DIŞ EKONOMİK İLİŞKİLER KURULU
FOREIGN ECONOMIC RELATIONS BOARD

Turkey 2000-2010: A Decade of Transition
Discussions Among Experts

Sena Eken
Susan Schadler

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Contents

Foreword by the President

Dear Readers,

Over the past three decades, Turkey experienced two major economic transformations. First, starting with the Decisions of January 24, 1980, Turkey successfully rearranged its economic policy framework and reform agenda according to economic liberalization principles in order to ensure proper functioning of market mechanisms. In that decade, Turkey liberalized its foreign trade, abolished all sorts of subsidies except export subsidies, and decreased the state's share in total economic activity. Thanks to the adoption of an export-led growth strategy along with financial and trade liberalization efforts, the Turkish economy became more integrated with the world economy in the 1980s.

The second transformation occurred after the financial crisis in 2001. Turkey transformed itself into a real market economy supported by IMF stand-by agreements and membership negotiations with the EU. The economic crisis in 2001 radically changed the dynamics in Turkey. New economic programs adopted after the crisis were based on a strong macroeconomic policy framework, wide ranging structural reforms including a major overhaul of the banking system, and a floating exchange rate regime. Moreover, a better investment climate, a liberal foreign investment regime, privatization, and creation of independent regulatory authorities and an independent Central Bank became the main pillars of the transformation.

Successful implementation of the economic program and the subsequent political stability triggered a deep structural transformation. Turkey started to grow rapidly after 2001. The reform process also paved the way for enhancing close economic relations with the rest of the world. These restructuring plans, along with regulatory and supervisory reforms enhanced the Turkish economy's resilience to shocks.

Turkey experienced a rapid transformation during this decade, and the results of this transformation have been significant and promising: Turkey has become the 17th largest economy in the world and 6th largest economy in Europe. Turkey now has the largest free-market economy and the greatest industrial power between Italy and China.

Furthermore, along with the reforms after the 2001 crisis, Turkey's EU accession process has strengthened and accelerated the economic transformation of the country. While Turkey has been a party to the EU's Customs Union since 1996, the Customs Union coupled with recent reforms have increased Turkey's competitive power and the private sector's adaptive capabilities. Turkey is now a functioning free-market economy in terms of the economic criteria of the EU, and has opened its doors for global competition. Also, Turkey adopted a notably liberal foreign direct investment policy in 2003. With the help of this policy, the country has attracted approximately $90 billion of foreign direct investment. The annual foreign trade volume reached $300 billion at the end of the decade.

Today, Turkey is one of the growth engines of the new polycentric global system. Istanbul is not only the business center of the region, but also one of the centers of global diplomacy. Turkey, with its democratic credentials, economic model, and strong private sector, is an inspiration for peace and stability in a volatile neighborhood.

As a leader of the Turkish private sector, I am proud that Turkish entrepreneurs have been the agents of change since 1980. Private sector investment has been the engine of economic growth and job creation in Turkey. The Turkish private sector has been and continues to be an important policy making partner through institutionalized public-private dialogue mechanisms.

Turkey has quite ambitious economic targets for the next decade: to be among the 10 largest economies of the world and a major global player, with stronger competitive power. There is no doubt that these ambitious targets can be achieved through effective policy making and reforms. To this end, structural reforms in areas such as innovation policy, industrial policy, public administration, social security, the legal system, the education system, the tax system, the labor market, and informality need to be carried out in a determined way. Changing Turkey's constitution is another important aspect of this structural reform process.

I hope this book – led by two distinguished scholars with the contribution of leading experts on Turkey from academia, media, financial markets, and international organizations – will enable us to understand Turkey's economic transformation better. Furthermore, I believe this book will be a guide for forward-looking economic policy formulation to make Turkey one of the top-ten economies of the world by 2023.

M. Rifat HİSARCIKLIOĞLU
President, the Union of Chambers and Commodity Exchanges of Turkey (TOBB) and the Foreign Economic Relations Board of Turkey (DEİK)
Deputy President, Eurochambres

Foreword by the Chairman of the Executive Board

Dear Readers,

The Foreign Economic Relations Board of Turkey (DEİK) was founded in 1988 to promote the economic and commercial relations of the Turkish business community abroad consonant with the broader goal of ensuring the overall integration of the Turkish economy into the global economy.

As a consequence of the economic liberalization policies of the 1980's, Turkey became a prominent actor in global trade as well as an attractive destination for foreign direct investments. DEİK has earned considerable credit for this achievement as an institution that makes every effort to open the Turkish economy up to the world economy.

In this new era, the foremost priorities of DEİK will be to encourage the manufacturing of value added and highly competitive products and services. It will also be focused on securing easy access to large and diversified foreign markets, while supporting Turkish firms in establishing and strengthening their brands abroad. Furthermore, DEİK is making an active effort to promote Turkey and its economy.

I hope this book on the economic transformation of Turkey during the past decade will be instrumental in raising interest and awareness among readers and have a positive effect on the Turkish economy and its future.

Rona YIRCALI
Chairman of the Executive Board, the Foreign Economic Relations Board of Turkey (DEİK)

Preface

This book addresses the question "In what ways was the decade 2000-10 transformational for the political economy of Turkey?". It is based on discussions in three workshops held in October 2011. The day-long workshops, the first in Istanbul, the second in Brussels, and the third in Washington DC, each brought together 12-15 individuals with expertise on some aspect of Turkey's political economy.[1] The experts were drawn from many backgrounds (academic, research institutes, journalism, financial markets, and policy) and disciplines (economics, political science, history, public policy, and sociology). Each workshop was moderated by and subject to the identical agendas drawn up by the authors of this book. As moderators, we strove to promote a free-flowing exchange of views, intervening only to keep the discussion on topic and draw attention to differences of view.

The objective of this book is to present the sense of the discussions—to recreate, as faithfully as possible, where experts agreed on the interpretation of developments and where debates and differences of view arose. Obviously this required the use of judgment, though we have made every effort to avoid injecting our own views on the topics covered. Even where we disagreed with points made or felt that there were gaps in the analysis, we, as rapporteurs, have adhered strictly to the sense of the discussions.

To the extent possible, the rendition of the discussions is comprehensive. As the discussion was carried out under Chatham House Rules, there is no attribution. It also must be emphasized that a wide range of views is synthesized here and, as such, no single participant would necessarily agree with or support all of them.

The book is organized in seven chapters. The first, an introduction, lays out the defining parameters of the decade and then provides a very general summary or roadmap of the discussions on each major topic. Chapters II through VI, which present the detailed descriptions of the discussions, follow a single format. They start with a short summary of the basic stylized facts that form the background to the discussions reported in the chapter and then present the description of the discussions. The final chapter offers conclusions and an interpretation of the implications of the discussions for the policy agenda.

Each section draws on the content of all three workshops, intermixing views from each to highlight the areas of agreement and areas of debate, even when the "debate" consists of the juxtapositions of views from different workshops. For the most part, issues that attracted the most attention in each workshop were broadly similar—that is, rarely did an issue come under much greater scrutiny in one workshop than in the others. Thus, in reporting the discussions we have not ascribed any points of view to a specific workshop.

The project was made possible by generous funding from the Central Bank of Turkey, the Doğuş Group, and Robert Bosch Stiftung. It also was supported in many essential forms by the Middle East Institute and the Turkish Coalition of America. We wish to thank H.E Namık Tan, Ambassador of Turkey to the United States, for the informative perspective he provided at the Washington D.C. workshop.

Sena Eken and Susan Schadler

1. Workshop participants are listed in Annex I.

Executive Summary

The course of economic development is rarely smooth. Income convergence between an emerging market economy and advanced countries occurs over a long period with intervals of rapid growth, modest growth, and even backtracking. Moreover, the transformative changes in economic policies and institutions that underpin convergence almost always come in waves. In Turkey, the past decade appears to have brought such changes.

In October 2011, three one-day workshops (in Istanbul, Brussels and Washington DC) brought together experts on many aspects of Turkey's political economy to exchange views on the nature of these changes during the past decade. How important were the changes? How much did they actually move the foundations for inclusive and sustainable growth? What gaps and challenges did they leave or create?

A large range of views made for vigorous debates. There will probably never be complete agreement, but since the period under scrutiny is quite recent, the diversity of views was particularly large. Still, patterns of consensus and divergence in views became clear. Describing these is the objective of this book.

Nowhere was the change in the economic landscape clearer than the approach to macroeconomic and financial policies. The macro environment had reached a crescendo of instability at the turn of the century: inflation had hovered around a growth-defying 80 percent for years, savings rates had fallen, the financing of soaring fiscal deficits had pushed public debt, real interest rates and capital inflows to unsustainable levels, and risk-taking by undercapitalized banks went uncurbed. This perfect storm of vulnerabilities paved the way to Turkey's most devastating post-war economic crisis in 2001, pressing the necessity for a broad post-crisis reformulation of macroeconomic policies and institutions.

Participants agreed that this reformulation had changed the tenor of economic policies and helped secure strong economic performance during the middle of the decade. From the introduction of inflation targeting and central bank independence, to fiscal control, to financial sector supervision, the changes had put Turkey in the company of emerging market countries with better economic policy frameworks. These changes were viewed as having been key ingredients of the speed and strength of recovery from the hard impact of the global crisis later in the decade.

But changes, even ones that endure a decade of challenges, can be undermined as they encounter new circumstances. Thus, the most actively debated question concerning macroeconomic policies was whether the monetary, fiscal and financial frameworks crafted over the decade continued to enable policy decisions that will steer the economy away from the risks of overheating, excessive dependence on foreign financing, and unsustainable domestic indebtedness. As the robustness of any policy framework is proved by its ability to contain volatility, participants agreed that the 2001 revolution in macroeconomic policies continued to face the test of time. It was certainly too soon to tell whether the achievements would be permanent. Moreover, with successes came higher expectations and greater ambitions for the speed of income convergence with advanced countries and for the inclusiveness of prosperity.

A dominant theme in the discussion was that macroeconomic stability was necessary but not sufficient for strong and sustained growth in Turkey. Perhaps the most common distinguishing differences between countries that reach their potential and those that do not are found under the rubric of structural and social policies. These are the broad swath of conventions and institutions that guide relationships between constituents of an economy and set the incentives for their decisions: how much to invest in physical and human capital, the activities in which to invest, the incentives and disincentives to work, the inclusiveness of economic activity and prosperity, and the interplay between cultural and economic attitudes, to name those most debated during the discussions.

Participants brought to the table a wide range of views on structural and social changes. While change for the better had occurred, particularly in the health care system, in conditions that had spawned the growth of small business in the Anatolian heartland, and to some degree in education, serious impediments to strong and equitable growth remained to be tackled. Attention was especially focused on policies that would render the education system better at meeting the needs for creative thinking and lift the exceptionally low rate of employment of the working age population. These goals called for multi-faceted policy innovations. They would also depend on changes in the role of and attitudes toward women in the economy, and efforts to tailor regional policies toward more growth in weaker regions.

