Turkey: Despite Growth, Europe Remains Distant

Slide 1: Historical Perspective

Since becoming a candidate European Union member in 1999, Turkey has undertaken reforms that have boosted its economy substantially. Despite persistent corruption and the current political issues facing Prime Minister Erdogan, growth remains stronger and inflation lower than it has for most of Turkey's modern history.

Turkey's annual growth has been highly volatile since 1960 with a 5.5% standard deviation; however, since 2004 it has sustained some of the highest growth rates in the world. Per capita PPP GDP growth averaged 3.26% from 2000 to 2011—greater than the prior 3 decades.[1] Growth was at or above 8% for 6 of the last 8 years for which data are available. While inflation has increased over the past several years to 10% as of early 2014, it remains well below the 50 year averages and its peak rates of 100% in 1980 and 1994.

If it is ever to complete its accession to the EU, though, Turkey must strengthen its institutions and strive to achieve levels of inflation and GDP per capita comparable to existing members[2] by pursuing the interrelated goals of drawing women into the workforce, promoting economic formalization, and encouraging domestic savings.

Slide 2: Growth Accounting Comparison

Despite its rapid growth, Turkey remains an emerging economy in many respects. Its GDP per capita remains well below even the more peripheral eastern European countries in the EU. Although TFP is in line with countries like Spain and Greece, its capital base per worker is almost a third (and even less when compared to the total population). More troubling, its already low ratio of workers per capita has fallen in every 10 year period measured. In particular, the female workforce participation rate is only 29%, which is less than it was in 1999.[3] This figure compares more closely to Libya, Yemen, or India than most EU countries which range from 40-65%.

Slide 3: The 2000-2001 Financial Crisis

Even as Turkey was first attempting to gain entry into the European Union in the late 1990s, inflation was near 100% and the government was experiencing expanding deficits. High inflation and an underdeveloped banking system resulted in low savings and investment rates and left the country dependent on foreign investment to fund capital expansion and government deficits.

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[1] "PMT 8.0 Country Data." 2011.

[2] European Commission. "Turkey 2013 Progress report: Enlargement Strategy and Main Challenges 2013-2014." 2013.

[3] "World Bank Open Data." 2013.

While the situation had been deteriorating rapidly since 1996, the recession in Europe along with efforts to control inflation triggered a financial crisis in late 2000 resulting in interest rates exceeding 3,000%, the collapse of the Lira, and a rescue of the banking sector.

Slide 4: Post-Crisis Reforms

In response to the crisis, Turkey undertook fiscal, monetary, and microeconomic liberalization reforms, which contributed to the strong growth the country has experienced over the past decade. Fiscally, the government reduced its deficit below the GDP growth rate—enabling bank funds and foreign investment to be redirected to infrastructure and industrial capital expansion—and it took steps to convince the international community that spending and inflation expectations should change. To further control inflation, the central bank was given political independence and a mandate to target 5% inflation within a 2% band, and the rebased currency was allowed to float freely. Additionally, the government expanded its privatization program significantly (resulting in over $32B in proceeds for the government from 2000-2009)[4], reduced FDI restrictions, simplified corporate taxes, and aligned banking regulations with EU requirements.

Turkey's efforts largely succeeded, as inflation moderated, stabilized FDI allowed for increased capital investment, and privatization spurred TFP growth that closed much of the gap with Europe.

Slide 5: Low Workforce Participation

At 9%, Turkey's unemployment rate is similar to much of Europe. However, Turkey's labor force as a percentage of its population (L/N) is significantly below average. Male workforce participation is in line with many developed nations at 71%, but the female participation rate is only 29% (some sources place it as low as 24%).[5] The official statistics may understate female participation due to large numbers of discouraged workers and due to the presence of a large informal economy. Outside the formal economy, women lack full access to social security, workplace protections, and the ability to fully contribute economically.

There are two demographics of women driving the low participation rate. First, as Turkey urbanizes, many women previously employed in agriculture have moved to cities from rural areas and lack the education to obtain a job. Second, educated women are leaving the workforce after having children often due to the high costs of finding childcare.[6]

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[4] Palmer, Marc C. "The Turkish Privatization Experience, 1984 to 2009." Turkey: Bridging Two Worlds (Lehigh University) 28 (2010): 79-88.

[5] "World Bank Open Data." 2013.

[6] Fowler, Susanne. "Women Still an Untapped Labor Force in Turkey." The New York Times, May 4, 2011.

Slide 6: Poor Competitiveness

Turkey has undoubtedly benefited from increased trade over the past 10 years. However, in addition to having a lower TFP than some EU members, many of its current macroeconomic issues including a wide current account deficit (over 10%) and low savings rate can be traced to efficiency growth in many industries being outpaced by labor inflation (and not offset by currency adjustments).[7] The exchange rate, the health of export markets in Europe, and dependence on energy imports affect these balances greatly, but many structural issues related to inefficiency also contribute to its lack of competitiveness.

Although Turkey has improved in a number of categories in the World Bank's *Doing Business In* survey over the past 10 years, difficulty in starting a business has resulted in the informal economy equaling an estimated 26.5-35% of GDP.[8][9] The informal economy hinders the development of more sophisticated and productive larger corporations. Additionally, price controls, government economic intervention, and regulations have limited competition within the country and discouraged the development of firms that can compete internationally.

