

THE POLITICAL ECONOMY OF TURKEY'S ECONOMIC MIRACLE

(First draft)

Turan Subařat

Izmir University of Economics

turan.subasat@ieu.edu.tr.

Word count: 8420

October 2013

THE POLITICAL ECONOMY OF TURKEY'S ECONOMIC MIRACLE

Introduction

Turkey began to implement liberalisation policies in the 1980s in response to the balance of payments problems of the 1970s. The liberalisation of the capital account in 1984 and 1989 led to financial instabilities associated with unpredictable capital flows which in turn led to instability in economic growth rates. After the stabilisation program adopted in 1999, which led to the disastrous crisis in 2001, Turkey entered into another phase in its economic history. With the election of the Islamist-oriented Justice and Development Party (AKP) in November 2002, capital inflows increased dramatically. Despite an overvalued exchange rate, and radically increased trade and current account deficits, the Turkish economy has been considered successful and a model for developing countries. At first glance, this perception appears to be supported by evidence. GDP and exports have increased threefold since 2002, inflation has been brought under control and the public deficit has been reduced. The government and its supporters often claim that Turkey is looming to become the 10th largest economy in the world by 2023.

This positive atmosphere has found a common ground in the media and academic circles and "success" has been celebrated as an indisputable reality. For example, in an article titled "Why is Turkey Thriving" Jeffrey Sachs, who finds Turkey's economic performance remarkable, argued that Turkey's rise has been based on fundamentals rather than bubbles and resulted from Prime Minister Erdoğan's willingness to look to the long term and stick to the basics. At a symposium in Ankara the US Commercial Attaché John Fay said that the threefold increase in Turkey's economy in the last 10 years is a great success story (Dünya Newspaper, 15 May 2013). Ahmet Altan, a well-known journalist who supported the government up until recently but lost his job once he turned against it, wrote "a smart person should explain to me why politically we have to live in a "pin barrel" in a country where the economy is doing miraculously well" (Taraf Newspaper, 17 August 2012). The Kazakh President Nursultan Nazarbayev praised Turkey's "success" and said that Turkey was a model for the rest of the world (Anadolu Agency, 23 May 2012).

However, two important objections have been levelled against the overly optimistic arguments above. First, the real GDP growth with constant prices is modest and the economy is not growing faster under the AKP period than the pre-AKP periods. Second, external sources are the main determinants of economic growth in Turkey which are unsustainable in the long run.

Against such criticisms the government and its supporters developed a number of counter arguments which are mostly propagandistic but a few can be taken seriously. Firstly, given that the world economy and particularly Turkey's European neighbours are facing one of the worst economic crises in their history, Turkey's growth is respectable. Secondly, running a current account deficit allows a country to invest more than it saves which leads to better economic growth rates. Moreover, current account deficits are normal for rapidly growing economies which depend on energy imports. Finally, while Turkey's debt is increasing rapidly, the debt to GDP ratio is declining.

This article focuses on the second part of the liberalisation epoch in Turkey which started in 2001 and heightened in 2002 with the establishment of the AKP government and deals with the above counterarguments. In order to assess Turkey's performance under the AKP government, we first investigate Turkey's GDP and export growth performance by comparing Turkey with four income groups which are high, upper-middle, lower-middle

and low income countries. We show that, while Turkey grew faster than the high income countries under the AKP period, it grew slower than the low and middle income countries. In terms of exports, however, Turkey fell behind of all the income groups. We then deal with the current account deficit and external debt. Our analysis shows that Turkey is one of the leading countries in the world in terms of the increase in current account deficit. Although external debt to GDP ratio indeed declined between 2003 and 2012, external debt signifies only a small portion of the total resources that Turkey externally borrowed. The International Investment Position (or “net external debt stock” which covers the entire resources borrowed externally) to GDP ratio has, in fact, increased very rapidly since 2003.

This article concludes by arguing that although Turkey has attracted substantial external resources, only a small portion of these resources have been invested into the productive economy which is evident from stagnant investment to GDP ratios. Turkey’s economy, therefore, signifies another bubble economy where economic growth is led by domestic demand which is supported by external resources and low domestic savings. Turkey’s economy is, therefore, neither a “miracle” nor even a mild success story.

A brief historical background

Turkey began to implement liberalization policies under the military rule in the 1980s in response to the balance of payments problems of the 1970s. The foreign exchange regime and capital account were liberalized in 1984 and 1989. Full convertibility increased financial instabilities associated with highly unpredictable large short-term capital flows which in turn led to interest rate and exchange rate fluctuations as well as instability in investment and economic growth rates. The capital account liberalization aimed at financing the public sector deficit without crowding-out private investment, but an increase in real interest rates resulted in a rapid accumulation of public debt towards the end of the 1980s.

Interest payments replaced the primary deficit as the most important component of the public sector deficit. Increases in the public debt led the government to engage in “Ponzi financing” where mounting interest payments could only be paid by new borrowing (Akyuz and Boratav 2003). During the 1990s, it became obvious that the liberalization of the capital account was premature and the financial markets were under-regulated (Rodrik 1990, Onis and Bakir 2007). The Mexican crisis in 1994, the Asian crisis in 1997, the Russian crisis in 1998 and a massive earthquake in 1999 pushed the Turkish economy into recession.

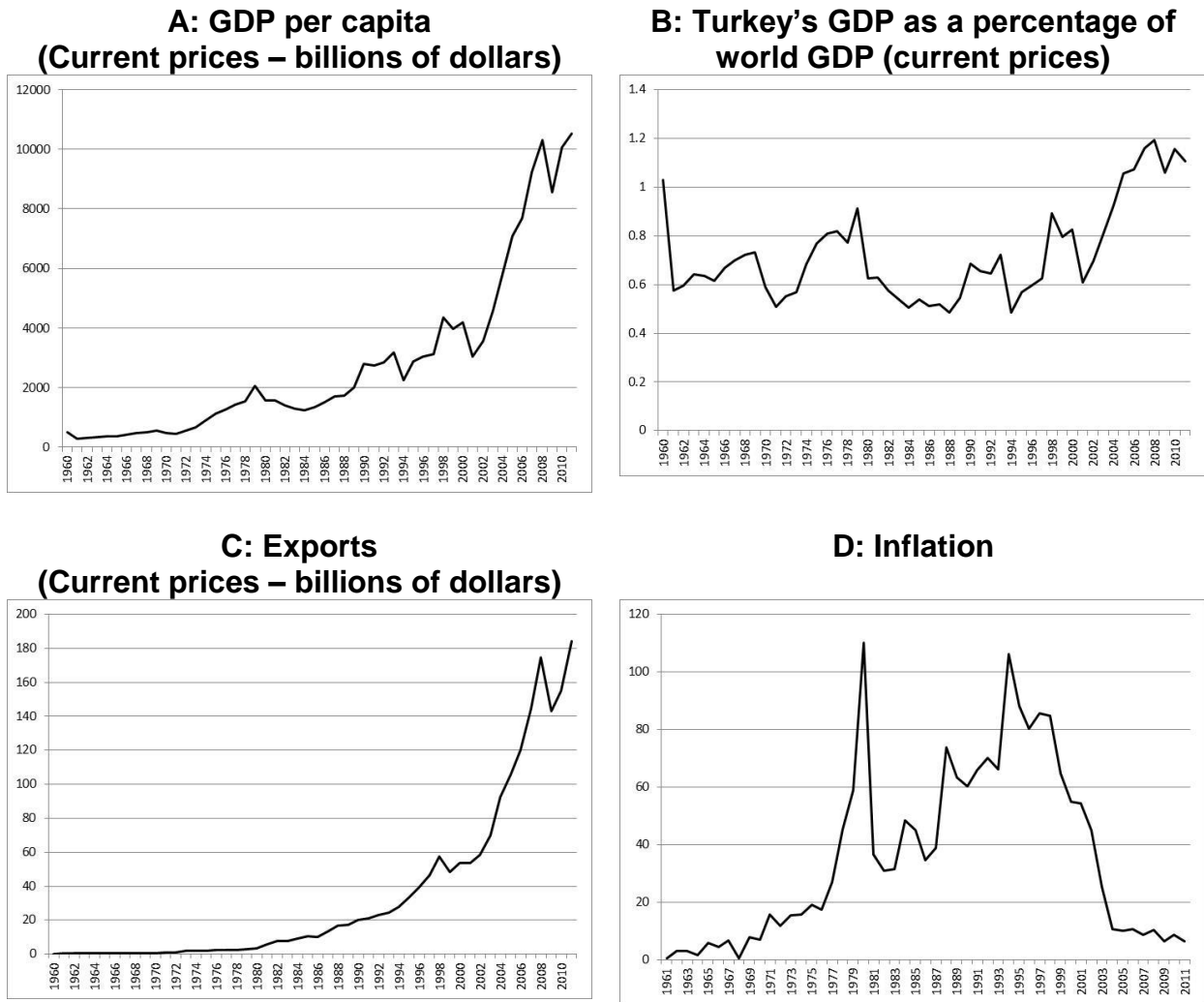
In order to deal with high inflation, unsustainable public debt and increasing financial fragility, Turkey launched an exchange rate based stabilization program in December 1999 with a strong support from the IMF. While the programme was fully implemented and achieved its monetary and fiscal policy targets, it failed to achieve its inflation target in the first year (Akyuz and Boratav 2003). The overvaluation of the real exchange rate combined with the worsening of the internal and external environment (delays in privatization, a criminal investigation into several banks, deteriorating relations with the EU, oil price increases and the economic situation in Argentina) brought the first shock in November 2000 and the second shock in February 2001. Large capital outflows led to soaring interest rates and declining reserves. The fixed exchange rate policy was abandoned, per capita GDP declined by 9.2% and external debt to GDP ratio increased from 41% in 1999 to 57.7% in 2001. According to Telli, Voyvoda and Yeldan (2008), the major flaw of the program was its excessive dependence on speculative short-term capital flows.

