Turkey at the Crossroads
From Crisis Resolution to EU Accession

Prepared by a team led by Reza Moghadam
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Preface

This Occasional Paper analyzes the transformation of Turkey’s economic performance under its reform program supported by the International Monetary Fund, and sets out guideposts for the reform agenda that lies ahead. The paper was prepared by a team led by Reza Moghadam. The authors—Oya Celasun, Xavier Debrun, Mark Griffiths, Mats Josefsson, Christian Keller, Christoph Klingen, Chris Lane, Cheng Hoon Lim, David Marston, Donal McGettigan, Ashoka Mody, Ernesto Ramirez Rigo, Martin Schindler, and Mathew Verghis—include staff who have worked closely on the IMF program in Turkey, together with members of a number of the IMF’s functional departments, in particular the Research Department, as well as World Bank staff.

The analysis is based on data available as of July 2004. However, more recent data do not alter the thrust of the analysis.

The authors would like to thank Michael Deppler, Susan Schadler, and Odd Per Brekk for their guidance and advice on these studies, and also for deepening our understanding of the economic issues facing Turkey more generally. We are also grateful to the Turkish authorities and to participants in seminars held in Ankara and Istanbul for discussions and comments, which have improved the papers. Chanpheng Dara provided excellent research assistance throughout, while Julie Burton, Connie Strayer, and Alimata Kini Kabore ably assisted in preparing the manuscript. The External Relations Department edited the manuscript and coordinated production of the publication.

The opinions expressed in this paper are solely those of its authors and do not necessarily reflect the views of the International Monetary Fund, its Executive Directors, or the Turkish authorities.
I  Overview

Mark Griffiths and Reza Moghadam

Almost five years after the 2000–01 economic crisis, the fortunes of the Turkish economy have been transformed. The economy has grown rapidly for three successive years, inflation has fallen from 70 percent at the end of 2001 to single digits, both nominal and real interest rates have dropped sharply, and the government debt ratio has fallen significantly, improving prospects for debt sustainability. Maintaining and advancing these gains will be the key policy challenge in the coming years. Against this backdrop, this Occasional Paper reviews policy performance in the key areas of growth, inflation, debt, fiscal and financial sector reform, and labor markets. The analysis aims both to assess the effectiveness of reforms pursued since the crisis and to provide guideposts for the future direction of economic policy.

Improving Turkey’s growth performance has been a key objective of the 2001–04 reform program, through both macroeconomic stabilization and structural economic reform. For Turkey, higher growth can contribute significantly to debt sustainability, raising living standards toward European Union (EU) levels, and reducing unemployment. Chapter II documents Turkey’s growth record and the factors that explain it. Performance has been slightly better than the world average, especially since 1980, mainly because of increased openness to trade, financial market liberalization, and broader economic reform efforts. But Turkey could have done much better than it did. One key factor holding back the country’s growth and increasing its volatility has been the lack of discipline in fiscal, monetary, and financial policies. This has destabilized the economy and reduced its trend growth rate. Looking ahead, the analysis suggests that Turkey has the potential to grow at a rate similar to those of the East Asian economies. Indeed, the recent decline in inflation should help boost the growth rate in the future. However, maintaining policy discipline and ongoing structural reforms will be essential to sustain high growth and reduce volatility.

Reducing high and persistent inflation has been another focus of reform policies aimed at enhancing Turkey’s medium-term economic performance. Inflation first took off in the 1970s, peaking at more than 100 percent with the second oil price shock, and then rising again in the mid-1990s. The uniqueness of this experience lies not so much in the high level of inflation itself but in the fact that Turkey managed to live with these high rates for so long, rather than exploding into hyperinflation or launching a successful disinflation effort. With such high inflation over such a long period of time, there was a concern that price-setting had become more backward-looking, which would have complicated the task of reducing inflation. Instead, Chapter III finds that much of this persistent inflation was self-fulfilling: the inflation process was driven more by expectations of future high inflation than by formal backwards indexation. Fiscal policy turns out to be a key determinant of these expectations, so the reform program’s focus on generating sustained, high primary surpluses has been central to the success of disinflation.

Balance sheet weaknesses in the financial and corporate sectors have contributed to Turkey’s propensity to fall into crisis. Chapter IV documents these pre-existing weaknesses and shows how they were magnified by the depreciation of the Turkish lira in 2001 and the increase in interest rates during the crisis. The chapter also shows how private sector balance sheets have since been restored, in part because of the economic recovery and success in macroeconomic stabilization, but also because some of the vulnerabilities have been transferred to the government, which has taken on greater foreign currency and interest rate risk. Although balance sheets have improved considerably and risks have fallen, the analysis shows that Turkey still remains vulnerable, especially while dollarization remains so extensive. This again points to the need for continued low inflation, which should encourage the demand for lira-denominated assets, and reduce vulnerabilities.

The weakness of the government’s balance sheet has also been a source of instability for Turkey’s economy. For this reason, the reform program has stressed efforts to ensure the sustainability of the debt and improve its structure. Chapter V surveys the literature on the appropriate level of public debt for emerging market economies such as Turkey, and concludes that projecting debt sustainability is not enough. Turkey’s external debt ratio is well above levels considered safe for emerging markets, while its high level of public debt raises concerns about fiscal dominance, which could undermine the effectiveness of monetary policy in re-
Reform of the financial sector has also been at the heart of the program. Such reform has been essential both to prevent any recurrence of the weaknesses that precipitated the 2000–01 crisis and added to the government’s debt burden, and also to foster increased lending and recovery in the real sector. After describing the outbreak of the banking crisis and the measures the authorities took to contain it, Chapter IX explains the reforms that have been introduced, including the restructuring of state banks and the recapitalization of private banks. This strategy has largely succeeded in strengthening the banking system and maintaining the confidence of depositors. Even so, both asset recovery and the resolution of intervened banks have been slow, and this has increased the costs of the crisis. Further reforms are needed to enhance the effectiveness of banking supervision and asset resolution.

Chapter X considers recent developments in the labor market, particularly Turkey’s low employment rate, the increase in unemployment, and low labor force participation rates, especially for women. Increases in labor productivity have helped Turkey maintain its competitiveness and reduced pressures on inflation, but at the cost of weak employment growth. One obstacle to employment growth is the cost of complying with recent legislation on statutory employment protection. The cost of such compliance is more than twice the average of the nations of the Organization for Economic Cooperation and Development (OECD). These new regulations have helped entrench the existing dual labor market structure, making it harder for new entrants to the labor force to find work in the well-paid formal sector. Labor market reform may be needed to ensure that recent improved growth performance translates into reduced unemployment.