Slide 7: Capital Gap

Turkey's capital depth also lags Europe. Despite banking system reforms, savings rates have actually declined since 2000 and are below peers with similar GDP growth rates. This has left the country dependent on foreign investment (partially driven by comparatively high interest rates) to fund capital expansion. In fact, based on a Solow growth model, at current levels of private saving, the capital base per worker would barely grow without outside investment. While external investment is currently helping the country expand, as the previous crisis demonstrated, foreign capital inflows can drive inflation and evaporate in times of crisis.

Slide 8: Encourage Women to Enter Workforce

While many suggest Turkey's low female workforce participation rate is due to cultural differences regarding women in the workplace in the Middle East versus Europe, educated unmarried women in Turkey have a 90% workforce participation rate.[10]

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[7] OECD Economics Department. "Tackling Turkey's External and Domestic Macroeconomic Imbalance." 2012.
[8] Schneider, Friedrich, Andreas Buenhn, and Claudio Montenegro. "New Estimates for the Shadow Economies all over the World." International Economic Journal, 2010: 443-461.
[9] http://www.project-syndicate.org/commentary/mehmet--im-ek-the-global-battle-against-the-informal-economy
[10] Fowler, Susanne. "Women Still an Untapped Labor Force in Turkey." The New York Times, May 4, 2011.

Turkey must address issues facing both educated and uneducated women. Government childcare subsidies and the creation of preschool options would encourage mothers to remain in the workforce. Additionally, while economic development and trade have benefited the economy as a whole, unskilled women engaged in agricultural activities lack the skills to compete in an increasingly skills-based economy. The adoption of targeted continuing education programs will help these women transition back into the workforce.

Increasing the female participation rate in line with the European average would result in an increase in per capita GDP of more than 35% by increasing L/N from .31 to .46 (assuming women are empowered to be as productive as men and ignoring the effects of lower home economies) and will be key in closing the gap between Turkey and the EU.

Slide 9: Promote Economic Formalization

While growth in the next 10 years will continue to be largely driven by increasing capital per worker, long-run economic growth must be fueled by productivity improvements. Besides not counting towards official GDP figures, the large informal economy in Turkey prevents the formation of large enterprises, deprives workers of protections that promote human capital development, and inhibits the collection of taxes to support strong institutions. The key to reducing the informal economy is further improvement in the business environment where burdensome restrictions and corruption make it disadvantageous to run formal enterprises.

Although the World Bank ranks Turkey in line with EU members such as Greece and Spain in terms of doing business, Turkey should strive for improvements, especially in the areas of creating and providing credit to new businesses and easing labor restrictions.[11] Reducing the costs of applying to start a business (in terms of initial capital deposit), strengthening creditor protections, and reducing wage controls are all specific policies that would help with this aim. Additionally, according to the World Bank, non-competitive markets within Turkey drive its lack of competitiveness outside of the country, and promoting competition will improve its ability to develop new comparative advantages to compete internationally as its export markets in Europe remain stagnant.[12]

Ultimately, however, the government must strengthen the judiciary and reduce widespread corruption so that it has an executive and bureaucracy focused on creating a competitive business environment. Such reforms would be in the current administration's interest as they may quell

[11] The International Bank for Reconstruction and Development / World Bank. "Doing Business 2014 - Economic Profile: Turkey." 2013.

[12] World Bank. "TURKEY: Fostering Open and Efficient Markets through Effective Competition Policies." 2013.

some of the opposition's complaints and help the country meet the institutional benchmarks required for EU ascension.

Improvements in taxation policy have already modestly reduced the size of the informal economy.[13] A further reduction in line with the non-illicit informal economy in the EU of approximately 10% would boost official GDP per capita by more than 20% while enhancing TFP. Moreover, further economic formalization will increase access to existing legal workplace protections and social security services for women encouraging workforce participation.

Slide 10: Encourage Domestic Savings

Significant intermediate-term growth in Turkey could come from deepening its capital base, and the current ruling party has targeted priority export industries and made increasing saving rates a priority.[14] However, households have kept assets outside of the formal financial system and memories of inflation have resulted in the buying of hard assets instead of saving. To improve savings, the government should introduce structural and banking reforms and better control inflation.

Formalization of the private sector (see previous recommendation) would encourage the creation of large enterprises that would be better able to save and invest. Additionally, permitting and encouraging banks to offer more sophisticated savings products may increase individual saving.[15]

For most of the last 10 years, inflation in Turkey has correlated highly with GDP growth suggesting demand driven inflation which could be controlled by rising interest rates.

However, in 2012 and 2013 inflation remained above the 5% target but the central bank waited until 2014 increase rates potentially under pressure from Erdogan. This resulted in many in the international community questioning whether the central bank had truly achieved independence.[16]

To give savers confidence that the government can control inflation, Turkey must ensure the independence of the central bank and focus on strengthening its institutions and reducing corruption. Without these improvements, the country risks its exclusion from the EU persisting another 15 years.

[13] ŞIMŞEK, MEHMET. "Economic Shadows and Light." Project Syndicate. Jan 9, 2014. http://www.project-syndicate.org/commentary/mehmet--im-ek-the-global-battle-against-the-informal-economy.

[14] U.S. Department of State. 2012 Investment Climate Statement - Turkey. n.d. http://www.state.gov/e/eb/rls/othr/ics/2012/191254.htm.

[15] OECD Economics Department. "Tackling Turkey's External and Domestic Macroeconomic Imbalance." 2012.

[16] Dombey, Daniel. "Turkey’s central bank prepared to tighten policy further." The Financial Times, 1 30, 2014.

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