After the financial crisis in 2001, Turkey continued with the orthodox stabilization policies which were based on tight monetary and fiscal policies to achieve price stability (through independent central bank and inflation targeting policies) and the usual structural reforms (such as privatization and the abolition of subsidies) which resulted in high real interest rates, substantial capital inflows, overvalued exchange rates, soaring current account deficits, increased external debt, low domestic savings and jobless-growth. Therefore the Turkish post-crisis period has been “speculative-led” and volatile (Voyvoda and Yeldan 2005). The government aimed to maintain a small primary surplus and low inflation levels to reduce interest rates (by reducing the country risk perception) which was hoped to stimulate private investment and economic growth (Telli, Voyvoda and Yeldan 2008). While the primary surplus has been high and inflation has been brought under control, real interest rates remained relatively high. The deregulation of the financial markets coupled with liberalization of international trade and prioritization of the control of inflation above any other macroeconomic considerations implied that interest and exchange rates became almost exogenous variables, determined by external factors which set them at undesirable levels, i.e. high interest rates and overvalued exchange rates.

Capital inflows have intensified since 2002 which increased the availability of foreign exchange and caused overvaluation of the Turkish Lira which, in turn, not only reduced real exports but also led exports to depend on cheaper capital goods imports in import-intensive assembly industries such as automotive parts and consumer durables (Voyvoda and Yeldan 2005). These are relatively low value added activities and create very few employment opportunities. The radical decline in real exports led to unprecedented current account deficits and external indebtedness which have caused serious concerns about their sustainability. While public sector borrowing was brought under control the private sector took the lead. The growth of GDP failed to create jobs and unemployment remained high.

Despite the above facts, Turkey’s experience has been portrayed as a successful model for other developing countries. At first glance this perception appears to be supported by evidence. Turkey experienced a period of uninterrupted economic growth between 2003 and 2007. Although the global financial crisis caused a decline in growth in 2009, Turkey’s economy remained resilient and recovered relatively rapidly. Turkey grew by 9.2% in 2010 and 8.5% in 2011. Figure 1A shows that per capita GDP increased threefold between 2002 and 2012. In the same period Turkey’s share in the world economy also increased from 0.69% to 1.1% (Figure 1B). During this time, exports increased more than threefold (figure 1C) and inflation was brought under control (figure 1D).

Figure 1: Turkey's economic success



Source: Calculated by using data from World Development Indicators

A few objections have been levelled against the overly optimistic outlook above.

- The claim that Turkey has tripled its GDP for the last 10 years focuses on nominal GDP which is misleading. Calculations by using real GDP, however, show that Turkey's economy has not been growing faster in the AKP period than pre-AKP period (Rodrik 2013 and Yeldan 2013)
- A historically very large and rapidly growing current account deficit and external debt are the major determinants of economic growth in Turkey which is unsustainable in the long run. There is, therefore, no real success in Turkey (Yeldan 2013).
- Several genuine successes in the Turkish economy, such as the decline in inflation and relatively healthy banking sector, have been due to the reforms undertaken prior to the AKP government (Onis 2012 and Aybar 2012). The restructuring of the banking sector with a set of regulations after the financial crisis of 2001 allowed the banking sector to expand substantially without carrying toxic assets which explains the resilience of the banking sector (Uygur 2010). AKP, therefore, cannot take any credit for them.

Against such criticisms the government and its supporters developed a number of counter arguments, most of which are propagandistic. Those that should be taken seriously can be summarised as follows.

- Even if Turkish economy was not growing faster in the AKP period than earlier periods, given that the world economy and Turkey's European neighbours are experiencing one of the worst economic crises in their history, Turkey's growth is respectable. It is not meaningful to compare Turkey's economic growth performance in the two time periods regardless of world economic conditions. Success is a relative concept and Turkey is successful compared to the rest of the world in the AKP period.
- The current account deficit is a global phenomenon and not specific to Turkey. Moreover, there is no agreement among economists as to whether, and at what level, current account deficits become a serious problem. Running a current account deficit allows a country to invest more than it saves which leads to better growth rates, which in turn allows the country to service its debt. Also current account deficits are fairly normal for rapidly growing economies which are heavily dependent on energy imports.
- While Turkey's debt has grown rapidly, the debt to GDP ratio is declining. More importantly, public debt to GDP ratio has been declining very rapidly and is very low historically.

This article deals with the above counterarguments that sound fairly reasonable at first. In order to assess Turkey's performance under the AKP period, we will first investigate Turkey's GDP and exports growth rates in a comparative perspective by comparing Turkey with a number of income groups. We then deal with the debates on the current account deficit and external debt.

Criteria to judge economic success

The assessment of economic success claims in a particular time period requires the identification of the following criteria.

1. A structural break must be observed for the time period (2003-2012) under consideration. For example, the average GDP and exports growth rates must be significantly higher or current account deficit to GDP ratio must be significantly lower.
2. Since success is almost always a relative concept, comparative performance should be used to assess real success. Every economy is affected by external factors that are beyond the ability of the country to control which should be taken into account. Turkey's GDP, under the considered time period, may be growing faster than before but Turkey is falling behind if other countries are growing faster than Turkey.
3. Outliers should be avoided when a country's economic performance is compared with the others. Comparing Turkey's economic performance with China and India, for example, would be unfair as most countries would look unsuccessful compared to these very successful countries. In the same manner, it would not be fair to compare Turkey with the USA and EU countries that are going through one of the worst financial crisis in their histories.
4. The sustainability of "success" should also be taken into account. It is not difficult to stimulate rapid growth in the short run by hampering growth in the long run. For example, economic growth can be increased by depleting natural resources rapidly,

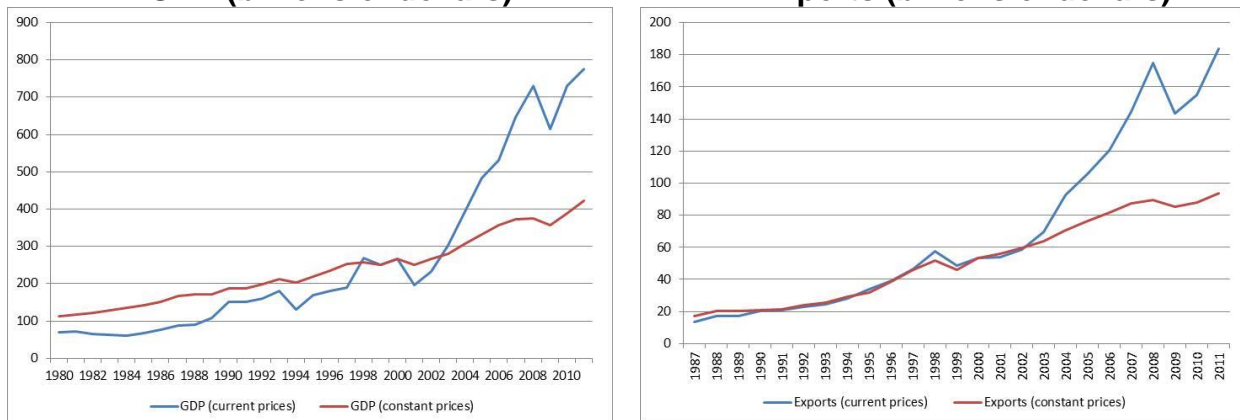
by privatization policies and by accumulating large external debt. Such successes will not only be unsustainable but also come at the expense of large long term costs: natural resources will run out, there will be no more public firms to sell and obligations to service debt will reduce investable resources.

5. Successes and failures in one period may be due to the policies produced in the preceding periods or due to unpredictable positive or negative external factors. Such factors cannot be considered as success or failure of the current government.
6. The measures that are used to assess success should be selected carefully as statistics can often be abused.

GDP and exports

A real success story requires the consideration of the above criteria. Firstly, the data used to assess success must be selected carefully. Figure 2 shows Turkey's GDP and exports in current and constant prices. Both GDP and exports show a very radical structural break with the current prices but no such break is observed with the constant prices. Figures 2A and 2B show that neither real GDP nor real exports increased threefold in Turkey in the AKP period. Once the appropriate indicators are selected, the increase in real GDP and exports are rather modest.

