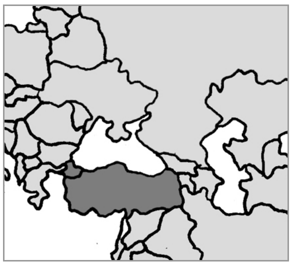

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Turkey:
a show of confidence – or a struggle for survival?

For months now, the IMF has been extending a helping hand, yet the Turkish government is still reluctant to grasp it. However much the government's aloof attitude may impress the Turkish electorate, it annoys both domestic and foreign financial investors. When in early June, Ali Babacan, the Minister for Economic Affairs, announced that Turkey was preparing for a future 'with or without lending' from the IMF, stocks plummeted, while bond yields rose. At the same time, Prime Minister Erdoğan voiced yet again his concern that a stand-by deal might contain conditions 'harming the country's interests' or it might have 'political content'. He put forward these views when presenting a new economic stimulus package. Turkey's government is heavily engaged in economic stimulation policies; the central bank has adopted a similar approach.

The self-confidence of Turkish policy makers may come as a surprise given the major setback that the Turkish economy has suffered. The shock waves after the collapse of Lehman Brothers hit the Turkish economy in a critical phase: an extended period of high industrial and GDP growth was just beginning to lose momentum. As a result, GDP declined by 6.2% in real terms (year-on-year) in the final quarter of 2008. Industrial production had already started declining in August, whereafter it dropped massively to 25.9% (year-on-year) in February 2009. In subsequent months, the situation improved somewhat. Whereas in February industrial output was some 15% below the 2005 average, by April it had almost regained that former level. This fuels hopes that the crisis may have bottomed out during the first quarter of 2009, when the GDP declined by 13.8% (year-on-year). Whereas in January and February the manufacturing sectors used only 64% of their capacity, the capacity utilization rate rose to 70% in May. The central bank's business confidence indicator also bolsters hopes of improvement. After dropping sharply in the last quarter of 2008, down to 52 in December, the confidence index was back to the norm level of 100 in June 2009.

Export figures, however, offer no sign of the crisis relaxing. In contrast to industrial output, exports did not rise after February. In April, they were lower than in previous months, and the year-on-year decline was 33% (but 41% for exports to the EU). Imports were more in line with the industrial output trends. In March and April, their volume was higher compared to January and February (yet 38 and 43% lower year-on-year).

It was in November 2008, when foreign trade went into massive decline. Since then imports have contracted more than exports, with the result that the current account deficit came down to EUR 0.9 billion in the first quarter of 2009 (compared to EUR 8.2 billion in the same quarter of 2008) and is no longer the main concern. In the latter respect, Turkey's need for external financing has diminished.

This is helpful given that the net inflow of FDI diminished (EUR 1.5 billion compared to 2.3 billion); the net outflow of portfolio investment rose (from EUR 0.9 to 2.5 billion); and other investment (net) turned negative (EUR –3.1 billion compared to +6.3 billion in Q1 2008). Thanks to a major capital inflow registered under 'errors and omissions' (EUR 4.1 billion compared to 0.4 billion a year earlier), the decline in currency reserves was small (EUR 0.9 billion). Today, external funds are mainly needed to service external debt. So far, this has been manageable. Following substantial depreciation in the second half of 2008, the exchange rate has since stabilized and even come under slight appreciation pressure. In mid-2008, inflation started to decelerate. Initially, the main reason was the decline in world market prices for energy, while later on the deteriorating business climate assumed a major role. The central bank has exploited this trend to reduce gradually its interest rates[1]. In May 2009, consumer prices were only by 1.3% higher compared to November 2008. There is a convention calling for monetary tightening as a response to rising government deficits. So far, its violation has had no adverse effect.

Government revenues will be much lower than those envisaged when the budget for 2009 was drawn up. Observers' concerns may shift in focus from the balance of payments to the government budget. The deficit is likely to rise to around 6% of GDP in 2009. Were expenditures to be kept at the level planned, automatic stabilizers would be free to do their jobs. The government, however, is determined to actively improve economic performance by increasing expenditures and temporarily reducing tax and social security rates. To date, the stimulus packages have mainly consisted of measures such as temporary cuts in sales tax on cars and domestic appliances. Scheduled to expire at the end of June, a decision as to their prolongation was still pending in the middle of the month. The new stimulus package that Prime Minister Erdogan announced in early June adopts a rather systematic approach; it is supposed to strengthen economic recovery in 2010. It introduces three different investment categories: large project investments, regional investments and sectoral investments. It also envisages incentives designed to boost employment.