Like all open economies, Turkey had faced new challenges stemming from globalization during the decade. Turkey's success in meeting these challenges was attributed in no small part to its shift toward more outward oriented trade and supporting diplomacy. This shift in perspective, along with stable macroeconomic conditions and the new vitality of intermediate technology lines of production, had contributed to a renewal of export growth, particularly to new Middle and Near East markets alongside the traditional EU market. An unresolved debate took place around the question of whether an industrial policy focused on promising export sectors might have led to faster, better diversified, and higher technology exports.

EU accession had been a profound force for change—political, social, and legal—that had contributed importantly to economic successes during the decade. However, the vigor and single-mindedness of the push to adopt changes required by the EU had clearly faded after the middle of the decade. Opinions were divided on what this meant for the future. Would the absence of an EU push eliminate interest in continued pursuit of many institutional changes? Or had the early part of the decade set in motion a process that would eventually resume?

The consensus on the impact and durability of Turkey's decade of change was cautiously optimistic. True, there were immediate challenges on the macroeconomic front, particularly reining in the excessive dependence on foreign financing by raising domestic savings and containing inflationary impulses that had come at the end of the decade. But a policy framework for tackling these problems was in place if the will to use it to those ends was present. Structural and social challenges—not met as decisively during the past decade—remained substantial. Should choices be made to address these actively while continuing to promote an outward orientation of business and the development of democratic institutions, Turkey could secure a stronger and steadier development path in the decade to come.

Chapter I: Introduction

There is a widespread perception that the past decade has been transformational for Turkey. This perception is built on developments in several domains: the new role Turkey plays in a part of the world of growing strategic importance; the transition from a string of coalition governments to a forceful majority government with ambitious agendas for domestic governance as well as foreign policy; and the emergence of a more stable political economy from the crisis-ridden decade of the 1990s. In significant respects, all these developments were interrelated. However, understanding the extent and nature of the change in each area requires an analytical focus that zooms in on actual changes and their underlying causes. This book takes up the political economy dimension of the decade of transformation.

Indeed, much changed in the political economy during the decade. Some of the change was the result of deliberate policy decisions, some of events well beyond the government's control, and some of the continuation of longstanding trends. The tide of these developments had profound influences. But the debate on what those influences were and how far, in fact, they went in producing a "New Turkey" will go on for years. The aim of this book is to contribute to the ongoing process of disentangling the various threads of Turkey's political economy during the past decade—to distinguish what changed and what did not, what old problems were addressed and what new problems emerged, and what parts of the transformation set the stage for permanently better macroeconomic performance and what parts were more ephemeral.

The term political economy covers a broad range of issues. For the purposes of this project, it was delineated to include issues most germane to macroeconomic performance: monetary, fiscal and financial policies, macroeconomic vulnerabilities, the functioning of the labor market, social policies and cultural attitudes as they bear upon economic inclusion, and key challenges from globalization. While more issues could certainly have been included, it was necessary to be selective in order to strike the right balance between depth and breadth in a day-long discussion at each workshop.

What was different about 2000-10?

Whenever a particular decade is held up as transformational, an obvious question is "Why this decade?". For Turkey, the defining parameters of 2000-10 are clear.

While it may be debated whether in fact the decade saw lasting changes, it cannot be questioned that several fundamental developments at the beginning of, and even during, the decade set the stage for distinct breaks from the past.

The tail end of the 1990s held stark contrasts of hope and despair. In 1999, after decades of small steps toward the long-held goal of becoming part of the European Union, Turkey was granted candidate status for full membership. The decision at the Helsinki Summit was heralded as a major boost for Turkey's economic prospects. Requirements for institutional changes prior to accession were widely seen as a potentially powerful impetus to better governance.

Yet the exuberance was tempered by the present challenges of a chaotic macroeconomic landscape. Inflation hovered around a growth-destroying 80 percent, large fiscal deficits were increasingly difficult to finance, and banks (many undercapitalized and overexposed to exchange rate risk and excessive maturity mismatches) were picking up the government's financing burden against the backdrop of weak supervision. After years of haggling about how to address these problems, an IMF lending arrangement had been put in place, aiming to accomplish disinflation through a crawling peg exchange rate arrangement. The approach, fraught with risks insofar as it had gone ahead with weak supporting policies, was the best that could be agreed within a fractious coalition government.

The turn of the decade brought crises of an unprecedented scale. Two major earthquakes in northwestern Turkey in late 1999 pushed government responses to the breaking point. In retrospect, the inability of the government to respond adequately in humanitarian or financial terms would be seen as a critical turning point in public perceptions of the capacity of government to address national catastrophes.

One year later, a financial crisis struck. In November 2000, the collapse of a bank heavily involved with using foreign funds to purchase domestic government bonds prompted large capital outflows and a run on reserves as the exchange rate was defended. By February 2001, a full-fledged crisis unfolded. Capital outflows had depleted reserves, and funding for the government had dried up. The exchange rate peg had to be abandoned, inflicting mortal wounds on already weak bank and corporate balance sheets. The economic devastation was severe, even by standards of a country that had suffered periodic balance of payments crises since the 1950s.

The extent of the output loss was not the only feature that made the 2000-01 crisis a watershed. Another important difference from previous crises arose from the interaction of the severity of the crisis, the reach of policy responses, and the subsequent 6-year period of IMF lending and monitoring arrangements. The monetary policy framework was overhauled with a shift to a floating exchange rate, central bank independence, and implicit inflation targeting. Fiscal policy was severely tightened. A major privatization program was started. An overhaul of the banking sector brought recapitalization, government ownership of several banks, and the creation of an effective supervisory system. In short, the very severity of the crisis almost mandated that the response would constitute a clear discontinuity from the past.

The 2002 general elections sealed the commitment to the new direction for economic policies. The right-of-center Justice and Development Party (AKP) was swept to power and able to form a majority government. The transition of power was close to seamless from the perspective of the economic program, and the new government increasingly took ownership of the content of the program.

This transition also set up new forces in Turkey's political culture. The majority government was propelled to office by a wave of support from the Anatolian heartland, home to a socially conservative constituency and a burgeoning and economically ambitious small-and medium-sized business sector. The growing economic importance of this constituency brought Turkey face to face with the need to resolve any tensions between the challenges of competing in the global economy and the increasing influence of its socially conservative values.

The decade was also distinguished by some developments that defined the constraints on and choices for economic and social policies. Longstanding demographic changes continued. Perhaps most serious from a political economy perspective were the very gradual increase in the old-age dependency ratio accompanied by continued high growth of the working age population and the ongoing rural-urban migration. These changes exacerbated several economic and social problems, from low and falling household savings rates, to strains on urban social services, to inadequate employment growth, to weaknesses in the quality of education. Though these problems were not new, they were cumulative and therefore more formidable than ever in this decade.

Lastly, the global environment presented both unprecedented opportunities and challenges. The Great Moderation—the historically unusual combination of strong global growth, ample global liquidity, and low inflation—continued through the first half of the decade, providing an ideal environment for Turkey's recovery from the 2000-01 crisis and disinflation. But this gave way to the Great Recession in 2008-09 when Turkey's ability to cope with a crisis not of its own making was tested.

Discussions on the Decade: Consensus and Controversies

In all the workshops, participants agreed that Turkey's political economy had changed in major ways during the decade. Macroeconomic policy changes were most obvious and clear cut. Far more complex were questions about what had happened to microeconomic, structural, and social conditions. Across the board, it was too soon to tell whether the apparent accomplishments had produced permanent changes. Indeed, even changes for the good were themselves opening the door to new conflicts, challenges, and vulnerabilities.

On the macroeconomic and financial side, Turkey had overcome longstanding sources of instability (Chapter II). The new environment of single digit inflation, low fiscal deficits, moderate public debt, a flexible exchange rate/inflation targeting framework, and well-capitalized and better supervised financial institutions had put Turkey in the company of the better-managed emerging market countries.[2] Yet, while cross-country studies tend to find that macroeconomic stability paves the way for strong output growth, the decade had not stood out in this dimension for Turkey. True, growth, driven by a substantial increase in total factor productivity, capital investment, and absorption of labor into non-traditional manufacturing, had been strong during 2002-07. But at least in part owing to the global crisis in 2008-09 the record for 2000-10 as a whole differed little from previous decades. In sum, the decade had been noteworthy more for the improvement in underlying macroeconomic conditions for growth than for the growth record itself.

While the shift to more stable macroeconomic policies had not had as strong an effect on growth as might have been wished, it had increased Turkey's resilience to shocks (of either domestic or external origin). Indeed, the 2008-09 global crisis had been a first major test of this resilience. The scope for countercyclical monetary and fiscal policies and the strength of the financial sector were viewed as having been key ingredients of the speed and strength of recovery from the hard impact of the crisis.

Yet the decade had also brought to Turkey the full force of vulnerabilities that are commonly associated with the "impossible trinity" (with no barriers to foreign capital, it became increasingly difficult both to achieve a low inflation target and to restrain an inflow-driven appreciation of the Turkish lira) (Chapter III). As in many other emerging market countries, more stable macroeconomic policies had attracted large and disproportionately short-term capital inflows. During much of the decade, the Turkish lira had appreciated and the current account deficit had risen.

Nevertheless, Turkey had stuck to a relatively orthodox macroeconomic policy response through most of the decade. Some viewed this as a reflection of the limited potential for effectiveness of more activist policy responses in the face of the impossible trinity. Others felt that more could have been done through a combination of more aggressive foreign exchange market intervention and macroprudential measures to discourage capital inflows and moderate credit growth.[3] Some questioned why there had not been even more stringent fiscal tightening to cool

2. Selected economic indicators are provided in Annex II.

3. Macroprudential policies refer to the range of regulations and prudential measures that can be applied to banks in a way that supports central banks' monetary policy objectives.

domestic demand. Most felt that improving the supply response of the economy through microeconomic reforms, though unlikely to have eliminated immediate pressures, would have placed Turkey in a better position to contain overheating and the loss of competitiveness in the future. Regardless of the perspective on the policy choices made, most participants felt that the appreciation of the Turkish lira pushed it, by the end of the decade, to an overvalued level, setting the stage for an increase in the current account deficit in 2011 to a dangerous level.

Herein lay the new vulnerabilities: no longer were high inflation, profligate fiscal policy and a fragile financial sector the problem. Instead, the fairly continuous appreciation of the Turkish lira during the decade, which was partly offset by the increase in productivity, had cut deeply into export profitability and private savings while encouraging imports. With low and declining domestic savings and a heavy dependence on foreign capital to finance surges in investment, Turkey had been at the mercy of changing risk premiums and sudden stops. These were vulnerabilities that, with any number of domestic or external trigger events, could plunge the economy into crisis.