Figure 2: GDP and exports in current and constant prices in Turkey
A: GDP (billions of dollars) **B: Exports (billions of dollars)**

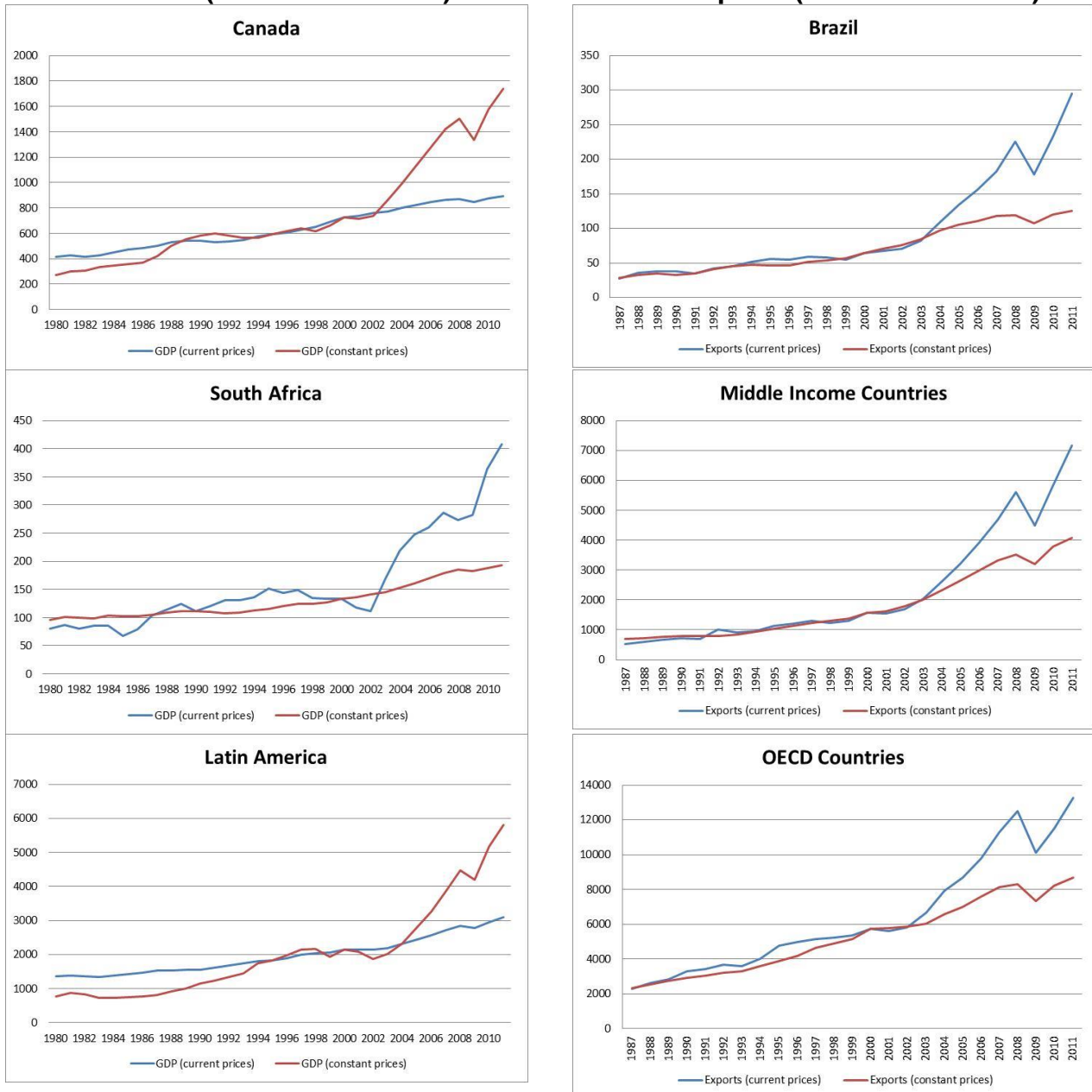


Source: World Development Indicators

A similar pattern emerges for a random sample of countries and country groups which imply that what is observed in Turkey is a global phenomenon linked with a radical decline in the value of dollar since 2002 (Figure 3).¹ This, in turn, increased the dollar prices of goods and services, caused an artificial boom in GDP and exports in current prices and led to the radical divergence of the figures with current and constant prices. Therefore the radical increase in nominal GDP and exports in Turkey since 2002 is not specific to Turkey as almost all countries experienced similar patterns. The same figures with constant prices, however, display a rather different picture.

¹ Coincidentally when the AKP came to power!

Figure 3: GDP and exports in current and constant prices in sample countries
A: GDP (billions of dollars) **B: Exports (billions of dollars)**



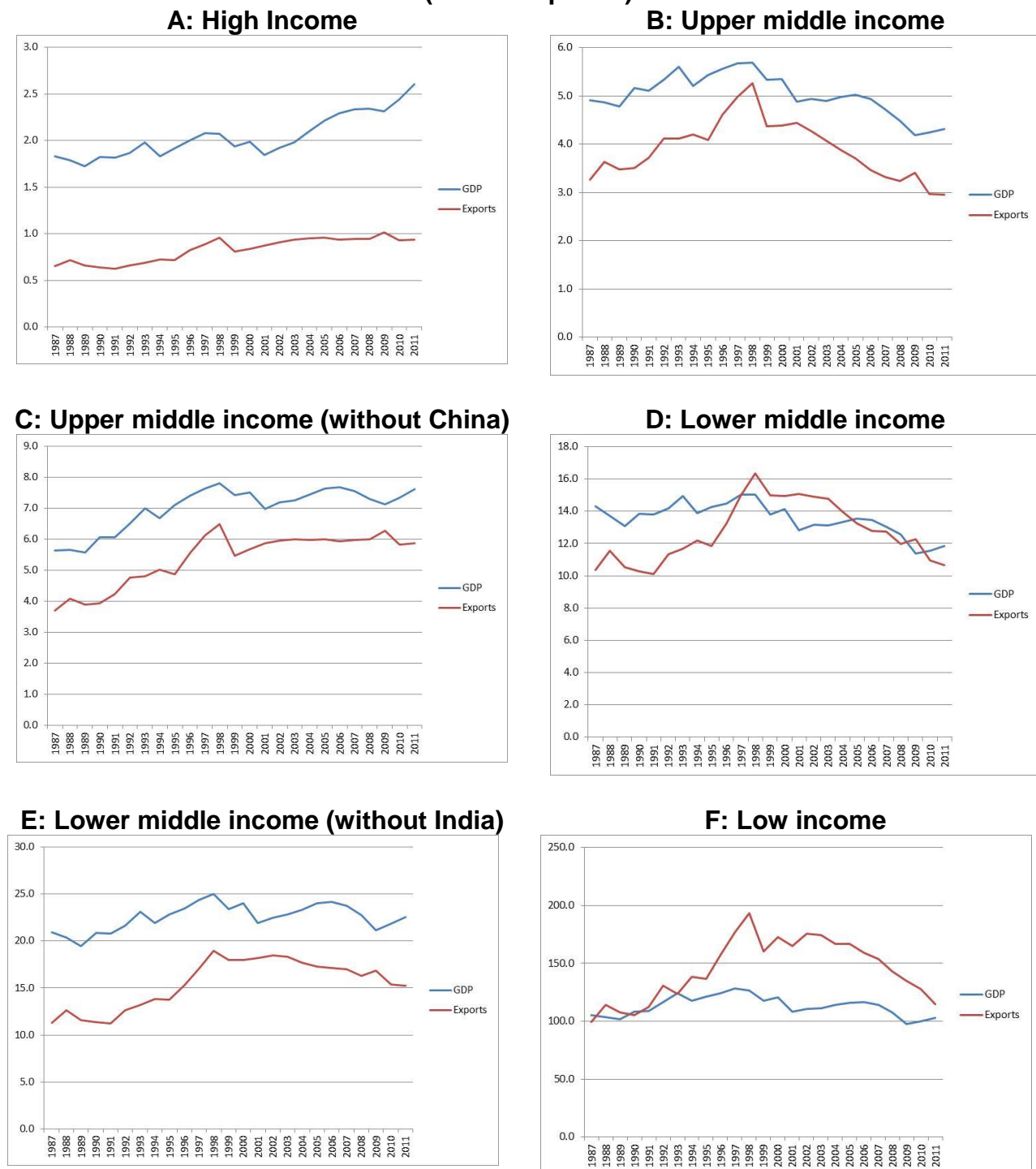
Source: Calculated by using data from World Development Indicators.

The second criteria suggest that success is always a relative concept and the external conditions must be taken into account. Therefore, it would be interesting to compare Turkey's performance with other countries. While in the earlier years of the AKP government external conditions were highly favourable, this has changed since the global financial crisis. There is a need, therefore, to compare Turkey's economic performance with other countries. Since such a comparison would be impractical on a country by country basis for over 200 countries in the world, Turkey's performance is compared with different income groups.

Figure 4 denotes Turkey's GDP (and exports) as a percentage of the GDP (and exports) of "high", "upper-middle", "lower-middle" and "low" income countries. An increase (decline) in the figure implies a faster (slower) growth for Turkey compared to the income groups. The lower-middle income group includes India and upper-middle income group includes China. Since comparing Turkey with these very large and rapidly growing economies would be

unfair, the figures for the lower-middle and upper-middle income groups are also calculated without India and China.

Figure 4: Turkey's relative GDP and exports performance (constant prices)



Source: Calculated by using data from World Development Indicators

An inspection of figure 4 shows that Turkey's GDP increased faster than all the income groups between 1987 and 1999, and declined between 1999 and 2002 due to a massive earthquake in 1999 and disastrous financial crisis in 2001. Between 2002 and 2011, however, Turkey's GDP grew faster than only the high income countries, which are going through one of the worst financial crises in their histories. In other words, Turkey appears to be successful only when its GDP growth is compared with the high income countries.

