

An overview of the Turkish economy: outlook and current perspectives

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Turkey is at the centre of an economic and political area known as 'Eurasia', where three regions of the world, Europe, the former Soviet Union and the Middle East intersect. The proximity to the Balkans and the rest of Europe as well as to the growing emerging markets in Central Asia, the Middle East, and North Africa creates unique business opportunities. The experience of numerous global firms confirms Turkey, as a predominant investment location and export platform. Companies like Microsoft, Coca-Cola, GE, Procter & Gamble and Phillip Morris, as well as international investment institutions like the World Bank Group's International Finance Corporation have already selected Turkey as a regional base. Turkey is fast becoming a production centre for Europe in diverse industries in particular in automotives.

Turkey is the leading investor in the Caucasian and Central Asian Turkic Republics. Due to her strong cultural and historic ties, Turkey provides privileged access and a perfect base to develop business with these countries.

The international image of Turkey in terms of a destination for investment is generally shaped by the diverse market opportunities, both domestic and export-oriented, that Turkey offers. The potential of these markets covers over one billion consumers, including:

- * a huge and growing domestic market (approximately 72 million);
- * high-income European markets (approximately 600 million);
- * emerging Russian, Caucasian and Central Asian markets (approximately 250 million);
- * diverse and expanding Middle Eastern and North African markets (approximately 160 million).

Turkey's potential has long been recognized by the international community, but its star has not been easy to rise due to a number of reasons. Political conflicts and instability created a sense of immobility, limiting the potential of the economy. Structural problems such as high inflation and real interest rates, high unemployment, unstable exchange rates, and income inequality that needed urgent attention were not adequately addressed, delaying long awaited economic and political reforms.

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Turkish history is marked with great successes that follow important crises. For example, the decimation of the Ottoman Empire after World War I was followed by the formation of the secular, democratic republic of Turkey by the one of the greatest leaders in history, Atatürk. The serious economic crisis of the second half of the 1970s was followed by the economic reforms of Turgut Özal that liberalized the Turkish economy. Similarly, the 2001 financial crisis turned out to be a blessing in disguise, despite the fact Turkey had to pay the cost of such a shock for many years afterwards. In fact, the aftershock of the crisis was so strong that political choices were radically reviewed and politicians were forced to address a number of politically difficult structural reforms.

Such hardship eventually paid off. After more than 40 years of struggle towards integration with the EU and 25 years with the rest of the world, Turkey has now embarked on a new level of development. Not only are the aftershocks of the economic crisis that hit the country hard in 2001 are fading away, but also the country's full potential has been brought to the attention of foreign investors, mainly thanks to the commencement of full membership negotiations with the EU and the success of an economic programme that has so far been yielding positive results.

Such a blessing in disguise also triggered a serious change in the mentality of politicians and businessmen alike. Although the former had no other alternative but to address politically difficult choices, the latter had to improvise in the face of an increasingly open and competitive economy. Producing cheaply was no longer sufficient. The business community also had to improve quality and create world brands, and in such tasks they are proving to be successful. Recently, Turkey has become one of the top countries to host European Quality Award winners, and Turkish brands are becoming household names in a wide range of countries.

Other lessons were also learned. Until 2001, the Turkish business community generally preferred to maintain their interests within Turkey. After the crisis, they learned the hard way that diversifying their interest outside Turkey would not only be acceptable, but was also a necessity if they really preferred to integrate with the global economy. Many Turkish companies are gaining ground against global companies in high growth markets such as Russia.

In this setting, an important question still remains to be answered: has Turkey done enough to ensure that growth and stability are here to stay? To address such matters is almost always tricky. However, when one considers the current economic climate as well as the potential Turkey has to offer for investors, it is fairly safe to argue that the usual concerns of the past do not fit into the picture of the future.

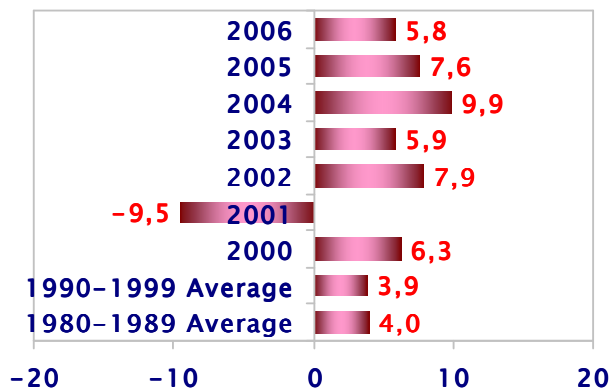
To substantiate our arguments, it may be useful to begin our analysis by addressing the general economic situation in Turkey from a historical perspective.