In contrast to hard decisions and actions on macroeconomic policies, microeconomic policies were mostly seen as disappointing. But just how disappointing was the subject of debate. For those inclined to see the glass half full, the success in financial sector reform, a major overhaul of the transportation sector, some areas of regulatory reform, and privatization initiatives were noteworthy accomplishments in an environment where aggressive interest groups opposed reform. But for the larger group that saw the glass half empty, inaction on Turkey's most serious structural problems had been a major shortcoming contributing to the weak growth response to macroeconomic stabilization. In a panoply of areas central to the structural weaknesses of the economy—in particular, the flexibility of the labor market, the size of the informal sector, the role of women in the economy, the effectiveness of the educational system, and the efficiency of the tax system—problems continued to fester.

The very low participation of the working age population in the labor force was seen as a key impediment to reaping the full growth potential from macroeconomic stabilization (Chapter IV). Most participants saw impediments to job creation—especially high severance costs, high and undifferentiated minimum wages, skill mismatches, and constraints women faced in finding and keeping jobs—as the nub of the problem. Some, however, thought that the influence of globalization alongside Turkish lira appreciation had been at least as important as these structural impediments. Particularly the former group felt that the government had missed a major window of opportunity for action in 2005-7 to implement reforms. Certainly with the benefit of hindsight, the conditions had been ripe for galvanizing change in the context of strong electoral support, rapid domestic and global growth, and the synergies with improvements in macroeconomic policies that would likely have been possible.

Another range of issues explored in the discussions concerned the many and complex influences on the inclusiveness of economic prosperity (Chapter V). True, the decade had seen a reversal in a longstanding trend toward increasing income inequality—in contrast to most other OECD countries. But Turkey's legacy of highly unequal income distribution, substantial poverty rates, and large regional differences in income still constituted formidable hurdles to inclusive prosperity. There had been significant changes in the approaches to social policies to compensate for and address the problems. All had taken place under the umbrella of the governments' commitment to using market mechanisms where possible and maintaining fiscal discipline. Some—especially healthcare reform—were seen as significant accomplishments. But in other areas, there was little evidence that changes had brought more efficiency to social welfare policies. Many acknowledged that the extremely complex inter-linkages among social, cultural and regional challenges had made the formulation of social policies extremely complicated. But some also felt that the government had lacked a clear definition of its social policy objectives, for example, with respect to income distribution.

Ultimately, the education system was seen as the crux of the solution to more inclusive prosperity. Here, some improvements had taken place over the decade—more spending on infrastructure, establishment of internet access to schools, increases to near universal primary school enrollment, and experimentation with some decentralization and curriculum reform. But the fundamental problem—that education remained too uneven in quality and too focused on the objective of nation-building at the expense of teaching critical thinking skills essential to social mobility and to competition in the global economy—remained to be tackled.

Still, in Turkey's social and cultural context, it was agreed that inclusive prosperity implied more than reducing income disparities and improving educational opportunities. Fostering a middle class outside the traditional urban hubs and expanding the role of and opportunities for women were also key aspects of inclusive prosperity. The influences that had driven and those that had held back change in these areas were complex and subtle. One that attracted considerable attention was the increasingly open expression of religiosity and social conservatism. Was a new, less rigid secularism emerging that would facilitate broader economic participation and wider access to the opportunities presented by globalization? Or were more open expressions of social conservatism narrowing the scope of two key requirements for Turkey's ability to compete—education reform and a more active role for women in the economy? Views were expressed on both sides of this debate.

Like all open economies, Turkey had faced new challenges stemming from globalization during the decade. The discussions zeroed in on two of these—the degree to which the export sector had been able to adjust to changing global conditions and the management of the relationship with the EU (Chapter VI). A range of views were expressed on the success of the export sector. Some felt that it had in many respects succeeded in diversifying product lines and markets and in moving up the technology ladder. Others acknowledged these accomplishments, but felt that they had been too slow to secure a strong place for Turkish exports, especially in competition with the most dynamic emerging market economies. Still others felt that the combination of pressure for specialization and competition from globalization, together with the real appreciation of the Turkish lira, had been almost insurmountable conditions for exporters. Each of these views was matched by a lament that policies—removing structural impediments to productivity growth, undertaking activist industrial policies, and stemming the appreciation of the Turkish lira—had not been more aggressive.

The twists and turns related to Turkey's aspirations to accede to the European Union had been an unquestionably defining part of the decade (Chapter VI). The negotiations on Turkey's path to fulfilling the acquis communautaire in the first half of the decade had been a rallying cry for substantive changes that improved institutions. The halt to the negotiations in 2006 had been at least partly responsible for the slowdown in the domestic reform process. But beyond that quite tangible loss had been the setting in motion of a gradual diminution of interest in EU accession. The discussions revealed considerable ambivalence about how much Turkey needed the EU accession process to forge ahead with modernization and institutional reform. Some felt a return of an EU anchor in some form was critical, while others pointed to the scope for a more self-driven process that could even be stronger in the absence of EU constraints.

The discussions mainly focused on characterizing the nature, extent, and permanence of changes in Turkey's political economy during the decade. But they also touched on the policy challenges ahead—challenges that must be met to complete the unfinished parts of the transformation during 2000-10, to address the new vulnerabilities that arose from the transformation, and to ensure that changes for the good will last. The concluding chapter (Chapter VII) summarizes these views.

* * *

This project is clearly but one way to approach an assessment of the decade. It should be taken in the spirit of an exercise in constructing a "first history" of the decade. Hard conclusions on many of the questions raised will only be possible with a longer perspective and rigorous empirical investigation. Indeed, we hope that in helping to identify the salient political economy issues of the decade, the project will stimulate future research agendas.

Chapter II: The Macroeconomic Policy Framework and Growth

A popular view at home and abroad is that profound reforms to the fiscal, monetary and financial policy frameworks during the decade 2000-10 paved the way to stronger economic growth. This view entails two broad propositions: first, that changes in policy frameworks were significant, durable and at least potentially growth enhancing; and second, that economic growth was in fact stronger and more stable than in previous decades. The weight of opinion was that improvements in macroeconomic and financial policy frameworks had indeed been impressive, but they had not in the course of this decade translated into either stronger or more stable growth.

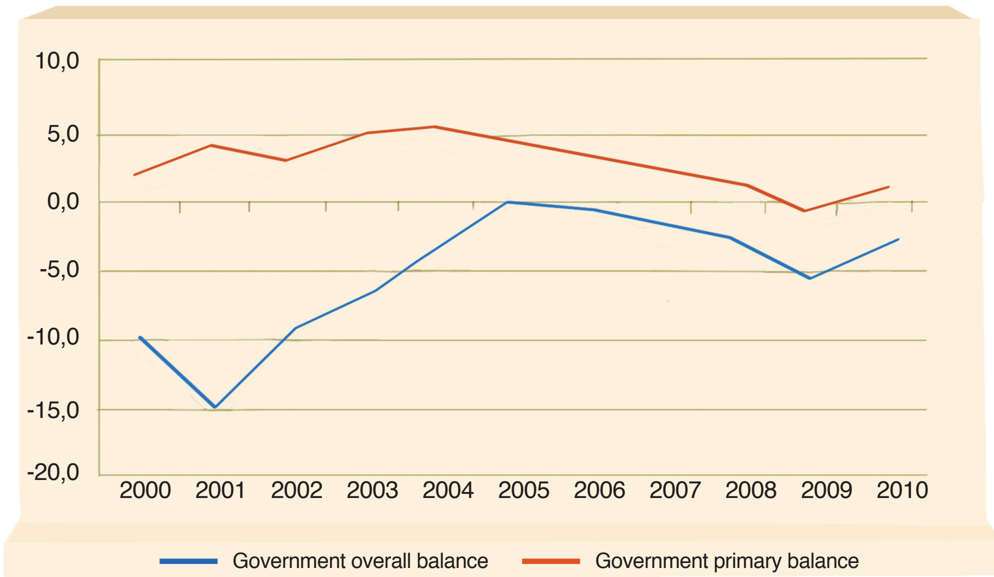
1. The Stylized Facts

The policy frameworks

Fiscal policy through much of the decade was anchored on a target for the primary surplus (the balance excluding interest payments) of 6 ½ percent of GNP. [4] Though the target was not fully achieved, the government was able to hold the primary surplus steadily around 5 percent of GDP through 2006 (Figure 1). After that, the surplus fell and turned to small deficit in 2009. These developments resulted in a major change in the public debt profile (Figure 2). Public debt spiked with the recapitalization of some key banks during the 2000-01 crisis and the drop in GDP. But the strong primary position and the greatly reduced financing needs together with the resumption of GDP growth after 2002 permitted a steady reduction in public debt to GDP ratio through 2007. By the end of the decade net public debt was a moderate 36 percent of GDP, just above half its level at the beginning of the decade.

4. The target was set as a percent of GNP. To ensure consistent and comparable data series from available sources and in line with the discussions in the workshops, all the stylized facts are presented as a percent of GDP.

Figure 1: Public Sector Finances
(Percent of GDP)



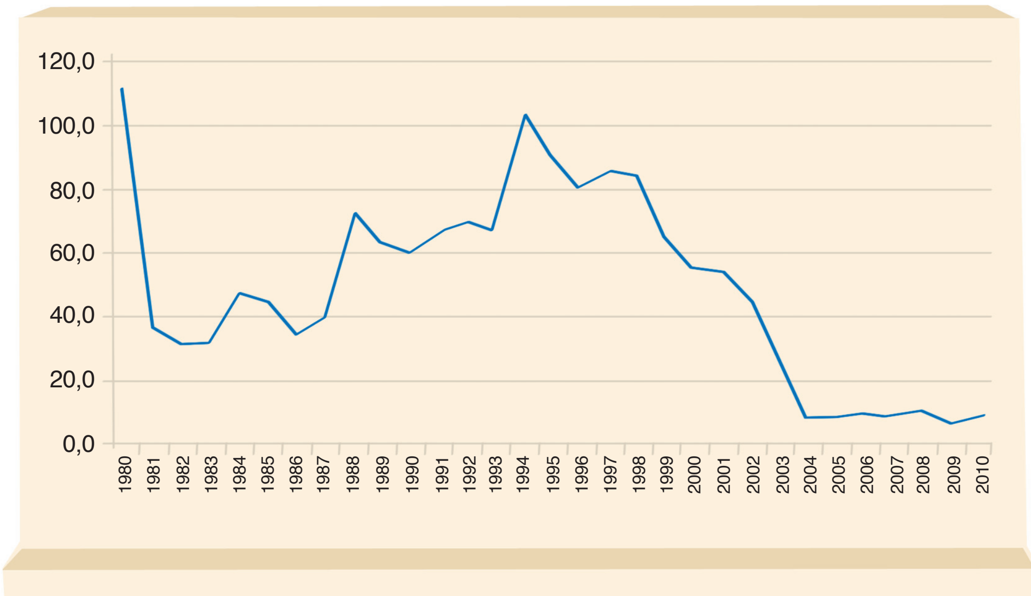
Sources: International Monetary Fund, World Economic Outlook Database, September 2011 and Article IV Consultation Reports (various issues).
Note: There is a discontinuity in the data series between 2000-02 and 2003-10 because of a chance in the content of government category.

Figure 2: Goverment Debt
(Percent of GDP)

Source: International Monetary Fund, World Economic Outlook Database, September 2011.