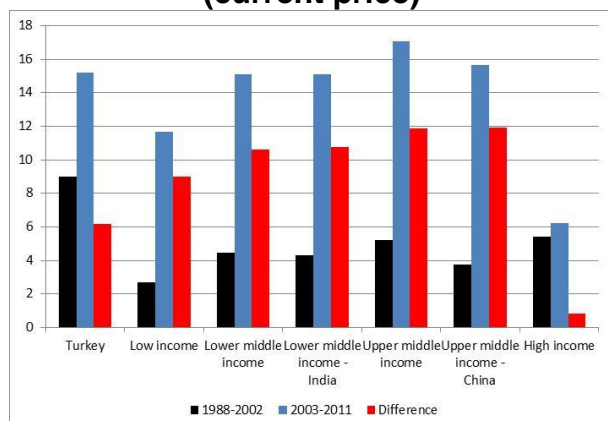
For all the other income groups Turkey's GDP declined relatively. The export figures show a dismal performance during the AKP period. Turkey appears to me more successful than all the income groups between 1987 and 1999, and (while the decline started from 1999) unsuccessful during the AKP period.

The above observations show that Turkey has been relatively successful compared to the high income countries in terms of GDP but unsuccessful against all the income groups in terms of exports during the AKP period. These observations can be confirmed by the growth rate comparisons. Figure 5 compares Turkey with the income groups in terms of GDP and exports growth rates for the pre-AKP period (1987-2002) and AKP period (2003-2011) by using current and constant prices. Figure 5A shows that current price GDP grew faster in Turkey than all the income groups in the pre-AKP time period. While Turkey increased its GDP growth considerably in the AKP-period, with the exception of high income countries, all the other groups increased their growth faster than Turkey. With the constant prices (figure 5B), Turkey grew faster than all the income groups except the lower middle income countries in the pre-AKP period. Only high income countries experienced a decline in their GDP growth rates in the AKP period. While Turkey grew faster in the AKP period than pre-AKP period, other income groups increased their growth considerably faster than Turkey. Turkey, therefore, can be considered successful compared only to the high income countries. Other low and middle income countries surpassed Turkey in terms of the increase in GDP growth rates.

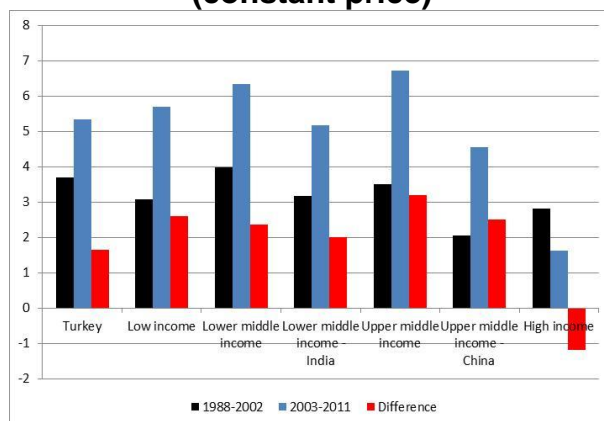
With current prices, Turkey had higher exports growth rates than all the income groups in the pre-AKP period (figure 5C). While export growth rate in Turkey increased from 10.7% in the pre-AKP period to 14.3% in the AKP period, all the other income groups (including the high income countries) increased their exports much faster than Turkey. Figure 8D, however, reveals an important narrative which goes against the common perceptions on Turkey's trade. Exports with constant prices slowed down only in Turkey and in high income countries whereas increased considerably in all the other income groups in the AKP period. The decline in exports growth rate was more severe in Turkey (-3.8) than in high income countries (-1.3).

**Figure 5: Turkey's relative growth performance
(1987-2002 and 2003-2011)**

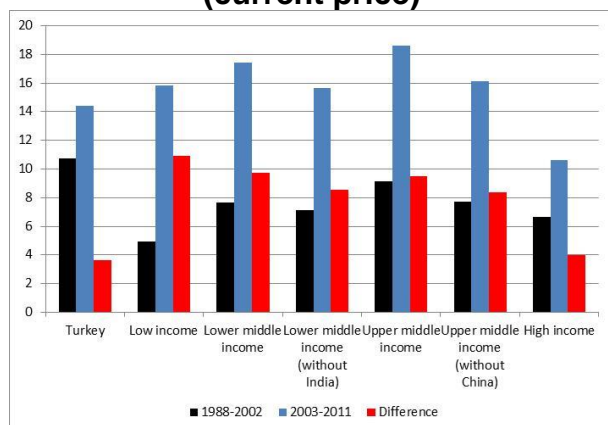
**A: Average GDP growth rates
(current price)**



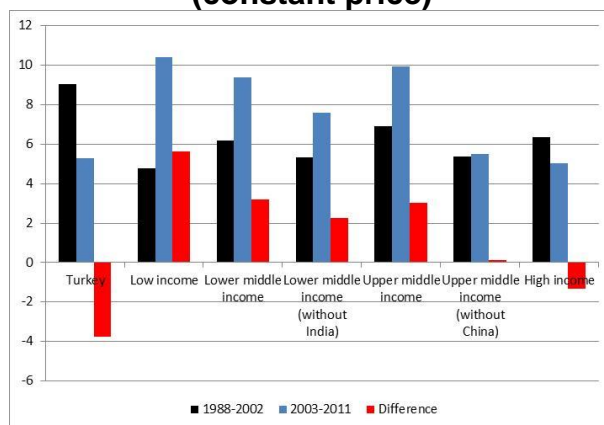
**B: Average GDP growth
(constant price)**



**C: Average exports growth
(current price)**



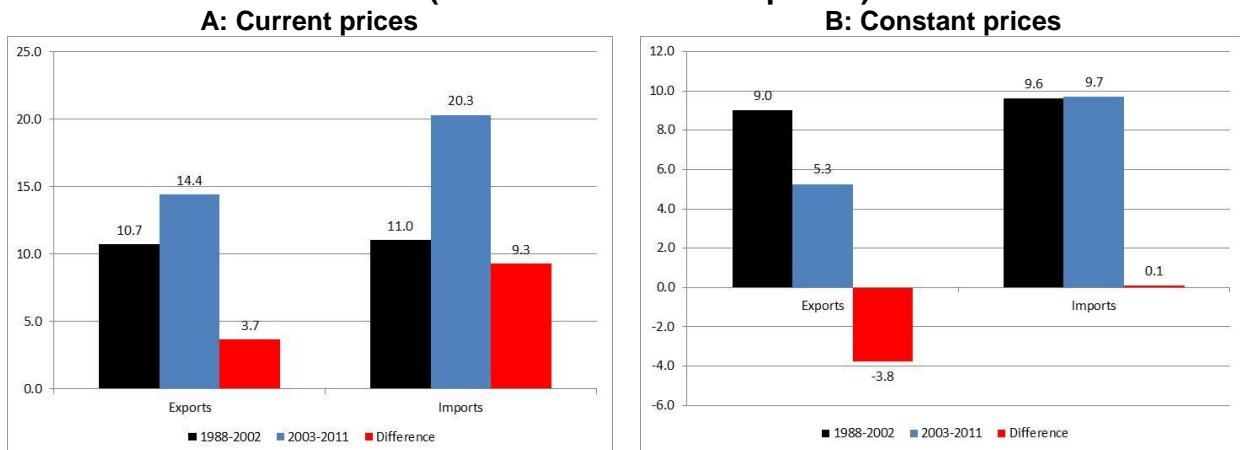
**D: Average exports growth
(constant price)**



Source: Calculated by using data from World Development Indicators

These findings require further elaboration as they defy most of the debates over Turkey's trade and balance of payments deficits. It is commonly accepted that Turkey's exports increased very rapidly in the AKP period but imports increased faster and led to trade and current account deficits. It is often argued that the trade and current account deficits have become a permanent structural feature of Turkey's economy (Dogruel and Dogruel, 2009; Oguş Binatlı and Sohrabji, 2009; Saygılı and Saygılı, 2009). Import dependency of exports plays an important role in this story. An easy way to check the consistency of this story is to compare exports and imports growth rates in Turkey.