Economic growth

Turkey has witnessed three major crises since 1994, and the last one in 2001 was one of the worst economic downturns Turkey has ever experienced. Although the average historical growth rates have been more than satisfactory, political instability, problems in foreign affairs, populist domestic policies and a major earthquake at an industrial centre have all contributed to these crises.

Growth rates since 2001, on the other hand, have been the highest in the OECD area (see Figure 1 and Table 1). What is different from the past is the fact that in the period since 2001, Turkey has carried out some of the most impressive and long-awaited structural reforms, which were recognized by the international community: the EU has agreed to open full membership negotiations with Turkey and the IMF declared Turkey a success story. It would not be an exaggeration to suggest that in the absence of a *force majeure*, Turkey is set on the right track for economic growth of satisfactory levels.

Figure 1 Economic growth, 1980 to 2006 (%)



Source: State Planning Organization (SPO) %

Table 1 GDP, 1980 to 2006

	GDP growth (%)	GDP nominal (billion US\$)
1980-89	4.0	----
1990-99	3.9	----
2000	6.3	200
2001	-9.5	146
2002	7.9	184
2003	5.8	241
2004	8.9	301
2005	7.6	361
2006	6.0	390

Source: Turkstat, Treasury

According to the economic programme, it is expected that the Turkish economy will continue to grow at an average of five per cent annually for the next two years.

Furthermore, the long-term perspectives look even more promising. With Turkey's population growth rate having fallen from over two per cent to roughly 1.5 per cent, it is on the verge of entering a 'golden demographic period' similar to what East Asia experienced in the 1980s, where the productive working population is the largest relative to children and retirees, providing the potential for even more rapid income growth.

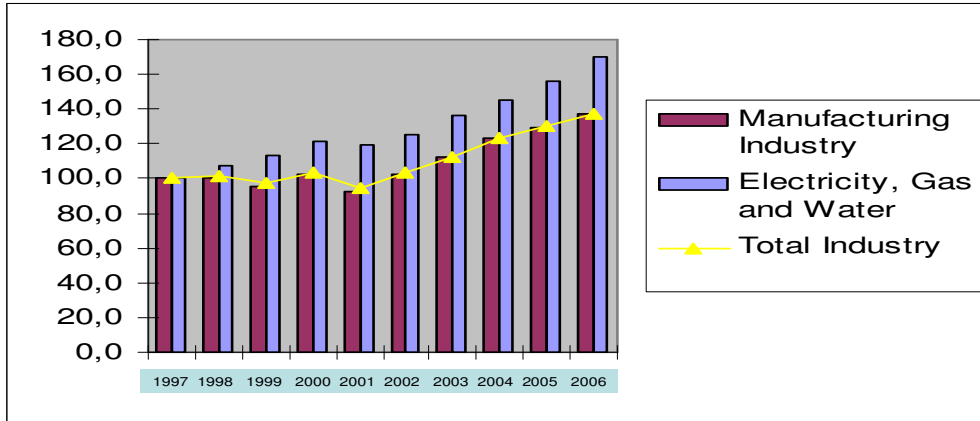
This situation is likely to be a panacea for improving the competitiveness of Europe as well as Turkey's. The continuation of reforms to bring Turkey into full EU membership will not only increase the confidence in the Turkish potential and investments in Turkey, but is also likely to make Turkey indispensable for the EU. For example, with her renowned hospitality, quality of medical care and pleasant climate, Turkey is likely to become the Florida of the EU, in terms of caring for the old.

Only a few emerging markets in the world have the potential of attracting investment both for export as well as for their domestic market. Turkey is in a privileged position to create a 'virtuous investment cycle', with a more competitive domestic business environment further strengthening Turkey as a platform for exports, and exports in turn stimulating firms to upgrade and better serve the domestic market. This is true not only for products, but also for the young managers. Young Turks are being employed by global firms throughout the world, with their professionalism and flexibility to deal with a wide range of circumstances. The Chairman of Pfizer suggests that, the most important export of their Turkish operation is qualified managers / leaders.