The monetary policy framework was shifted in the aftermath of the 2000-01 crisis from a crawling peg to a freely floating exchange rate. In 2001, the Central Bank of Turkey was granted independence vis-à-vis policy actions. After a four year period of implicit inflation targeting with moderate reserve accumulation targets, formal inflation targeting was adopted in 2006. Inflation, after peaking at more than 100 percent in the mid-1990s and an unsuccessful exchange rate-based disinflation attempt at the beginning of 2000s, was brought under control and reduced to single digits by 2004 (Figure 3). The average inflation rate during 2000-10 was about 22 percent, compared with 77 percent in the 1990s. With interest rate policy focused on disinflation, the policy rate was held at levels substantially above the realized inflation rate until 2009.

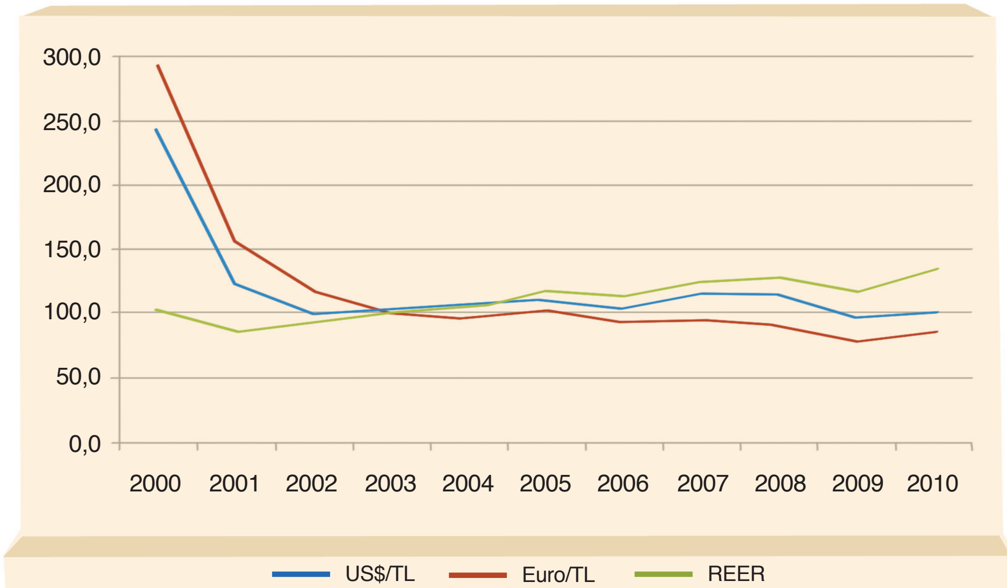
Figure 3: Inflation
(Average consumer prices, percent)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

During 2000-01, the sharp, crisis-driven nominal depreciation of the lira far exceeded the still-significant excess of domestic over foreign inflation and the CPI-based real effective value of the lira fell by about 18 percent (Figure 4). However, during much of the rest of the decade as the inflation rate fell and the nominal value of the lira turned around, the CPI-based real effective value of the lira appreciated by a cumulative amount of some 50 percent. Given the rapid increase in labor productivity in non-traditional manufacturing after 2002, a portion of this appreciation clearly reflected the Belassa-Samuelson effect (a more rapid increase of productivity in the traded goods sector than in the non-traded goods sector). Indeed, according to the Central Bank data, the real effective value of the lira based on unit labor cost increased by 33 percent between 2003 (after most of the 2000-01 crisis depreciation had been reversed) and 2010.

Figure 4: Exchange Rates (2003=100)



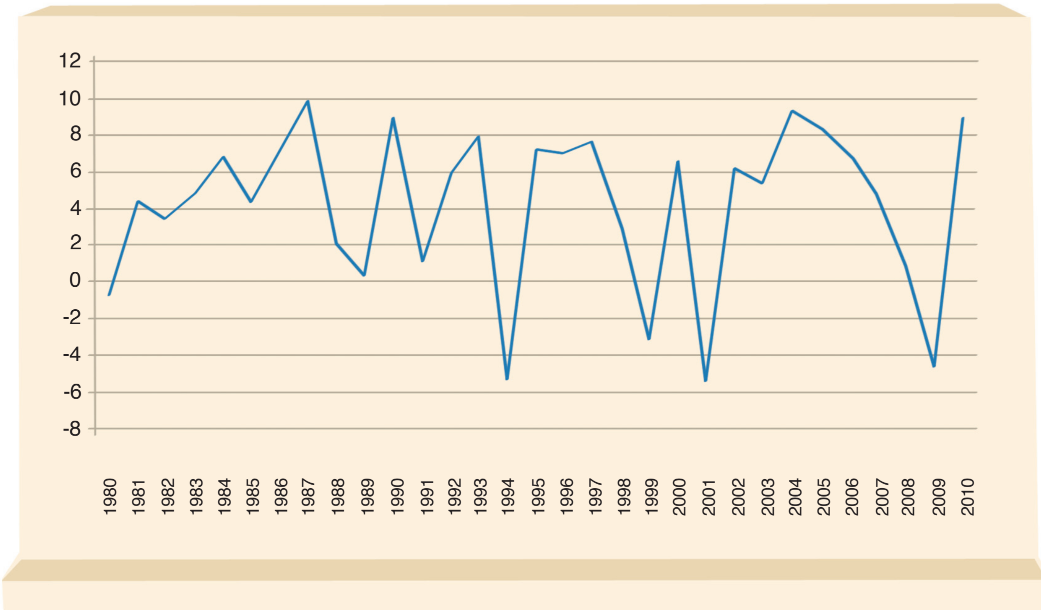
Sources: Central Bank of Turkey and Turkey Data Monitor.

The financial sector, seriously impaired during the 2000-01 crisis, was subject to many reforms in the first few years of the decade. Some $30 billion was put into the recapitalization of restructured state-owned banks and a program for strengthening the private banking sector was implemented. The latter involved intervening in nonviable banks and subjecting banks to audits that assessed their balance sheets and recapitalization needs uniformly. By mid-decade, the average capital adequacy ratio (the ratio of bank capital to total assets, a key indicator of a bank's ability to withstand shocks) had risen to a very strong 20-25 percent. Supervision was strengthened in a number of ways, most significantly by the establishment of the Banking Regulation and Supervision Agency (BRSA) to put the regulatory and supervisory activities under one roof, to distance them from political influence, and to put in place supervisory and regulatory practices in line with international standards. Several banking laws were adopted during the decade to further refine the framework.

Growth

Historically, economic growth in Turkey has been something of a roller coaster. Relatively strong and consistent growth during the 1960s and early 1970s gave way to a sharp slowing in late 1970s followed by an upward trend in growth through the mid 1980s (Figure 5). Thereafter, swings in growth became more frequent and sharper—often 1-2 year periods of growth were followed by sharp contractions.

Figure 5: Real GDP Growth (Percent)



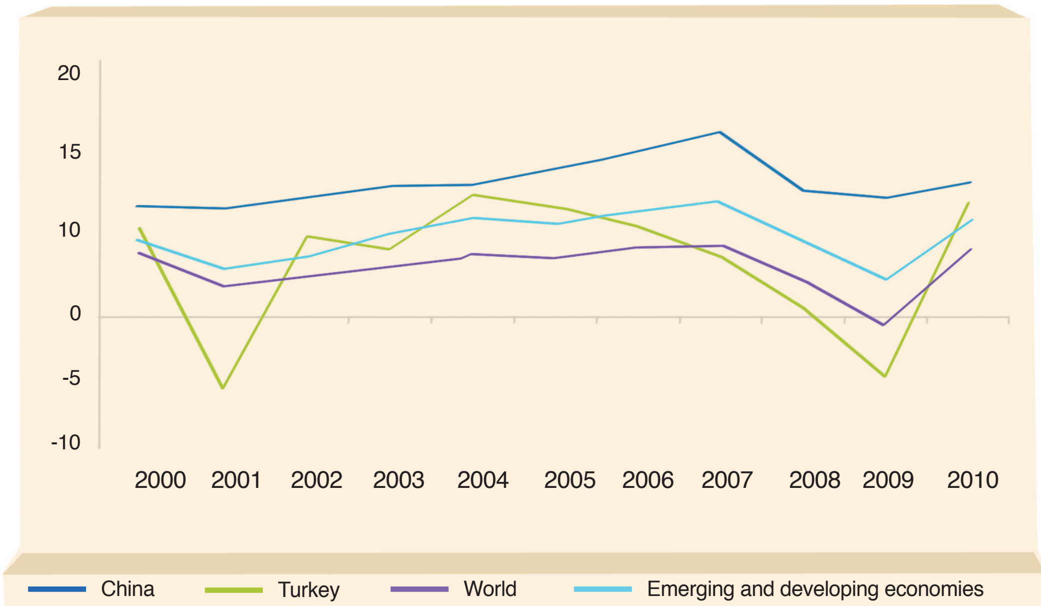
Source: International Monetary Fund, World Economic Outlook Database, September 2011.

Following the deep recession during the 2000-01 crisis, the economy bounced back strongly, growing at an average annual rate of almost 7 percent during 2002-07. However, with severe recessions both at the beginning and end of the decade, average annual growth for 2000-10 was 4.2 percent (2.9 percent per capita) following 4.0 percent (2.4 percent per capita) during the 1990s. During the same period, the average growth rate in emerging and developing economies was slightly above 6 percent (Figure 6).[5] The standard deviation of GDP growth was 5.3 during 2000-10 as compared to 5.1 during the 1990s.[6]

5. The "Emerging and developing economies" grouping is from IMF's World Economic Outlook Database. See http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/index.aspx

6.The growth rate in 2000-09 (when only ten years are considered as in previous decades) was on average not stronger and its volatility as measured by the standard deviation was the highest when compared to outcomes in the previous five decades.

Figure 6: GDP Growth Comparisons (Percent)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

The surge in GDP during 2002-07 reflected some increase in employment economy wide, but the larger share of the change came through an increase in GDP per worker by some 5 ½ percent per year. Underlying this was a mix of growth in total factor productivity (TFP) and in the capital labor ratio. The increase in TFP (3.1 percent per year) accounted for more for than 50 percent while the increase in physical capital per worker rose by almost 2 percent per year. Though detailed data for 2008-10 were not yet available, other indicators showed that all magnitudes suffered sharp cyclical slowdowns or falls.

2. Discussions on macroeconomic policy, financial sector reform, and growth

The signature economic policy achievement of the decade had been the stabilization of macroeconomic and financial policies: the improvement in the fiscal balance, in the level of public debt, in the inflation rate, and in the strength of the financial sector had been nothing short of impressive.

Insofar as there was little to debate on the value of these accomplishments, much of the discussion of macroeconomic policies and outcomes focused on the obvious ensuing question: "Had strong enough policy frameworks been put in place to ensure that macroeconomic and financial sector stability would be permanent?". It was agreed that the decade-long discipline had been impressive, yet some special characteristics of the period had helped. Abundant global liquidity and low interest rates in advanced countries, which were unlikely to be permanent, had supported stabilization and investment financing. Also, policy conditionality in the lending arrangement with the IMF (which ended in 2007) had been a clear anchor. Whether adequate alternate anchors had been put in place was debated.