**Figure 6: Average annual growth rates of exports and imports
(current and constant prices)**



Source: Calculated by using data from World Development Indicators

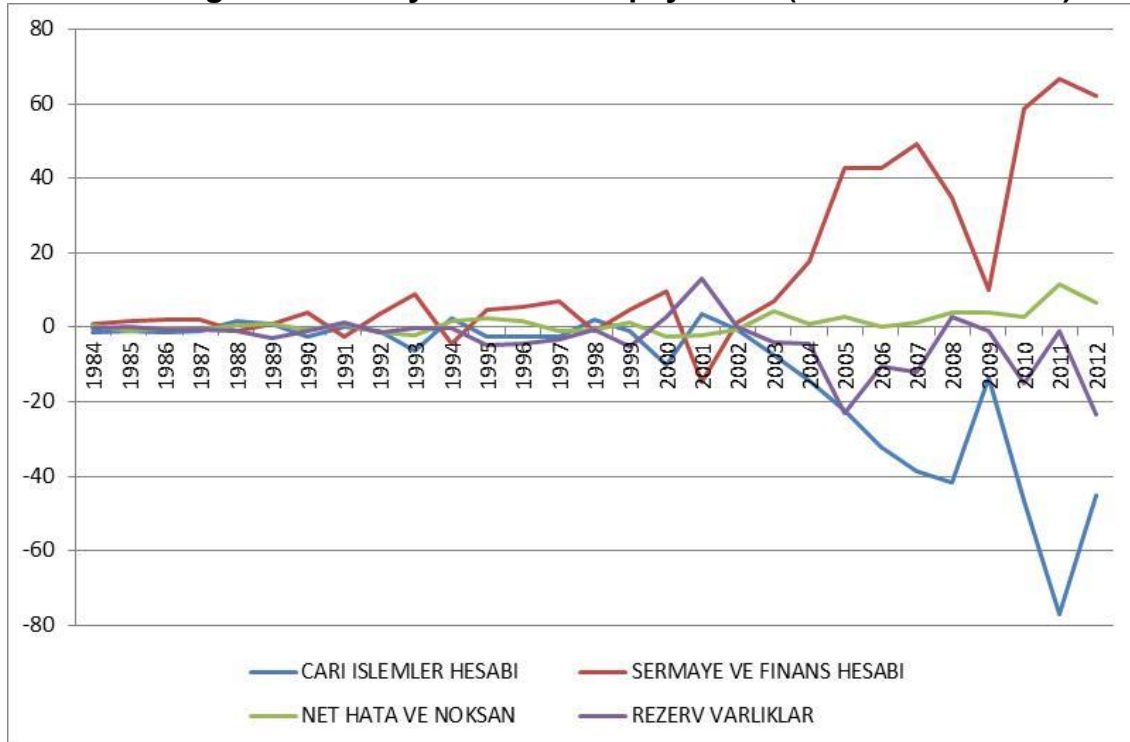
Figure 6 shows the growth rates of exports and imports in current and constant prices for both periods. Figure 6A supports the common perception. Although exports increased considerably in the AKP period, imports increased much faster and caused the increase in trade deficit. Figure 6B, however, tells a different story. The growth rate of real exports declined from 9% in the pre-AKP period to 5.3% in the AKP period whereas the growth rate of real imports increased marginally from 9.6% to 9.7%. The actual problem is not that imports growth rates increased radically but that export growth rates declined radically. In other words, trade and current account deficits did not increase in the AKP period because of a rapid increase in imports stimulated by rapid increase in exports and GDP but a very radical decline in real exports due to overvalued exchange rate. This does not, of course, refute the argument that exports may have become more dependent on imports as the overly valued currency also made inputs cheaper to import than produce domestically. In any case, however, import dependency alone is unlikely to sufficiently explain the trade deficit of Turkey.

Current account deficit

The large and growing current account deficit and external debt levels are often considered as the greatest weaknesses of the Turkish economy since 2002 when capital inflows started intensifying considerably. Following the Federal Reserve's announcement in June 2013 regarding its intentions to reduce bond purchases, many countries experienced stock market loses, currency devaluations and interest rate rises, but Turkey was amongst the hardest hit countries. This was a rehearsal of what is likely to happen in the future when external conditions worsen and Turkey is unable to attract sufficient external resources. Indeed the "capital-freeze index" of The Economist (2013) which measures vulnerability to "sudden stops of capital inflows" and "current account reversals" placed Turkey at the top of the list of 26 countries by a large margin.

While a radical increase in the current account deficit since 2002 is not a matter of dispute in Turkey (figure 7), the debates have mostly focused on the causes and consequences of it. The critics argue that such a large and rapidly increasing current account deficit results from the faulty development strategy which requires large external funds to maintain economic growth which cannot be sustained forever. The government and its supporters, however, developed a number of counter arguments to claim that the current account deficit is not problematic. These arguments can be summarized as follows:

Figure 7: Turkey's balance of payments (billions of dollars)



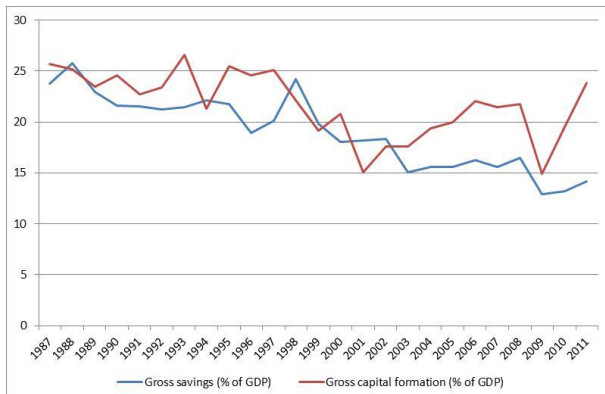
Source: Central Bank of the Republic of Turkey

- Provided that it is not caused by public sector deficit, a current account deficit allows a country to invest more than it saves. The larger the current account deficit, the higher the level of investment, which stimulates faster economic growth. This, in turn, allows the country to service its debt without major problems. As long as the public sector is in equilibrium, the current account deficit can cause no serious risks to Turkey's economy (Yasar 2013).
- A current account deficit (particularly for energy importing countries) can be considered as the price or by product of success. Since imports are determined by domestic GDP while exports are determined by foreign GDP, the increase in imports will exceed exports in a rapidly growing economy. Therefore, Turkey's current account deficit is a sign of a healthy economy rather than a threat.
- The government is taking the current account deficit seriously and implementing a system of incentives to reduce it.
- FDI, a relatively benign source of external finance, has been growing rapidly under the AKP government which reduces the risks associated with the current account deficit.
- The current account problems are global in nature and are not specific to Turkey. During the 2000s, many countries have experienced rapid current account deficits and surpluses. Currently, there are many countries that have larger current account deficit to GDP ratios than Turkey. Moreover, Turkey escaped the financial crisis that hit many countries with high current account deficits. This is largely because Turkey has a low public debt to GDP ratio. Since 'all evil come from fiscal imprudence' (Onis and Guven), Turkey should not be compared with other high current account deficit countries.

The above arguments can be criticized from a number of different perspectives. First, it cannot be assumed that external resources will necessarily increase investment as they can be used to increase consumption. In this case, economic growth will be curtailed and debt service will be very difficult. In Turkey, investment to GDP ratio fluctuated around

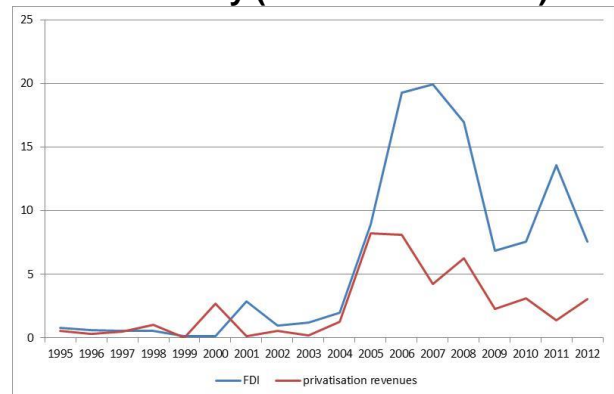
25% between 1987 and 1998, and gradually declined to 15% in 2001 (figure 8). Since 2002 it fluctuated around 20%. Savings to GDP ratio, however, fluctuated around 22% between 1987 and 1998. It rapidly declined to 15% in 2003 and fluctuated around 15% between 2003 and 2011 which implies that external resources financed consumption rather than investment.² External resources can also be invested in unproductive and speculative types of investment which will not generate economic growth. Investing external resources into socially and economically productive areas that do not generate foreign currency can also be problematical as the external resources are borrowed and will be serviced in foreign currency.

Figure 8: Gross savings and investment as % of GDP



Source: World Development Indicators.

Figure 9: FDI and privatisation revenues in Turkey (Billions of Dollars)



Source: Central Bank of the Republic of Turkey

Second, as it was argued above, the current account deficit in Turkey resulted neither from rapid economic growth nor dependency of rapidly increasing exports on imports. It was caused by a radical decline in real exports resulting from an over-valued currency. Dogruel and Dogruel (2009) argued that increase in oil prices played a minor role in the increase in current account deficit in Turkey. Moreover, the large current account surplus of China (a rapidly growing energy dependent country) proves that neither rapid GDP nor export growth need to cause any current account deficit.

Third, the incentives system to reduce current account deficit is very new. While it is difficult to comment on its potential impacts, the limited nature of the incentives system and the magnitude of the structural problems of the Turkish economy do not offer much optimism.

Fourth, while it is true that FDI increased rapidly under the AKP period, the share of FDI in the total capital account is only 26.5% for the 2003-2012 period, and rapidly declined to 15.3% after the global financial crisis. Moreover, a substantial part of this FDI is motivated by the privatisation policies (figure 9) and real estate purchases by foreigners in Turkey (Yeldan 2008) and was in the form of “mergers and acquisitions” rather than “greenfield investments” (Uygur 2010). Without privatization policies and real estate purchases, FDI would have been very limited. Such FDI contributes very little to the economy and is unsustainable in the long run.