Industrial production and capacity utilization

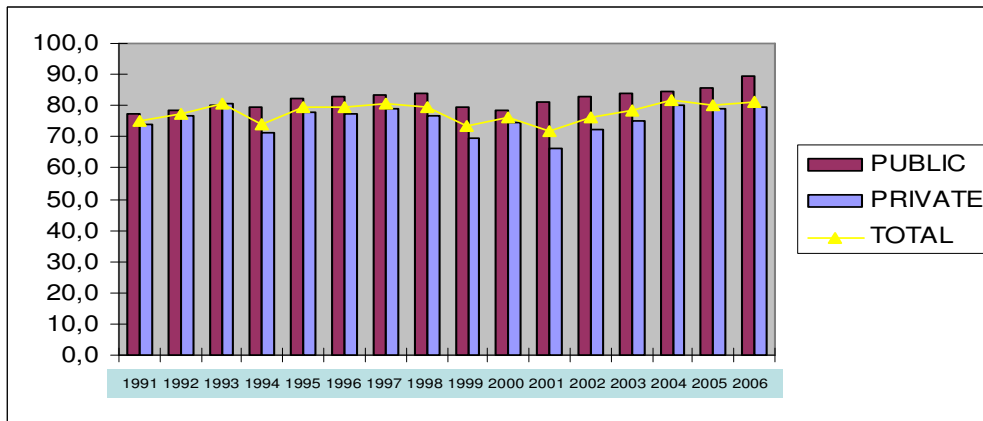
Industrial production has shown a steady increase since 2001 (see Figure 2) and reached its highest ever level of 138 at the end of 2006, based on the 1997 index. Capacity utilization rates have demonstrated a similar pattern and have been hovering around the 80 per cent mark over the last year.

Figure 2 Industrial production, 1997 to 2006



Source: Turkstat

Figure 3 Capacity utilization, 1991 to 2006 (%)



Source: Turkstat

Figures 2 and 3 on the levels of industrial production and capacity utilization, demonstrate increased levels of confidence in the markets. Industrial production is on a steady increase since the 2001 financial crisis and capacity utilization rates demonstrate the characteristics of a booming economy, as was the case between 1991 and 1993 as well as between 1995 and 1998.

Foreign trade and current account deficit

Turkish foreign trade has increased tremendously over the past decade, growing almost 20 per cent annually. According to WTO figures, Turkey ranks fifth in the world in terms of exports growth. In fact, Turkey's exports have

more than tripled in the last six years, reaching an impressive US\$ 85 billion for 2006. Its imports have also been growing at an impressive rate. The structure of imports remains concentrated in raw materials and other industrial inputs, suggesting that however high they may be at this stage, imports are merely supporting the export base.

Table 2 Foreign trade, 1980 to 2006 (US\$ billions)

	1980	1990	2000	2003	2004	2005	2006
Exports	3	13	28	47	63	73	85
Imports	8	22	55	69	97	116	137

Source: Turkstat, SPO

The only serious concern in the major economic indicators relates to the current account deficit, which is high by any standards at its annual current level of US\$18.9 billion as of end of 2006, down from US\$22.8 billion in 2005. Historical data suggest that although the current account deficit has been high in recent years, the rate in which it is growing is slowing down and the possibility of financing it is definitely improving.

Any correction to such a high figure carries its risks. The general attitude of the government towards financing the deficit is to keep calm, carry on with the IMF programme and the EU integration process and continue to improve the quality of financing over time.

Exchange rates and introduction of the New Turkish Lira

In order to create a psychological impact and to facilitate accounting, the present government introduced the the New Turkish Lira (first YTL and TL again since the beginning of 2007) by getting rid off six zeros of the currency. Such a change gave a boost to the positive expectations about the economy.

After a very strong devaluation in 2001, TL has been left to float freely – with minor interventions – and has become overvalued against major currencies by some 49 per cent, according to the exchange rate index at the end of 2006. Needless to say, such an overvaluation has its consequences in the exporting ability of the country. However, despite numerous outcries from the business community, the government insisted on freely floating the TL.