The stimulation of large investment projects offers tax breaks for projects larger than 250 million lira (EUR 115 million) in twelve capital or technology intensive sectors, including transit pipeline, air transport equipment, metals, mining, transportation and oil refining.

The programme divides the country into four regions according to the level of socio-economic development. Tailor-made measures are supposed to reduce regional disparities and strengthen the country's competitive power. A new set of investment incentives, which is envisaged to expire at the end of 2010, will promote specific industries in particular regions of the country. It gives priority to agriculture, textiles, leather, metal and plastic goods in the east and high-technology manufacturing in the west.

In provinces to the east of the country, the programme offers investors free land, cheap loans and reductions in the corporate tax rate (2% instead of 20%) for a longer period of time. It also exempts

1 On 16 June, the central bank lowered the overnight interest rates by 50 basis points, down to to 8.75% (borrowing rate) and 11.25% (lending rate).

them from social security employment premiums that they would normally have to pay for new employees. Provinces to the west are better developed, and incentives will thus be less pronounced.

The new stimulus package could cost, over the years, the government up to TRL 60 billion (approximately EUR 28 billion or 6.3% of the GDP in 2008). A second, much smaller package aims at increasing employment, given that in February the rate of unemployment exceeded 16%. Companies will be exempt from paying social security premiums for workers hired after April 30. The programme also envisages employing jobless persons for six months to repair public buildings (e.g. schools and hospitals) and plant trees. It will support vocational schools and apprenticeship schemes. The package could cost close to TRL 1 billion (about EUR 460 million or 0.1% of the GDP in 2008). Claims that it will create half a million additional jobs seem to be exaggerated.

Increasingly, Turkey is becoming aware of the economic and political opportunities offered by the countries in the neighbouring regions to the north, east and south. The EU membership option remains on Turkey's agenda; however, EU politicians have repeatedly expressed their objections to Turkey joining the EU: an attitude that the Turkish public regards as humiliating. The government's EU integration efforts have become less popular. So far, only one chapter (science and research) has been preliminarily closed. Nine more chapters have been opened, but have yet to be concluded (company law; intellectual property law; statistics; trans-European networks; enterprise and industrial policy; consumer and health protection; financial control; information society and media; and free movement of capital).

In our view, recession reached its deepest point in the first quarter of 2009. Recovery can be fast and intensive if a positive global trend – which is not yet in sight – reinforces the stimulation efforts. Should the country's economy be swift to overcome recession, the ruling Justice and Development Party (AKP) will be able to maintain its popularity and avoid internal tensions. Longer-term stagnation would push unemployment up to a politically intolerable level. The government is thus committed to furthering economic recovery in any way it can and wants to ensure that any future deal with the IMF supports the government's stimulus efforts. Should that deal materialize, its impact might not be purely positive. It might well imply tighter monetary policy and nudge the lira towards appreciation. If that happens, it could harm the competitive strength of Turkish producers of tradables. Whereas financial risks would lessen, the likelihood of longer-term real sector stagnation might even increase. The popularity of the AKP would falter: a trend that might induce a return to weak unstable coalition governments and generate more votes for radical parties.