Fifth, it is also true that current account imbalances are a global phenomenon and not specific to Turkey. It will be shown below, however, that Turkey is one of the leading countries in terms of the increase in the current account deficit. The “successful” financing

² A similar story can be told for the USA where the vast majority of the current account deficit was caused by the imported consumption goods (Freund ve Warnock, 2005).

of the current account deficit for a substantial period of time has no academic meaning in terms of its sustainability. It is impossible to decide on the sustainability of the current account deficit on the basis of such factors as how long it has lasted, the current account deficit to GDP ratio,³ trade volumes or the exchange rate regime. “Sustainability” should be defined in terms of whether the external resources are productively used to construct the necessary economic capacity which will allow repayments. If the resources are invested in productive economic areas which will generate future capacity to repay liabilities, then running a current account deficit will cause no major problems and should be considered as sustainable regardless of how large it is. If the resources are invested into unproductive areas and used for consumption, however, the current account deficit should be considered unsustainable regardless of how small it is. The size of the current account deficit matters less than where the external resources are used. Theoretically speaking there is nothing wrong with borrowing external resources as long as they are used productively. When global conditions prevail, it is possible to maintain large current account deficits for a considerable period of time. As long as the lenders are able and willing to transfer resources, financing a current account deficit for a long time is possible. It is, however, impossible to sustain large deficits forever and a correction is inevitable. Sooner or later, the unsustainability of the current account deficit will become obvious and the damaging impact of the necessary adjustment will be linked with the length of the delay.

As suggested above, Turkey is one of the leading countries in terms of increase in current account deficit. If we start with some simple observations, the average current account deficit to GDP ratio was -0.73% in the pre-AKP period (1990-2002) and -5.09% in the AKP period (2003-2011) which indicates a very radical increase. The first method in table 1 shows the rank of Turkey in terms of current account balance to GDP ratio in both periods. Large numbers indicate smaller current account deficits or larger current account surpluses. For example in the AKP period, Grenada had the highest current account deficit to GDP ratio (-25.7%) and was ranked 1st and Kuwait had the highest current account surplus to GDP ratio (31.3%) and was ranked 104th in the list. Amongst 104 countries, Turkey was ranked 77th in the pre-AKP period and was ranked 41st in the AKP period. Turkey went up by 36 steps in the list and only Iceland (45 steps) and Mauritius (42 steps) went up more than Turkey in the list. This implies that Turkey experienced a larger increase in its current account deficit than most of the countries in the world.

Table 1: The rank of Turkey in World in terms of current account balance with alternative methods.

Methods	Pre-AKP period (1990-2002)	AKP period (2003-2011)	Difference
1. Current account to GDP ratio.	77	41	36
2. Change in current account to GDP ratio (difference method).	60	14	46
3. Change in current account (Cumulative index method).	25	6	19

Note: Large numbers indicate smaller current account deficit or larger current account surplus. Calculations involve 104 countries.

Source: Calculated from the World Development Indicators

Calculations based on period averages are meaningful but cannot tell the full story. For example two countries may have the same averages while one experiences an increasing

³ Milesi-Ferretti and Razin (1996) argued that current account deficit becomes a major problem when it exceeds 6% of GDP.

and the other a decreasing current account deficit to GDP ratio. Investigating the trends in current account deficit, therefore, is a worthwhile exercise. Since current account balance takes negative (indicating a deficit) and positive (indicating a surplus) signs, calculating the change in current account is not a simple task. Method 2 contemplates the simple change in current account to GDP ratio over time. For example, if current account deficit in a country declines from -4% to -2%, this country experiences 2% improvement in its current account.⁴ This method ranks Turkey 60th in the pre-AKP period (1990-2002) and 14th in the AKP period (2003-2011). Turkey went up by 46 steps in the list and Turkey's current account deficit deteriorated faster than 90 countries in the AKP period.

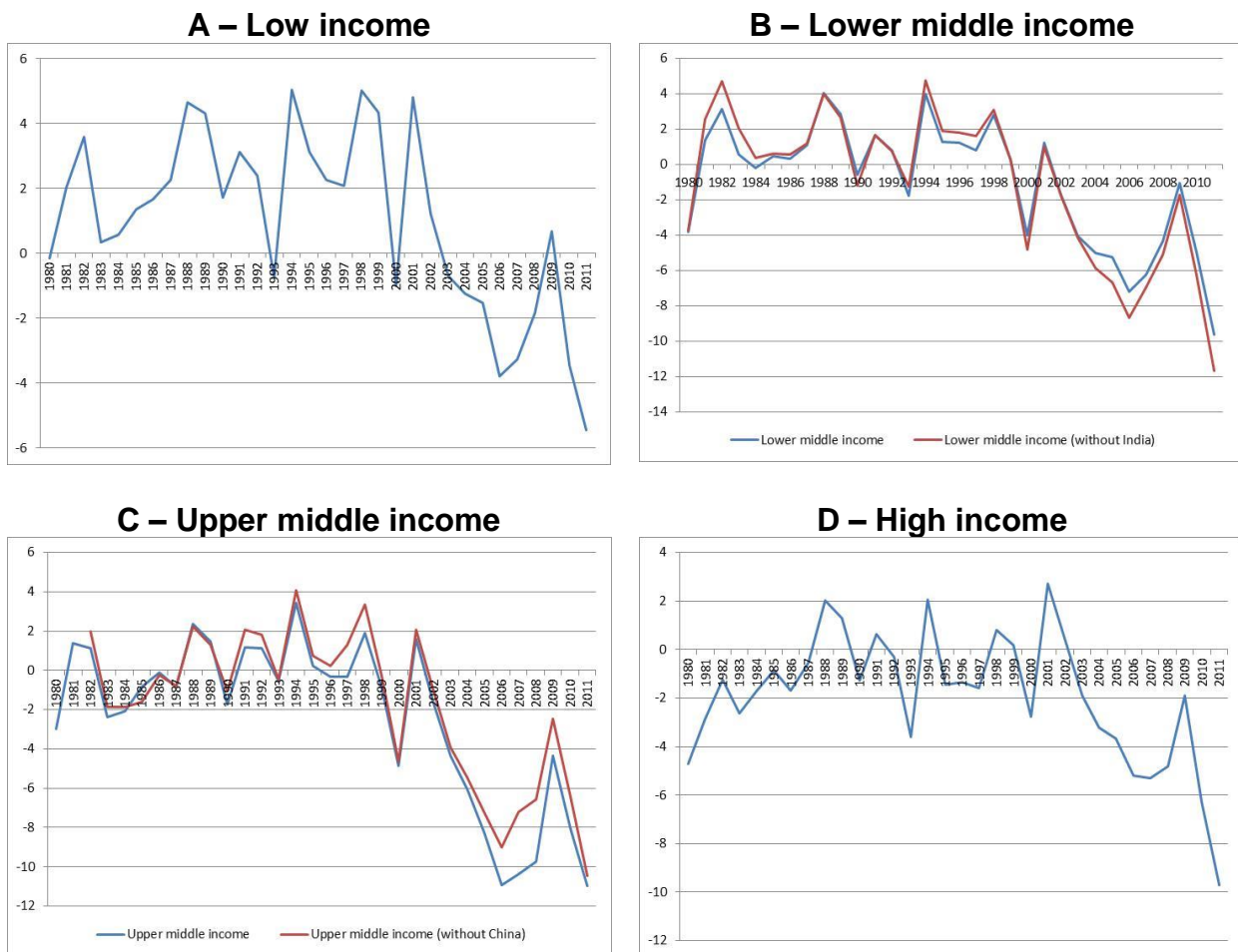
This method is simple to use but also problematical. With this method, for example, going down from -12% to -10% and from -4% to -2% give the same results but these are not proportionally the same things. The third method calculates the current account cumulatively for the entire time period in order to reduce fluctuations, indexes the starting year (1990) to 100 and calculates the logarithmic change. With this method Turkey was ranked 25th in the pre-AKP period and was ranked 6th in the AKP period. In conclusion, all the methods indicate the same phenomenon: Turkey's current account deteriorated much faster in the AKP period than pre-AKP period and deteriorated faster in the second period relative to the vast majority of countries.

These trends are confirmed by figure 7 which shows the difference between Turkey's current account balance and the current accounts balance of income groups that were used earlier.⁵ The figures reveal a clear picture. Turkey's current account deteriorated much faster under the AKP period in Turkey than all the income groups.

⁴ $(-2) - (-4) = 2$.

⁵ For example if the current account deficit in Turkey in a particular year is -5% and current account deficit in low income countries is -2% then the difference will be $(-5) - (-2) = -3$. If in the next year current account deficit goes up to -10% in Turkey and remains the same in low income countries, then the difference will be $(-10) - (-2) = -8$ and will indicate the worsening of current account deficit in Turkey compared to low income countries.

Figure 10 – Turkey’s current account balance compared to income groups.