A second main focus of the discussions was the question of how stronger macroeconomic and financial policies had impacted economic growth. Views differed on whether growth during the decade had been disappointing in light of the extent of the improvement in policies. There was more agreement on the view that the economy had demonstrated impressive resilience in the recovery from the global crisis.

Fiscal stabilization

The fiscal adjustment, particularly through the first half of the decade, had been remarkable. The substantial primary fiscal surplus, sustained during the first eight years of the decade and achieved in part through commendable expenditure restraint, had set in motion forces that had helped achieve further improvements in the overall fiscal profile: public debt had been pushed down, the government's exposure to foreign exchange risk had been reduced to negligible amounts, and risk premiums on government paper had fallen. The latter had been reflected in lower long term interest rates and credit default swap spreads (the cost to investors of insuring against government default). Such a performance was especially impressive against the background of sovereign debt problems in Europe.

The debate on whether the decade had seen a fundamental strengthening in the fiscal framework or a temporary improvement in policy coalesced around views on fiscal policy decisions during the recovery from the 2008-09 crisis. There was a substantial divide in views on whether, by the end of the decade, fiscal policy was still "within safe limits" or was posing risks for continuing stability. One view was that fiscal policy had remained appropriately tight through 2007 and thereafter had responded, also appropriately, to the conditions resulting from the global crisis. The government had both allowed automatic stabilizers to work and was able to pursue a discretionary countercyclical policy. The primary balance had returned to surplus by 2010.

The other view was that adherence to a fiscal targets had become less strict, and specifically that the fiscal framework had not produced the right response to Turkey's cyclical strength at the end of the decade. The countercyclical easing had been justifiable during the height of the crisis, but after mid-2009 it had not been reversed. There had been an improvement in the nominal balance, but this had been mainly conjunctural. The government had not been vigilant enough in calculating and maintaining a cyclically neutral fiscal position. It was acknowledged that cyclical adjustments were subject to enormous measurement problems, but this should not have undermined the attention to caution in fiscal policy during a strong cyclical upturn. The large increase in tax revenues (given the important indirect tax component) had reflected strong domestic demand-driven growth.[7] In the event of more balanced growth through a deceleration of domestic demand, it would become evident that the underlying fiscal position was not as strong as it needed to be.

Many felt that these concerns highlighted the absence after 2007 of a clear fiscal framework. Until 2007, the fiscal program agreed with and monitored by the IMF had effectively been a fiscal rule. This rule—continuous commitment to a primary surplus target—had been a constraint on policies and a source of credibility. Since the end of the IMF arrangement, however, there had been no comparable anchor. A fiscal rule that was proposed in 2007 was judged to have been reasonably sound by international standards, but in the end it was not implemented. Instead, the government had argued that the requisite discipline could be achieved through the construction of medium term fiscal plans. It was not clear that these in fact had imparted the needed discipline. Particularly those who felt that the countercyclical fiscal easing in 2008-09 had not been reversed adequately doubted that a sufficiently disciplining framework had been adopted.

Monetary and exchange rate policy

The new monetary policy framework that emerged over the decade was viewed as another major accomplishment. The signature achievement of the new regime was the dramatic reduction of the inflation rate to single digits. Gradual, yet appropriately ambitious, disinflation targets had been set and supported consistently by interest rate policy. The credibility of this approach had elicited supportive effects from market expectations. Other favorable factors—the control of public finances, the halt of large-scale Turkish lira depreciation after 2001, and the downward pressure on traded goods prices from increased productivity and low labor costs in global markets—had also helped.

As impressive as disinflation had been, Turkey remained at best in a middling position vis-à-vis other emerging markets. While no one expressed the view that getting inflation down to the low single digits was of prime importance, some called attention to the slip upwards in inflation at the end of the decade. Most felt that interest rates by the end of the decade had been brought to levels that were not compatible with the inflation targets, policies had become less “orthodox”, and focus had turned to macroprudential policies. These unorthodox policies were described by various participants as the abandonment of inflation targeting, or as interesting

7. Revenues from indirect taxes accounted for about 70 percent of total tax revenues in 2010.

and innovative, but largely unsuccessful. There was fairly prevalent concern that without more disciplining constructs ensuring the inflation target as the primary monetary policy objective, the very impressive achievements on inflation may not be permanent.

On the other hand, it was noted that the policy environment had changed significantly since the early 2000s. Expansionary monetary policies in advanced countries and hence abundant foreign capital at relatively low cost had led, as in many emerging market countries, to rapid credit expansion, a buildup of macro-financial risks, and external imbalances. In the circumstances, the Central Bank could not neglect the financial stability aspect of monetary policy by solely focusing on price stability. To achieve both price and financial stability, the policy interest rate was not a sufficient tool and had to be accompanied by unorthodox tools. That was why the emphasis on macro-prudential tools had increased. In this perspective, there had been a "rebirth of inflation targeting" rather an abandonment of inflation targeting.

The move to a floating exchange rate was considered to have been the right policy. Large capital inflows had exposed the economy to sudden stops and changing risk premiums.[8] In this environment, the floating exchange rate policy was a safety valve: for example when capital inflows had plunged in 2008, the depreciation of the Turkish lira had both obviated the need for an expensive defense of a peg and facilitated the needed current account adjustment. However, concern was expressed that the pass-through of exchange rate changes—both appreciations and depreciations—to the general price level had tended to be substantial.[9] For the floating exchange rate policy to be compatible with low inflation in these conditions, the pass-through of exchange rate depreciations to the general price level had to be offset by a tightening of policies. Yet because the Turkish lira had appreciated during most of the decade, the Central Bank had not been tested in its resolve to keep inflation low in circumstances of prolonged depreciation pressures.[10]

Notwithstanding the benefits of the floating exchange rate, some argued that it had also allowed large capital inflows to push up the exchange rate. Without a policy response to constrain in some way the inflows or their effects, the Turkish lira had appreciated. While some considered the appreciation before the 2008-09 crisis as a normal outcome of increases in productivity that had been "inevitable and healthy", the subsequent appreciation during the recovery was generally seen as excessive. Indeed, the increased capital inflows to the private sector had put Turkey face-to-face with the "impossible trinity"—with full capital account convertibility, it became difficult both to achieve low inflation and restrain an appreciation of the Turkish

8. Discussions related to vulnerabilities are covered in Chapter III.

9. This view stands in contrast to evidence that exchange rate pass through actually fell during the floating exchange rate period. Kara, Hakan and Fethi Öğünç, 2008, "Inflation targeting and exchange rate pass-through: the Turkish experience," *Emerging Markets Finance and Trade*, 44(6), pp. 52-66.

10. When the Turkish lira came under pressure for a brief period in 2006, the Central Bank raised its policy rate significantly to fend off inflationary pressures stemming from the depreciation of the lira.

lira. Insofar as the Central Bank was committed to inflation targeting, the lira was allowed to float virtually freely. By the end of the decade some unorthodox monetary policy instruments (such as differentiated increases in reserve requirements on banks) had been tried. But whether they would be successful remained a major question.

There were sharp differences of view on the appropriateness of the choices made in dealing with the surge in capital inflows through the decade. Some felt that preventing the appreciation of the Turkish lira, particularly as it became evident that the lira was significantly overvalued, should have been the priority. In this view, faster accumulation of official foreign exchange reserves, the standard tool for preventing appreciation, would have had the added benefit of increasing the reserve cushion, which was low by emerging market standards. While there would have been limits to how far intervention could have gone (either because of the cost to the central bank of sterilization or because of the monetary expansion that would have resulted in the absence of sterilization), it would have been worth testing those limits.

Another view was that the Central Bank should have experimented earlier and more widely with unorthodox policy tools—not just increases in reserve requirements on banks, but also measures such as restrictions on inflows, a Tobin tax, or the exercise of moral suasion on banks and large businesses importing capital.[11] Against this view, some argued that such measures tended to lose their effectiveness over time and when they took the form of taxes were not easily turned on and off as the intensity of the inflow problem changed. Moreover, some felt that the potential negative effects of such measures—disintermediation with harmful effects on the effectiveness of bank supervision and on bank profits—were not worth the potential benefits.

A minority view was that not much could have been done to limit the appreciation without seriously compromising the inflation target. Indeed monetary policy had been overburdened trying to contain inflation and credit expansion in the face of expansionary policies in advanced countries and accelerating short-term capital inflows. Other policies—in particular, a further tightening of fiscal policy, structural reforms especially in the labor market, and subsidies to offset the impact of the appreciation on exporters—might have been better employed to help reduce domestic demand pressures and improve supply-side conditions.

11. Tobin tax, originally suggested by James Tobin in 1972, is a currency transaction tax to dissuade short-term speculative capital movements and reduce volatility in financial markets and exchange rates. Several countries have implemented such a tax, though most have subsequently abandoned it. Studies of the actual implementation of a Tobin tax come to highly varied conclusions with respect to their effects on the scale of transactions, exchange rate volatility, currency overvaluation, and the structure of capital inflows.

Financial sector reform

During the 2000-01 crisis, severe weaknesses in the financial sector had been addressed. By the middle of the decade, commercial banks were well-capitalized and systems had been put in place to deal with weak banks. Greater independence in the supervisory authority had been institutionalized. The decisive actions in this area had been critical to the ongoing health of the financial sector insofar as the time-inconsistency problem was particularly important in this domain.[12] The dividends from these sweeping reforms had been critical to the swifter and stronger recovery of the Turkish economy from the 2008-09 global financial crisis than of most European economies.

While there was complete agreement that in the wake of the reforms the financial sector was sound, some expressed a concern that it still did not play as effective a role in smoothing domestic demand as it should. Credit expansion had been unduly pro-cyclical, expanding rapidly through the strong-growth period in the middle of the decade, contracting sharply during 2008-09, and then rebounding very strongly. Other participants, however, pointed out that this was very much the experience in other, even advanced, countries. Indeed it was even argued that the sharp pulling back of credit expansion in a recession was a self-protection mechanism that had been critical to banks' maintaining their strong capital bases through the global crisis.

Did macroeconomic and financial policy reforms improve economic performance?