Table TR

Turkey: Selected Economic Indicators

	2005	2006	2007	2008 1)	2008	2009	2009	2010	2011
					1st quarter			Forecast	
Population, th pers., average 2)	72065	72971	73436	74414	.	.	.	.	.
Gross domestic product, TRY bn, nom.	648.9	758.4	843.2	950.1	215.8	211.0	940	1000	1070
annual change in % (real)	8.4	6.9	4.7	1.1	7.3	-13.8	-7.0	1	3
GDP/capita (EUR at exchange rate)	5400	5700	6400	6700	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	9100	10100	10700	10700	.	.	.	.	.
Consumption of households,TRY bn, nom.	465.4	534.8	597.7	662.2	158.5	156.3	.	.	.
annual change in % (real)	7.9	4.6	4.6	0.3	6.1	-9.2	-4	-0.3	1
Gross fixed capital form., TRY bn, nom.	136.5	169.0	184.1	192.8	48.7	40.1	.	.	.
annual change in % (real)	17.4	13.3	5.4	-4.6	9.5	-29.7	-11	4	7
Gross industrial production									
annual change in % (real)	5.4	7.8	6.9	-0.9	7.3	-22.0	-15	2	5
Gross agricultural production									
annual change in % (real)	6.6	1.3	-7.3	.	.	.	.	.	.
Construction industry									
annual change in % (real)	21.5	.	.	.	.	.	.	.	.
Employed persons - LFS, th, avg. 3)	22046	22330	21189	21571	19831 I-II	19826 I-II	.	.	.
annual change in %	1.2	1.3	1.1	1.8	.	0.0			
Unemployed persons - LFS, th, average 3)	2520	2446	2333	2558	2634 I-II	3276 I-II	.	.	.
Unemployment rate - LFS, in %, average	10.3	9.9	9.9	10.6	11.8 I-II	15.8 I-II	16	17	17
Reg. unemployment rate, in %, average	.	.	.	.			.	.	.
Average gross monthly wages, manuf.ind., TRY 4)	1162	1301	1437	1590	.	.	.	.	.
annual change in % (real) 4)	4.3	2.1	1.6	0	.	.	.	.	.
Consumer prices, % p.a.	8.2	9.6	8.8	10.4	8.8	8.4	6	5	4
Producer prices in industry, % p.a.	7.1	9.7	6.0	13.0	6.7	7.8	.	.	.
General governm. budget, EU-def., % GDP 5)									
Revenues	.	22.5	19.6	18.2	.	.	.	.	.
Expenditures	.	21.4	20.6	20.4	.	.	.	.	.
Deficit (-) / surplus (+)	-0.6	1.1	-1.0	-2.2	.	.	-5.5	-5	-2
Public debt, EU-def., in % of GDP 5)	52.3	46.1	39.4	39.5	.	.	.	.	.
Discount rate of NB % p.a., end of period 6)	17.5	22.5	20.0	17.5	19.3	13.0	.	.	.
Current account, EUR mn	-17761	-25595	-27846	-27872	-8203	-887	-9200	-12000	-14000
Current account in % of GDP	-4.6	-6.1	-5.9	-5.6	-6.9	-0.9	-2.1	-2.5	-2.7
Exports of goods, BOP, EUR mn	63157	74397	84003	95447	23457	20067	90000	93000	102000
annual change in %	14.6	17.8	12.9	13.6	23.5	-14.5	-6	3	10
Imports of goods, BOP, EUR mn	89839	106996	117969	131169	31550	20878	94000	95000	103000
annual change in %	22.4	19.1	10.3	11.2	22.4	-33.8	-28	1	8
Exports of services, BOP, EUR mn	21691	20165	20887	23734	3523	3814	23000	23000	25000
annual growth rate in %	17.1	-7.0	3.6	13.6	14.8	8.3	-4	2	7
Imports of services, BOP, EUR mn	9224	9352	11195	11878	2676	2858	11000	11000	12000
annual growth rate in %	13.0	1.4	19.7	6.1	19.3	6.8	-4	0	9
FDI inflow, EUR mn	8289	15916	16237	12223	2996	1726	.	.	.
FDI outflow, EUR mn	863	713	1568	1732	662	273	.	.	.
Gross reserves of CB, excl. gold, EUR mn	42820	46251	49804	51022	48366	50436	.	.	.
Gross external debt, EUR mn	143683	157422	169118	198918	167606	.	.	.	.
Gross external debt in % of GDP	35.3	38.7	34.4	45.0	37.9	.	.	.	.
Average exchange rate TRY/EUR	1.6771	1.8090	1.7865	1.9064	1.8036	2.1635	2.1	2.1	2.1
Purchasing power parity TRY/EUR	0.9917	1.0332	1.0732	1.1954	.	.	.	.	.

1) Preliminary. - 2) SIS projections. 2007 figure: Eurostat. SIS figure 2007 (end of year): 70586 th. persons based on new census methodology. - 3) From 2007 according to census 2006. Quarterly data and forecasts according to new methodology starting from January 2009. - 4) From 2004 including overtime payment. - 5) According to ESA'95 excessive deficit procedure. - 6) Overnight lending rate.

Source: National statistics (Central Bank, State Institute for Statistics etc). Forecasts by wiiw.