Source: Author’s own construction based on data from World Development Indicators

External debt

Rapidly increasing external debt, which is linked with large trade and current account deficits, is another important weakness of the Turkish economy. While the current account deficit and external debt are closely linked, not all the resources that are externally borrowed to finance current account deficit fall into the boundaries of external debt. External debt excludes, for example, liabilities related to the inflows of FDI, portfolio investment in equity securities and net equities in foreign life insurance and pension fund reserves (Nakonieczna-Kisiel 2011). External debt, therefore, does not reflect the true risks associated with “sudden stops of capital inflows” and “current account reversals”. The “International Investment Position” (IIP) which shows the difference between a country's external financial assets and liabilities is a useful alternative concept. The IIP is a broader category than external debt and covers more entries. As opposed to external debt, which only covers liabilities, IPP also covers assets. The IIP data is primarily calculated by using balance of payments statistics but is adjusted for exchange rate changes and market valuation differences. Such adjustments can lead to significant changes in IIP levels which are unrelated to balance of payments transactions. IIP (also termed ‘net external debt stock’) is, therefore, a more meaningful indicator than external debt stock. It is entirely possible for an economy to have a declining external debt stock to GDP ratio but an increasing IIP to GDP ratio. Table 2 shows the components of the Turkish IIP calculated by the Central Bank of the Republic of Turkey (CBRT).

$IIP = \text{total assets} - \text{total liabilities}$

Where

Total assets = outward FDI + outward portfolio investment + outward loans and other investments + total reserve stock

Total liabilities = inward FDI + inward portfolio investment + inward loans and other investments

Table 2: International Investment Position of Turkey (Billions of dollars)

	2012
Outward FDI	30
Outward portfolio investment	1
Outward loans and other investments	63
Total reserve stock	119
Total assets	213
Inward FDI	184
Inward portfolio investment	179
Inward loans and other investments	269
Total liabilities	632
IIP (assets – liabilities)	- 419

Source: http://www.tcmb.gov.tr/uyp/uyp_tr.html

It is indeed true that external debt has been accumulating very rapidly under the AKP government but the government makes a number of counter arguments.

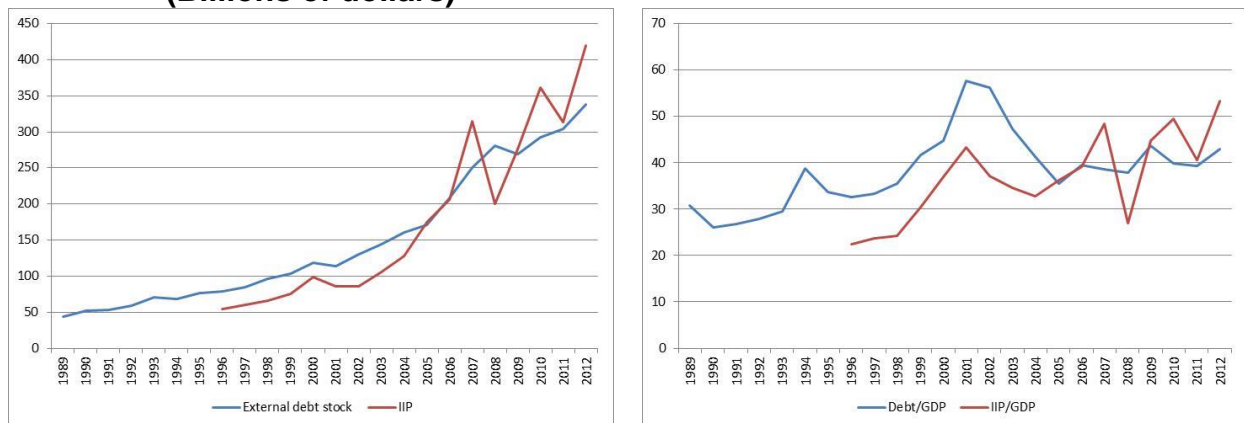
- Turkey paid off its debt to the IMF in full under the AKP government.
- The share of public sector debt in total external debt declined considerably, and rapidly increasing debt of the private sector is not within the responsibility of the government.
- Although external debt is rapidly building up, the debt to GDP ratio has actually declined since 2002. The same is true for IIP to GDP ratio. This is very important because it indicates that Turkey has the resources to pay off this debt.

We will add one more argument which can be used in defence of the AKP government. The global trend that we mentioned above which caused an artificial increase in nominal GDP and exports since 2003 can also be used to explain the boom in external debt. Therefore it makes more sense to look at the debt to GDP ratio.

It is not quite possible to take the first two arguments seriously. Neither the decline of public debt share in total debt nor paying off the debt to the IMF (which is about 3% of the total external debt) is any consolation for Turkey as long as total debt is growing rapidly. Public or private, the debt is Turkey's debt and when there are difficulties in debt servicing the whole economy will suffer. But the argument regarding the debt to GDP ratio is important and should be taken seriously.

Figure 11A shows the external debt stock and IPP in billions of dollars.⁶ Both indicators increase rapidly but IPP shows a more noticeable break from 2002 and tends to fluctuate around external debt stock. Figure 11B shows debt to GDP and IPP to GDP ratios. While debt to GDP ratio declined from 56% in 2002 to 43% in 2012, IPP to GDP ratio went up from 37% in 2002 to 53% in 2012. Neither of the figures however shows a radical break which can cause a serious threat to the economy.

Figure 11: Debt and IPP of Turkey
A: External debt stock and IPP
(Billions of dollars) **B: Debt/GDP and IPP/GDP**



Source: Central Bank of the Republic of Turkey

There are, however, reasons to doubt the validity of the IIP calculations by the CBRT. A relatively mild increase in IIP to GDP ratio in a country where the current account deficit to GDP ratio increased radically is surprising. If adjustments to IIP due to exchange rate changes and market valuation differences are disregarded, IIP is nothing more than a cumulative calculation of the current account and can be considered as “current account stock”.⁷

Assessing the accuracy of CBRT’s IIP calculations is not easy. While the balance of payments statistics are easy to access, information to calculate the impact of differences in market valuation is not. The impact of exchange rate changes is also difficult to calculate. We can, however, easily calculate the IIP by using the balance of payments data alone (IIP^{BP}), without taking the adjustments into consideration. Since IIP^{BP} excludes the adjustments to the IIP calculations, it shows Turkey’s “net external borrowings” rather than Turkey’s “net external debt stock”. If there were no exchange rate changes and valuation differences, net borrowing and net debt would be equal and the difference between these two measures would be equal to zero. In other words the difference between these two measures (IIP and IIP^{BP}) reflects exchange rate changes and market valuation differences.

⁶ Note that since liabilities exceed assets in Turkey IPP normally must have a negative sign. However external debt is expressed with a positive sign. For convenience we changed the sign of IPP from negative to positive which helps to compare trends in debt and IPP. Therefore an increase in IPP in figure 11 implies an increase in “real external debt”.

⁷ This can be explained by a simple example. Assume that net errors and omissions are zero and Turkey receives 100 billion dollars net resources (in the form of FDI, portfolio investment and loans and other investments which constitute its capital account) in 2010, and 70 billion are used to finance the current account deficit and 30 billion is used to increase reserves. Although Turkey “borrowed” 100 billion dollars, IIP is equal to 70 billion as 30 billion of this debt can be paid by the resources added into the reserves. Therefore the IIP is equal to 70 billion which is equal to the current account deficit.

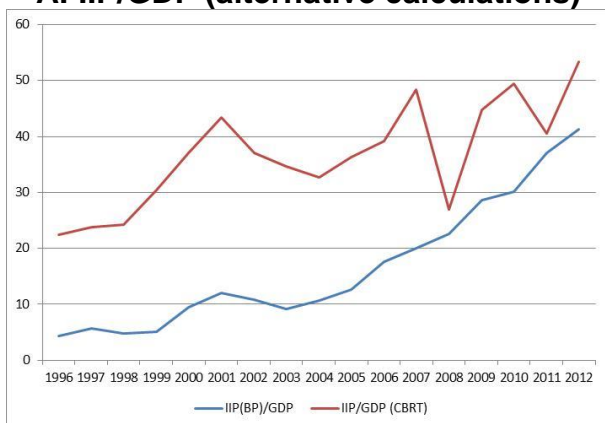
Comparing IIP^{BP} and CBRT's IIP (figure 12A) reveals some interesting inferences. The IIP^{BP} to GDP ratio shows a very radical break starting from 2003 and is considerably different from the IIP which starts higher but increases slowly. The IIP^{BP} to GDP data are more consistent with the radical increase in current account deficit to GDP ratio.

Normally a country's "net external borrowings" (IIP^{BP}) should be lower than its "net external debt stock" (IIP) since investors would expect to make profits on their investment in Turkey. If, for any reason, "net external debt stock" was lower than "net external borrowings", investors would make losses. While it is not unusual for investors to make losses occasionally due to exchange rate changes and valuation differences, it would be odd for them to continue to invest into an economy where they make systematic and long term losses.