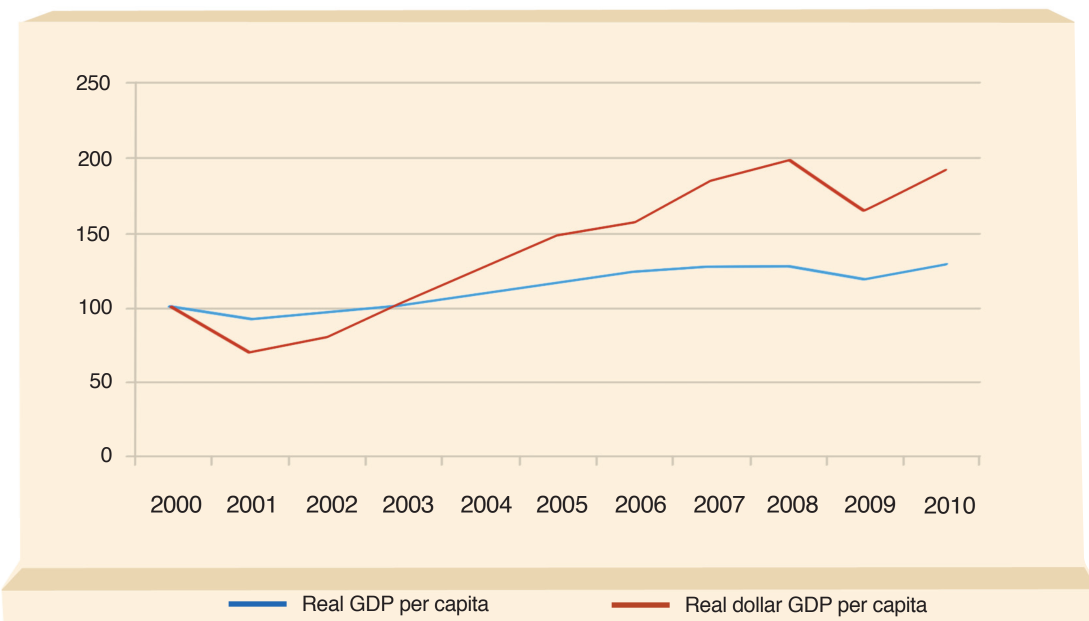
The facts pointed to a rather disappointing response of GDP growth to the significant macroeconomic and financial sector stabilization. The simple average and volatility measures of growth over the decade could not be seen as anything other than moderate by historical standards. Comparisons with averages of other emerging market countries put Turkey at no more than a modest performer. Moreover, until 2008, global conditions for growth—rapid increase in trading partner demand and the stabilizing influence of the "Great Moderation"—had been unusually favorable relative to pre-2000 conditions or likely future conditions.

But there were reasons for the general perception that economic prosperity had improved strongly during 2000-10. One was the impression that had been created by the sharp burst of growth during 2002-06. At 7.2 percent annually, GDP growth had been the fastest of any five-year record since the beginning of the Republic, while volatility during those years had been low. A second was the substantial

12. Given the history of lax enforcement of prudential measures and weak supervision, financial institutions and markets would probably not have found simple declarations of intent to clean up the banking sector credible. In other words, the declarations would have been time inconsistent. Thus, to establish credibility as quickly as possible, it was necessary for the government to take strict actions and put in place well-constructed institutions.

increase in purchasing power that had come from the real appreciation of the Turkish lira. This had been one of the important influences behind the faster growth of domestic demand than of GDP. One way of looking at this was in terms of a mismatch between the increase in Turkey's global purchasing power and in its real productivity growth.[13] While this had been a problem for macroeconomic imbalances (discussed below), the extraordinary increase in purchasing power had contributed to a sense of well-being (Figure 7). A third was that even if growth for the decade as a whole might rightly be characterized as moderate, it had been more inclusive than in the past: not only had income distribution improved slightly, but also the government had been successful in bringing to people basic services and amenities. Finally, the recoveries from the two crises, helped by appropriate policy responses and the resumption of capital inflows, had been rapid and vigorous. For all these reasons, people had probably perceived their economic circumstances as better than simple GDP growth suggested.

Figure 7: Purchasing Power in Dollars and Productivity (2000=100)



Source: Turkey Data Monitor.

13. Average real per capita income denominated in dollars (a measure of purchasing power if all demand were for traded goods) increased some 90 percent during the decade while average productivity increased by only about 30 percent. This gap directly reflected the real appreciation of the lira.

Yet it was inescapable that GDP growth had not been stronger or less volatile than in the previous decade and the discussion touched on possible explanations. One was that a strong growth response to stabilization had been cut short by the global financial crisis. Proponents of this view pointed to the strong increases in total factor productivity and investment during 2002-07 which, in this view, went beyond a mere bounce back from the sharp contraction in 2000-01 and rather heralded a sustained period of growth had the crisis not occurred. Against this view however, was the fact that domestic growth had already started to slow in 2007.

The bulk of opinion, however, sided with the view that ongoing microeconomic and structural weaknesses had prevented a stronger, sustainable output response to stabilization. The weaknesses that drew the greatest attention in the discussions were in the education system and the labor market, where a range of impediments (including regulations, minimum wages that were not differentiated by region, inadequate skills, and cultural attitudes that discouraged women from working) were seen as having far-reaching effects on labor costs and availability.[14] The importance of other weaknesses, (especially in the tax system, but also in product market competition and the adequacy of infrastructure) were noted, though, mainly owing to time constraints, were not elaborated.[15]

Yet even if the growth record had not improved, resiliency had. The experience during the global crisis was viewed as having revealed perhaps the clearest and most noteworthy manifestation of the new macroeconomic policy stability—the swift and sharp recovery from the 2008-09 global crisis. The contrast with the 2000-01 crisis was an indication of the very important effects of the new stability. The earlier crisis had, of course, been the culmination of a lengthy period of unsustainable fiscal, monetary, and financial sector policies. But, the recovery, on the back of highly restrictive fiscal and monetary policies, had been protracted.

In contrast, the 2008-09 crisis had been precipitated by the financial meltdown in advanced countries. Turkey, which had already started to see some softening in the pace of activity in 2007, had been hit hard by the collapse in Western European markets. Exports had declined, external finance had dried up, and as confidence and employment had sagged, domestic demand had dropped sharply. This was a harsh blow by emerging market standards: GDP had decelerated sharply in 2008 before falling by over 4 ½ percent in 2009.[16] The recovery had started, however, by mid-2009 and proved to be strong.

14. The discussions of developments in labor markets and education are presented in Chapters IV and V.

15. Deficiencies in product markets that were mentioned but not explored were the regulatory procedures of the energy sector and of other natural monopolies.

16. A year-over-year contraction of GDP reached 14.7 percent during the first quarter of 2009.

An important reason for the relatively quick recovery had been the scope for countercyclical fiscal and monetary policies, complementing the stimulus from a sizable depreciation of the Turkish lira and early resumption of capital inflows. The government's response in the initial months of the crisis had been cautious, driven by an overarching concern about fiscal and financial stability. But by the spring of 2009, a stimulative set of polices had been put in place. The broadly shared view was that this response had been measured, but effectively supportive. The relatively strong primary surplus and moderate level of public debt at the start of the crisis had allowed the operation of automatic stabilizers and some discretionary easing of fiscal policy. Similarly, lower inflation and the floating exchange rate had allowed the Central Bank to lower interest rates sharply during the crisis.[17] This together with the underlying strength of the financial sector meant that Turkey had escaped the specter of a lost decade now hanging over many other countries.

Supportive policies had even gone beyond blunt fiscal and monetary stimulus. Many felt that the nature of the fiscal measures had had a particularly effective pro-business orientation. Tax cuts on consumer durables in overstocked sectors as well as reductions in entrepreneurial costs through new subsidies on employers' share of social security premiums and research and development supports had been, in this view, well targeted. On the foreign economic policy side, concerted efforts toward export market diversification to reduce Turkey's conventional reliance on the European markets were viewed favorably. The effectiveness of these measures had been reflected not only in the speed and strength of the recovery, but also in the avoidance of widespread bankruptcies. In short, it could be argued that the targeted strategy had worked.

But the story was not entirely about policies. There was also the perception that after the traumatic years of 2000-01 and in the new environment of a floating exchange rate, businesses and financial institutions had become more cautious and had learned how to better protect themselves in the face of volatility.[18] This was evident in the increase in risk aversion following the depreciation of the Turkish lira in 2006. Also early in the 2008-09 crisis, banks curbed credit growth, while businesses reduced investment, production, and employment. Though these behaviors had contributed to the large output and employment losses, they had probably also prevented the real sector setbacks from spilling over to the financial sector and creating adverse feedback loops. However, these behaviors had also meant that a heavy burden of the shock had fallen on those who lost their jobs, could not enter the labor market, or, were in the small scale sector where the

17. Low inflation helped stabilize inflation expectations, while the floating exchange rate released monetary policy from the obligation to counter the downward market pressure on the Turkish lira.

18. This was in line with the findings that fixed exchange rates are prone to more external debt accumulation. The reference cited in the discussion was Alper, C. E. and Kamil Yilmaz (2003) "Domestic Needs for Foreign Finance and Exchange Rate Regime Choice in Turkey," Öniş, Z. and B. Rubin (eds.) *The Turkish Economy in Crisis: Critical Perspectives on the 2000-1 Crises*, Routledge: 67-91.

bulk of the bankruptcies occurred. Some participants argued that economically weak social groups had carried a disproportionate burden of the setbacks and that this was evidence of a "democratic deficit".[19]

19. Democratic deficit" refers to a situation in which socially weak groups cannot effectively defend themselves against developments that can harm or be unfair to them. Some consider that it plays a role in shaping the behavior of economic agents as well as the economic policies of governments. For a detailed discussion, see Alper, C.E. and Ziya Öniş, "Financial globalization, the democratic deficit and recurrent crises in emerging markets—the Turkish experience in the aftermath of capital market liberalization" in *Emerging Markets Finance and Trade*, 39(3), 2003.

Chapter III: Macroeconomic Vulnerabilities

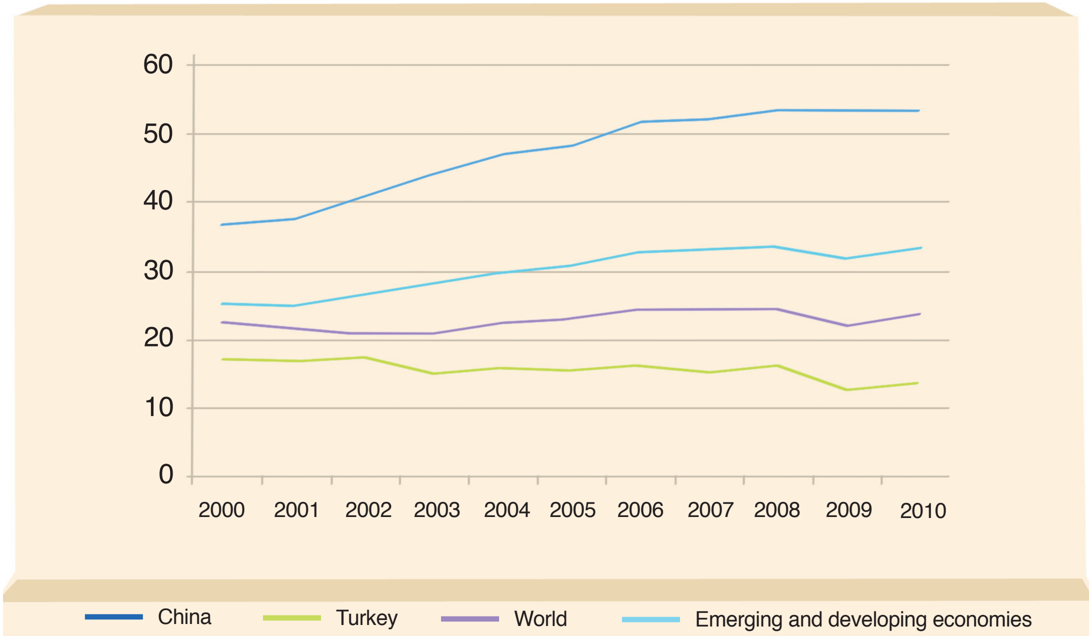
Macroeconomic policy stability, while addressing many of Turkey's longest standing vulnerabilities, had also opened the door to new vulnerabilities. As in many stabilizing emerging markets, the new macro and financial sector environment had produced greater confidence in the Turkish economy both at home and abroad. In the environment of ample global liquidity, capital inflows had surged, pushing up the value of the Turkish lira and adding to a strong pick-up in bank lending (albeit from a low base). Private savings had fallen and private investment had risen, particularly during the middle of the decade. Alongside this new dynamic had been longer standing demographic forces and structural rigidities that together had continued to put downward pressure on private savings. Taken together, these influences created strong pressures on the current account balance.