Inflation

The level inflation has reached in recent years is another success story in the economic programme (see Table 3). Despite numerous domestic and international pressures such as high oil prices, the steady decrease in inflation levels has not only boosted confidence in the domestic market, but also

allowed all the players in the economy to be able to plan ahead, perhaps for the first time in the last 30 years.

Table 3 Inflation, 2001 to 2006 (%)

	2001	2002	2003	2004	2005	2006
CPI	68	30	18	9	8	10
WPI	89	31	14	14	3	12

Source: Turkstat

Turkish business people are very happy to have the high inflation nightmare out of their sight. However, working in an unstable economic environment for such a long time has definitely built their financial skills and sensitivity. For example, many global businesses chose to utilize their Turkish managers' skills to deal with the Asian crises.

Interest rates

Having suffered from substantial real interest rates and having to deal with the financial crises under such unfavourable conditions, the Turkish economy is now getting accustomed to the idea of relatively lower interest rates, another manifestation of confidence in the markets.

Despite scepticism regarding its current level (some experts argue that they are very high compared to the inflation level), the risk elements are slowly disappearing, suggesting that in time, real interest rates, too, will reach a more comfortable level, reflecting the potential of the country (see Table 4).

Table 4 Interest rates, 2003-2006

	2003	2004	2005	2006
Government bonds	28	20	14	22
O/N borrowing	30	20	14	19

Source: Treasury

Budgetary data

For the first in its modern history, the Turkish government prepared and declared a three-year budget in line with the IMF targets (see Table 5). This development has definitely contributed to positive expectations in the market.

Table 5 Consolidated budget, 2004 to 2006 (in billion YTL)

	2004	2005	2006
Expenditure	141	145	175
Interest payments	56	46	46
Excluding interest payments	85	99	129
Revenues	111	131	171
Taxes	90	113	137
<i>Deficit</i>	<i>30</i>	<i>15</i>	<i>4</i>

Source: Treasury

It is important to underline a few facts about the fiscal discipline. Since the beginning of the economic programme, budgetary discipline has been maintained vigorously. Governments have been committed to the fiscal discipline and did not seek solutions in populist policies, which in the past have turned Turkey's budget into a black hole. Secondly, and again in line with the discipline issue, targets have always been set at acceptable levels.

It can be argued that expenditures have been kept under control, with interest payments beginning to stabilize at the very least. Tax collection is increasing and stabilizing at around 80 per cent of total revenues. Most importantly, the deficit is narrowing thanks to the positive economic outlook, reducing interest rates and thus risks.

Recent developments and targets for the future

As part of the economic reform programme, the Turkish government began a series of privatizations, some of which are in strategic industries. Out of the privatization programme, three transactions, namely Türk Telekom's sale to Saudi Oger, Tüpras' (petroleum refinery) sale to the Koç and Shell Consortium, and Erdemir's (steel) sale to OYAK group of Turkey, attracted a great deal of attention from international investors, and this has been a milestone for growing confidence in the government's economic programme. The privatization programme raised US\$9.65 billion in 2005 and US\$ 19.79 billion in 2006.

It seems that persistent attempts in the privatization programme will continue in the future, creating further and profitable opportunities in the energy, telecoms, agribusiness, transport and real estate industries.

As for relations with the IMF and other major financing institutions, Turkey has implemented most of the important structural reforms, giving the impression to the outside world that economic and monetary discipline are very important in order to maintain credibility, and that a stable economy and political system free of unnecessary turbulence are key to success.

A similar portrait was depicted in relations with the EU. To the surprise of many supporters and sceptics alike, Turkey has successfully completed a

series of political reforms and secured a new beginning with the EU in the form of initiating full membership negotiations. This prospect has placed Turkey in a highly desirable position in the eyes of foreign investors.

Concluding remarks

In short, with her high growth potential, qualified workforce and managers, and the entrepreneurial spirit, Turkey provides an important potential market for global businesses. Furthermore, regional political stability can only be established on a sustainable basis if the economic development spreads throughout the region. The engine for growth in the Balkans, Caucuses, Central Asia, and the Middle East is likely to be Turkey. Perhaps most importantly, as an observer of the Turkish economy has put it, 'Turkey will be the "viagra" for Europe' by becoming the key agent to help improve European competitiveness.