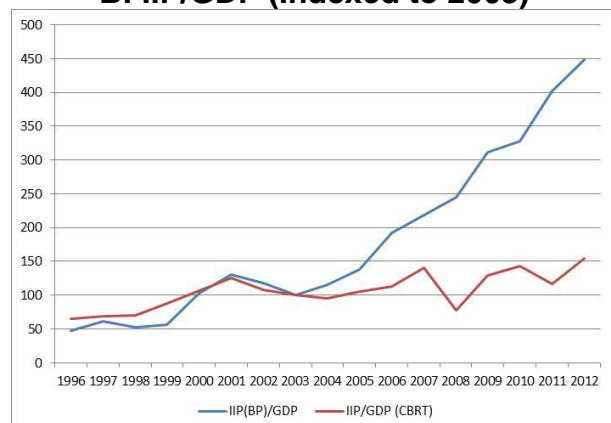
Since a direct comparison of IPP and IIP^{BP} would be problematical due to the methodological differences in their calculations, it would be more reasonable to compare trends through time. To facilitate comparison in trends, the variables are indexed to 100 in 2003 (figure 12B). Before 2003, both figures indicate a relatively close match. Since 2003, however, IIP^{BP} increases much faster than IPP. This shows that Turkey's "net external borrowings" increased much faster than its "net external debt stock" which implies that foreign investors made large and systematic losses. Since such losses make no sense in the long run, we assume that something must be wrong with IPP calculations of the CBRT. Assuming that IIP^{BP} is an accurate measure of Turkey's "net external borrowings" and assuming that foreign investors make profits from their investments in Turkey, even the radical increase in IIP^{BP} in the AKP period does not reflect the true nature of Turkey's "net external debt stock".

Figure 12: Alternative IIP calculations

A: IIP/GDP (alternative calculations)



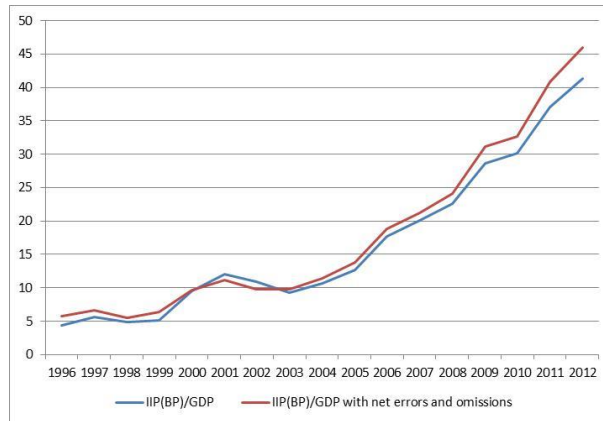
B: IIP/GDP (Indexed to 2003)



Source: Central Bank of the Republic of Turkey

Finally we should take the "net errors and omissions", which are systematically growing under the AKP government, into account. Before the AKP government the "net errors and omissions" were relatively minor and took positive and negative numbers. But during the AKP government they always remained positive and got larger. In 2011 they amount to 11.4 billion dollar and were equal to 1.5% of the GDP. In July 2013, in a single month, they reached to 4.8 billion dollars! This indicates that under the AKP government Turkey received a large amount of capital inflows from unidentified sources. When we take these unidentified capital inflows into account, the IIP^{BP} to GDP ratio increases significantly from 41% to 46% in 2012 (figure 13).

Figure 13: IIP^{BP} and IIP^{BP} to GDP ratio with net errors and omissions



Source: Author's own construction based on data from Central Bank of the Republic of Turkey

Conclusion

With the election of the Islamist-oriented AKP in 2002, Turkey entered its second phase of liberalization, marked by a radical increase in capital inflows. However, this increase stimulated mostly domestic consumption rather than investment and economic growth. Despite attracting considerable external resources, Turkey's economic growth has been moderate and remained below that of middle and low income country groups. Turkey only grew faster than the group of high income countries that are going through one of the worst economic crisis in their history. Turkey fell behind all the income groups in terms of exports. While export growth rates declined very radically due to the overvalued currency, import growth rates remained stable thanks to a radical increase in capital inflows. A large trade and current account deficits increased the "net external debt stock" which is a real threat to the economy.

Although economic growth became dependent upon external resources and an increase in the current account deficit, the government is in the habit of finding something to be happy about regardless of the nature of outcomes. When the economy and current account deficit grow, the government focuses on economic growth and when the economy and current account deficit shrink the government focuses on the declining current account deficit. The point, however, is that with its current development strategy it would not be possible to put Turkey into a sustainable growth path.

Worse, Turkey is yet to face serious problems once external conditions worsen and Turkey experiences "sudden stops of capital inflows" followed by "current account reversals". As Uygur (2004) argued, the current account deficit has played a decisive role in every economic crisis in Turkey in the last 50 years. Recently, this has become a widely recognised risk even by some of the senior members of the AKP government. As the Deputy Prime Minister Ali Babacan elegantly put it at a press meeting,

"Turkey needs to end its reliance on external resources to stimulate economic growth. Turkey's structural problems are quite well known: Domestic savings are very low (12.6% as of 2013) while the investment to GDP ratio is around 19.6%. The value-added in production is also low. Economic growth in Turkey would be healthier if it was based on domestic savings. Economic growth that is stimulated only by domestic consumption and external resources would involve serious risks. There is a close link between credit expansion and current account deficit. Borrowing for production, investment and exports is ok but borrowing to finance consumption goods imports is problematical. Citizens need to finance their

consumption expenditures by using their income not by accumulating debt. What happened to Greece is obvious. Welfare increase must be based on production and exports. Welfare increase that is based on external debt cannot be maintained and it is bound to collapse. Are we really growing sustainably or preparing the grounds for crisis?" (Hurriyet Newspaper, 11 October 2013)

These are sensible words but they would have made more sense if they were not coming from the person responsible for Turkey's economy for the last ten years and if the government was serious about adopting a new development strategy that is not based on external resources.

Bibliography

Aybar, S. (2012), 'Turkish Economy and the Development of Its Financial Sector', in Turkey on the Doorstep of Europe, (Athens: Panteion University).

Nakonieczna-Kisiel, H. (2011), 'International investment position versus external debt', Folia Oeconomica Stetinensia, Vol 10, Issue 1.

Akyuz, Y. and K. Boratav (2003), 'The making of the Turkish financial crisis', *World Development*, Volume 31, No 9, pages 1549-1566.

Binatlı, A.O. ve N. Sohrabji (2009), 'Türk lirasının değerindeki değişme Türkiye'nin dış ticaret ve cari açığını nasıl etkiler?', in Subaşı, T. ve H. Yetkiner (eds.), Küreselleşen kriz çerçevesinde Türkiye'nin cari açık sorunsalı, (Ankara: Eflatun Yayınları).

Dogruel, F. and S. Dogruel (2009), 'Türkiye'de cari açık: temel sorunlar ve dinamikler', in Subaşı, T. ve H. Yetkiner (eds.), Küreselleşen kriz çerçevesinde Türkiye'nin cari açık sorunsalı, (Ankara: Eflatun Yayınları).

Freund, C. ve F. Warnock (2005), *Current Account Deficits in Industrial Countries: The Bigger They are, the Harder They Fall?*, NBER Working Paper No. 11823.

Milesi-Ferretti, G. M. ve A. Razin (1996), Sustainability of persistent current account deficits, NBER Working Papers No. 5467.

Onis, Z. (2012), 'The Triumph of Conservative Globalism: The Political Economy of the AKP Era', *Turkish Studies*, 13:2, 135-152.

Onis, Z. and A.B. Guven (2010), Global Crisis, National Responses: The Political Economy of Turkish Exceptionalism. Koç University-TUSIAD Economic Research Forum Working Papers, Koc University-TUSIAD Economic Research Forum.

Onis, Z. and C. Bakir (2007), 'Turkey's political economy in the age of financial globalization: the significance of the EU anchor', *South European Society and Politics*, Volume 12, No 2, pages 147-164.

Rodrik (2013), 'Son On Yılda Türkiye Ekonomisinin Performansı Ne Kadar İyiydi?', *İktisat ve Toplum*, 33-34

Rodrik, D. (1990), 'Premature liberalization, incomplete stabilization: the Ozal decade in Turkey', *NBER Working Papers*, No: W3300.

Sachs, J. (2013), 'Why is Turkey Thriving?', Project Syndicate.
<http://www.project-syndicate.org/commentary/inside-the-turkish-economic-miracle-by-jeffrey-d--sachs>

Saygılı, M. ve H. Saygılı (2009), 'Türkiye'de İhracatın Yapısal Dönüşümü', in Subaşat, T. ve H. Yetkiner (eds.), *Küreselleşen kriz çerçevesinde Türkiye'nin cari açık sorunsalı*, (Ankara: Eflatun Yayınları).

Telli, C., E. Voyvoda and E. Yeldan (2008), 'Macroeconomics of twin-targeting in Turkey: analytics of a financial computable general equilibrium model', *International Review of Applied Economics*, Volume 22, Issue 2, pages 227-242.

Uygur, E. (2010), 'The global crisis and the Turkish economy', *Turkish Economic Association*, Discussion paper no 2010/3.

Uygur, E. (2004), 'Cari Açık Tartışmaları', *İktisat İşletme ve Finans*, Cilt: 19, Sayı: 222, Sayfa: 5-20.

Voyvoda, E. ve E. Yeldan (2005), *Turkish macroeconomics under the IMF program: Strangulation of the twin-targets, lopsided growth and persistent fragilities*, mimeo, http://www.Bagimsizsosyalbilimciler.Org/Yazilar_Uye/Vydec05.pdf

Yasar, S. (2013), 'Madem riskli o halde kim kullanıyor sıcak parayı?', *Sabah Newspaper*, 15 October 2013.

Yeldan, E. (2013), 'Türkiye Ekonomisi'nde Büyüme Başarısı Masalı', *Maden İş Dergisi*.

Yeldan, E. (2008), *Küreselleşme, Kim İçin*, (Yordam: İstanbul).