The confluence of these developments had created new vulnerabilities centered on a large current account deficit and exposure to sudden stops, variable risk premiums, and exchange market volatility. Crafting the appropriate policy responses had opened up a battery of new challenges, on which most participants felt progress had been disappointing. This had left Turkey with serious vulnerabilities that if triggered would produce a crisis. In addition, insufficient efforts to stop or reverse the drop in private savings that occurred over the decade had dimmed growth prospects.

1. The Stylized Facts

The savings rate fell from 17 percent of GDP at the beginning of the decade to 13 percent of GDP at the end of the decade (Figure 8). Such a level was low in comparison to several benchmarks: average savings of 21.5 percent of GDP in the 1980s and 1990s; Turkey's average investment rate of slightly over 19 percent during the decade; and average savings of 30 percent of GDP in developing and emerging market economies during 2000-10. Indeed, some of the fast growing economies had had savings as high as 40 percent of GDP.

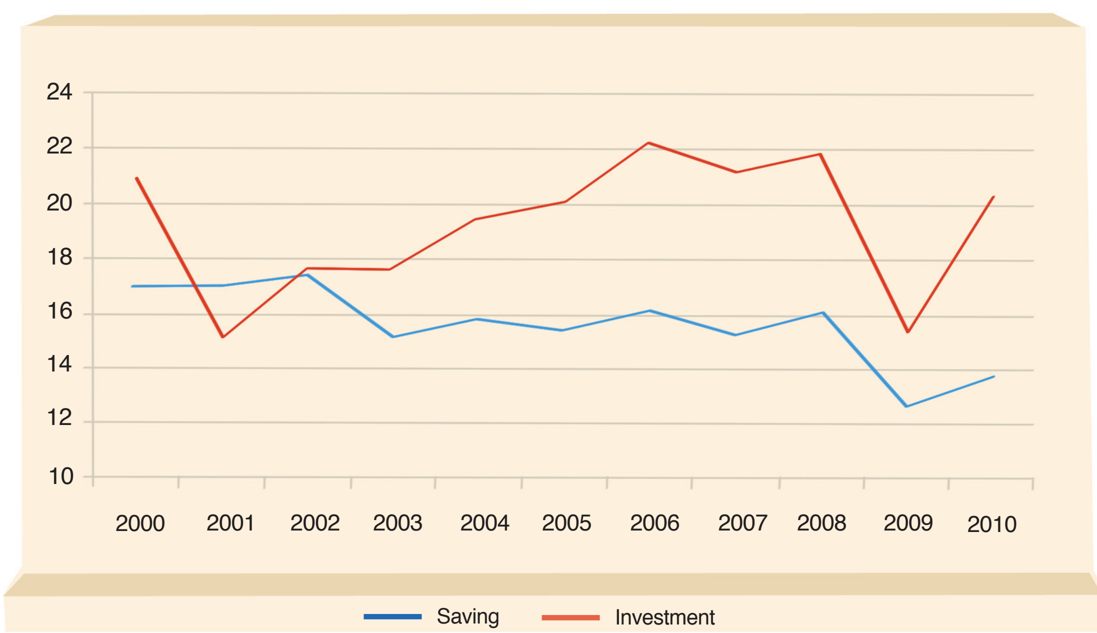
Figure 8: Gross National Savings (Percent of GDP)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

Investment fluctuated widely during 2000-10 (Figure 9). After falling to 15 percent of GDP in 2001, it increased steadily to 22 percent of GDP in 2006. Thereafter it declined sharply in 2009 but recovered quickly to 20 percent of GDP in 2010. On average, it was about 19 percent of GDP during this period, lower than the average of about 22.5 percent of GDP registered during the previous two decades and about 27.5 percent of GDP on average in emerging and developing economies.

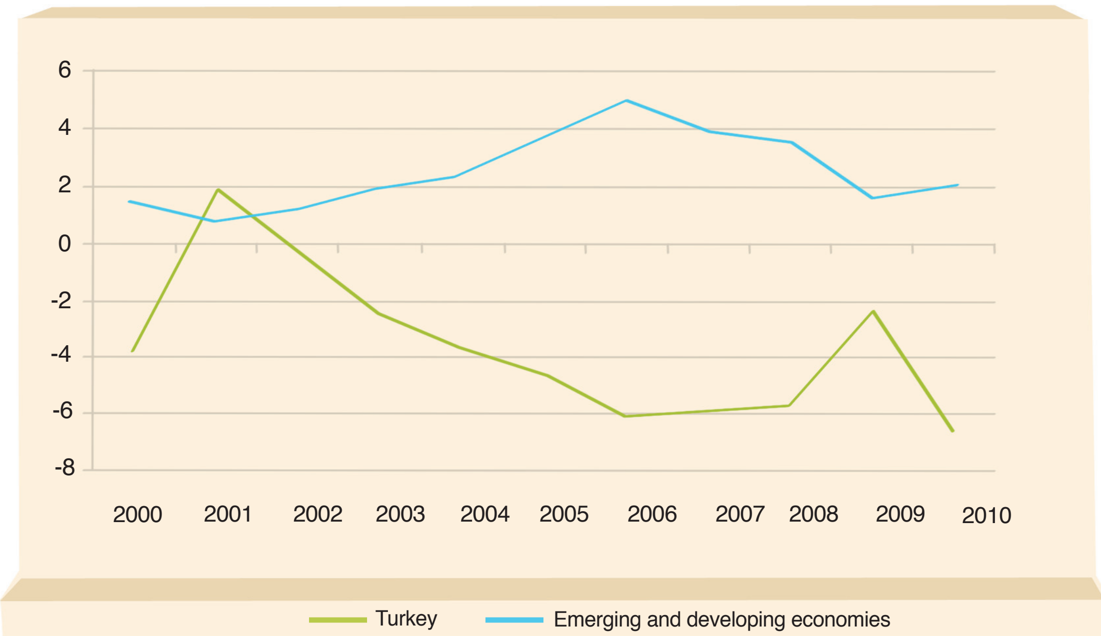
Figure 9: Savings and Investment (Percent of GDP)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

The current account deficit was substantial throughout most of 2000-10 (Figure 10).[20] After averaging about 1 percent of GDP (with maxima of 3.5 percent of GDP) during the 1980s and 1990s, it averaged close to 4 percent of GDP during 2000-10, ending at 6 percent of GDP in 2010. The deficit was also high compared with an average of 2.5 percent in emerging and developing economies as a group during this period. Wide fluctuations in the balance reflected domestic and global economic conditions, particularly demand conditions in trade partners and wide swings in the terms of trade (with a cumulative weakening of about 7 percent during 2000-10) .

Figure 10: Current Account Balance (Percent of GDP)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

A significant share of the deterioration in the current account position during the decade reflected rising energy prices and energy import volumes. Turkey, which has always been a large fuel importer, saw its fuel-related import bill rise by some 300 percent during 2000-10. The non-fuel balance, however, did not strengthen to compensate for this increase, and indeed deteriorated quite significantly in the aftermath of the 2008-09 crisis.

Net financial inflows including net errors and omissions, which had run at an annual average of some $600 million during the 1990s, turned to net outflows during the 2001 crisis and then returned to $400 million in 2002. Thereafter, they increased steadily (except during the global crisis when the net inflows declined but

20. Measurement problems involving errors and omissions could make this an overstatement. Inflows through errors and omissions amounted in 2010 to about 10 percent of the current account deficit. Part of this inflow is accounted for by the inclusion of the drawdown of deposits held abroad by nonbanks and repatriations from a tax amnesty. But the remainder is likely some combination of unrecorded flows through the financial account and unregistered current account transactions.

remained positive) reaching $62.8 billion in 2010. Portfolio investment and errors and omissions accounted for about half of the total.

2. Discussions on vulnerabilities

Low and falling savings

The drop in savings during the decade was at the nexus of concerns about Turkey's vulnerability to the vagaries of global capital market developments and its capacity for meeting the investment needs for a step-up in growth potential. The discussions focused on three questions. What had been the factors causing the drop in savings? How serious was the problem of low private savings? And had there been an adequate policy effort to stem or curtail the drop in savings?

Understanding the forces behind the drop in the savings rate was complicated by the dramatic shift in the composition of domestic savings over the decade. After plunging to less than -10 percent of GDP at the turn of the century, public sector savings had recently more or less converged on the policy target of about -1 percent of GDP. Until the 2008-09 crisis, the drop in private savings had tracked almost a mirror image of this. During the crisis, private savings had, not unexpectedly, fallen sharply further but the rebound in 2010 had not been complete. Insofar as the forces driving private savings were complex and often difficult to isolate, the change in the composition of savings had created a serious challenge for any policy efforts to reverse the decline.

A key problem in understanding the origins of falling private savings was the paucity of data separating the contributions of households and businesses.[21] Nevertheless, it was known that households had traditionally provided substantial net savings to the rest of the economy and there were good reasons to believe that the household saving rate had fallen during the decade. Transition toward economic stability after the 2000-01 crisis—particularly the reduction in government dissaving—had led to a decline in precautionary motives for savings. Then there had been the rather steady real appreciation of the Turkish lira. This had raised the purchasing power of households' lira earnings, and at least part of this gain had fueled consumption. The influence of demographic factors was more controversial. Some participants interpreted recent econometric evidence as showing that demographic changes—the small increase in the old-age dependency ratio and a (larger) drop in the youth dependency ratio—had had little effect on household savings rates. Others felt that their net effect may have been slightly negative for savings.[22]

Several influences were viewed as having contributed to the drop in savings of lower

21. There are no national accounts data delineating household and business savings. Household surveys suggest that household savings dropped through the decade and some firm-level data suggest that there might have been an increase in corporate savings of firms where data were collected.

