that of government's. These record a decrease in production while predictions for the rate of inflation mark 70%.

The structure of the budget also supports the pessimistic approach. The attempts to roll over both domestic and foreign debt, relying mostly on internal market will cause real interest rates to increase further. High real interest rates will hurt investment and production efforts and aggravate inflation.

Under these conditions, it is probable 1999 will be a year with higher rate of inflation, together with a reduced growth. The budget deficit to GNP ratio will exceed the 7% target of the government and may record a level of 10% or more. The growth rate may still be somewhat bigger than the government's target of 3%, but possibly will be below 4%. The slowing domestic demand will prevent balance of payments imbalances. In this regard, it is probable that the government's targets on foreign balances may come true.

Turkey's structural weaknesses

The account for 1999 reiterates the importance of structural reforms.

Despite the good management of the repercussions of the Asian and Russian crises and the above mentioned economic, structural and legal strengths, there are also some **structural weaknesses** of the economy which should be dealt with serious concern.

In this regard, the efforts since June 1997 although insufficient should be regarded as the necessary first steps. The progress attained so far, should be supported by additional measures.

In order to put the economy on a stable path, which is less vulnerable to international shocks such as the recent cases, the officials had to finalise the reforms on the agenda of the Parliament in nearest future. *Tax reform*, putting aside some of its deficiencies a part, constitutes a good example of how a consensus may be reached and solutions to structural problems are found.

In this way, the *social security system*, the *agricultural support system* and *financial sector reforms* should be finalised.

These reforms will not only allow a sustainable growth path, but also will give Turkey, the chance of coming out from the crises as the target country for international investors.

Thank you for your attention.