22. In this view the drop in the youth dependence rate (which should be positive for savings) had to be seen against the trend toward more youth staying in school, which effectively prolonged the period of dependence on income-earning members of the household.

income households (which had exceeded that of high-income households). At least partly reflecting the stronger position of banks and the availability of foreign financing, access of households to consumer credits and the use of credit cards, particularly among poorer households, had increased rapidly, albeit from very low levels. This came on top of an ongoing interaction between the rural-urban migration and labor market rigidities that contributed to the falling employment rate, especially in low-income households.

The contribution of corporate savings to the drop in total private savings was the subject of debate. There was not even a clear fix on the direction of change of corporate savings over the decade. Some argued that the real exchange rate appreciation from 2002 had reduced the profitability of exporting firms and had put upward pressure on real unit labor costs. Both influences had probably reduced the corporate savings rate.[23] On the other hand, those arguing that an increase in corporate savings might have offset a small share of the drop in household savings pointed to some data from firms that suggested that profit margins might have risen on average during the past decade. The hypothesis was that the rise in profitability of relatively capital and knowledge intensive production activity had compensated for the decline of corporate profits in traditional labor intensive production activity.

The drop in private savings that had more than offset the drop in public sector dissaving was viewed as perhaps the key vulnerability of the decade. It meant that a substantial portion of the surges in private investment during the decade had been financed by foreign funding, with the attending exchange rate, rollover, and interest rate risks born by domestic businesses and/or banks. The increase in the vulnerability of the private sector to changing risk premiums and sudden stops in capital inflows represented a major change in the vulnerability profile during the decade.

But the view was also expressed that the vulnerability stemming from low domestic savings went beyond the exposure to global market conditions and changes in global perceptions of Turkey's risks. Another set of concerns centered around the extent to which low domestic savings were a constraint on investment and therefore growth. Asymmetries in access to foreign financing meant that low savings had probably impeded the growth of businesses (especially small and medium sized firms) that either did not have access to foreign markets or were unable to take on the exchange rate risks involved in foreign financing. More generally, studies of emerging market countries have largely concluded that countries with higher domestic savings rates tended to have higher investment rates and higher growth on a sustained basis.

With these concerns in mind, it was agreed that the government had not done enough to halt or stem the drop in private savings during the decade. Most participants

23. A recent OECD study was cited. It found evidence of direct links between competitiveness, corporate savings, and aggregate domestic savings in a group of OECD countries. See André Ch., S. Guichard, M. Kennedy and D. Turner (2007), "Corporate Net Lending: A Review of Recent Trends", OECD Economics Department Working Paper no. 583.

also agreed, however, that effective policy measures to influence private savings were hard to identify, frequently politically difficult to implement, and often slow to show results. The debate, therefore, was what measures the government might have taken to slow the drop in or raise private savings.

There were differences of view on whether the government should have been more aggressive in offsetting changes in the private savings rate with even larger reductions in government dissaving than had already occurred. One view was that the fiscal adjustment had been large already and expecting the government to have done more, especially before or during the global crisis, would have been unrealistic. But others felt that fiscal policy had dependable effects on total savings and should have been used more aggressively, especially in the aftermath of the global crisis. Many felt tax policy had not been used as effectively as it could have been and that individual retirement accounts (IRAs), which were minimal in Turkey, could have been made more attractive for bolstering savings rates. In this context, it was pointed out that IRAs with generous tax benefits were already in effect. But because a large segment of the population did not pay income taxes, there had not been much demand for them. Thus, widening of the income tax base was a prerequisite for IRAs to be an effective vehicle to increase savings.

Of course, another line of attack on the drop in private savings would have been more aggressive action to stem the real appreciation of the Turkish lira. Such actions (discussed in the preceding chapter) would have gone a substantial way toward slowing the rise in purchasing power of real incomes and possibly also have raised GDP growth.

Another view was that the most effective policies for raising private savings would have been on the micro side. Considerable attention was focused on what might have been done to free labor markets of undue restrictions and promote greater female labor force participation. But there were also questions about why the government had not acted more aggressively on another range of micro and financial sector issues: to curb growth in credit card and consumption loans through macroprudential policies; to reduce barriers to home ownership (one of the main motives for household savings in Turkey); and to design special savings schemes and a mandatory pension scheme. It was recognized that policies in any of these areas would likely have had limited effects on private savings within the decade, but they would likely have reduced, over the longer term, vulnerabilities associated with foreign financing.

Current account

The current account deficit had been high through the middle of the decade but had risen still further in 2010. Estimates for 2011 were for a further sharp widening. This raised several questions. Had current account deficits during the decade reflected high productive investments alongside a falling savings rate? Had the level of the current account deficit during high growth years been too large for a country like Turkey? Had the characteristics of foreign financing added to the vulnerabilities inherent in a growth strategy that produced large current account deficits?

The rise in the current account deficit through most of the decade had been the counterpart of both a falling savings rate and a rising investment rate. Especially with a sizable foreign financed component of investment, a critical question for assessing the risks involved in the large current account deficit was whether the surges in private investment had improved productivity. The increase in investment had mainly been due to private investment in machinery and equipment, rather than investment in government infrastructure and private housing. But very little data existed on the quality of the investment undertaken during the decade. It could eventually increase growth potential, reduce reliance on imported energy, and increase productivity and competitiveness. But it might well not. The unremarkable rate of expansion of the tradable sector during the decade, according to some, did not bode well for the optimistic view.

For the most part, the rising current account deficit during the decade up to 2008 was not seen as the result of excessively easy macroeconomic policies. Most viewed the imbalances before the global crisis hit as resulting from large capital inflows alongside more structural domestic influences. Nevertheless, many felt that some sort of fiscal, monetary or macroprudential policy response would have been advisable to contain the appreciation of the Turkish lira, capital inflows, and boom conditions in the period before 2008.

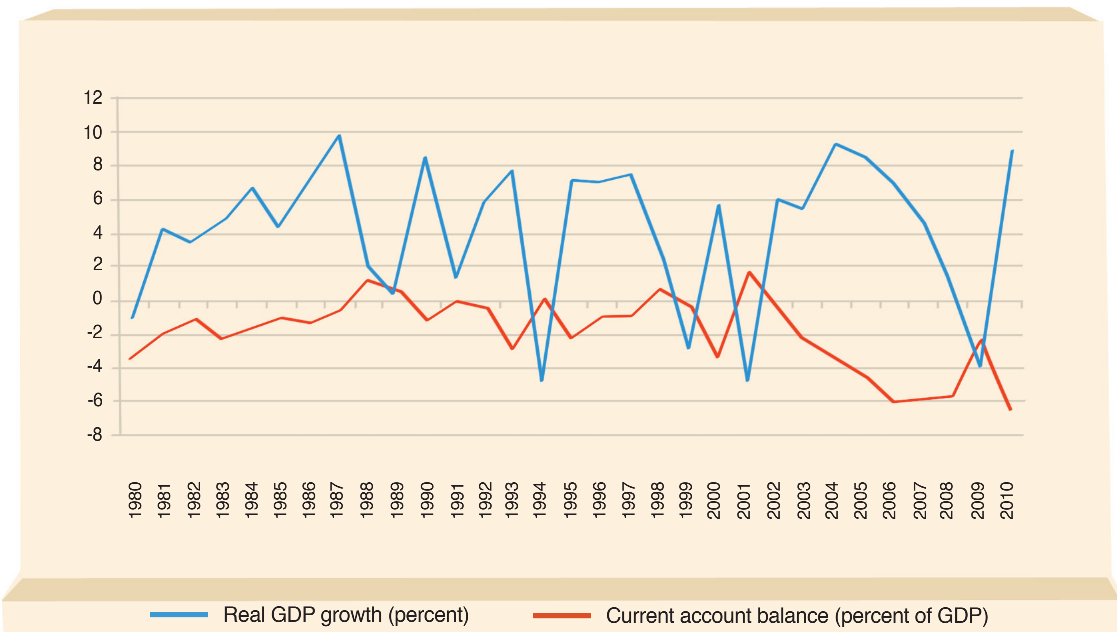
But the widening of the deficit at the end of the decade elicited more debate about the role domestic macro policies had played. Most viewed the recent deficits as evidence of excessively easy monetary policy along with the lagged effect of the Turkish lira appreciation. This was a manifestation of policy frameworks that were not robust enough to enforce needed caution in a situation of overheating. But the view was also expressed that the widening of the current account deficit had reflected to a large extent differing cyclical positions of Turkey (which, helped by a sharp easing in domestic policies, had enjoyed an exceptionally strong recovery from the crisis) and its trading and capital market partners. Easy monetary policies in advanced countries had also been important. In particular, Turkey's exports, which are business cycle sensitive, had been adversely affected by the economic slowdown, especially in Europe. At the same time, demand for investment and durable goods in Turkey increased with the decline in interest rates.[24]

There had been a strong correlation between Turkey's economic growth and current

24. The sharp widening of the current account deficit in 2011 (formally outside the focus period for the discussions) elicited a divergence of views. One participant assessed that the mismatch of the cycle in Turkey vis-à-vis that in its trading partners explained more than a third of the projected 2011 current account deficit of about 9 percent of GDP. Most others, while agreeing that cyclical factors were important, felt that this was an overstatement.

account deficits during the decade (Figure 11). During the five years following the 2001 crisis, GDP growth had surged while the current account position had widened from balance to a deficit of 6 percent of GDP. During the global financial crisis, GDP in Turkey had been hit hard and the current account deficit had slumped. With the subsequent revival of domestic demand and GDP growth, the current account deficit widened. This close relationship was not seen as surprising in view of the fact that GDP growth during most of the decade had been largely domestic demand driven.

Figure 11: Growth and Current Account Balance



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

Indeed, the success of stabilization had changed the basic policy trade-off in situations of overheating. In the previous decades, the most important macroeconomic trade-off had been between growth and inflation. As an overheating episode unfolded, inflation had risen and the macroeconomic policy choice was between reining in demand and living with rising inflation. During the past decade, however, the trade-off had been transformed. Now, inflation targeting with a flexible exchange rate, an open capital account, and globally tame inflation meant that episodes of excess domestic demand had given rise to larger current account deficits. In other words, the central trade-off that policy makers faced was between faster growth and lower current account deficits.

There was debate about the sustainable level of the current account deficit. Some pointed out that recent levels of deficit were excessive in comparison with Turkey's past experience, the averages for emerging market economies, and "international norms" or "rules of thumb" for long-term sustainability. Cross-country panel estimates of equilibrium current account deficits implied lower “norm deficits” for Turkey in the range of 2.5-5.0 percent of GDP. The “external debt stabilizing” deficit, calculated with Turkey’s trend economic parameters, suggested a lower equilibrium deficit of around 2.5-3.0 percent of GDP.[25]

Some others were of the view that “sustainable” current account deficits had likely risen during the decade. Estimates by the OECD for example put the sustainable deficit in Turkey in the range of 5-6 percent of GDP. The main reason was that the transformation of the financial system in the 2000s had improved the quality of capital allocation and financial sector intermediation. This would mean that financial institutions and businesses would be able to handle larger volumes of foreign capital efficiently.

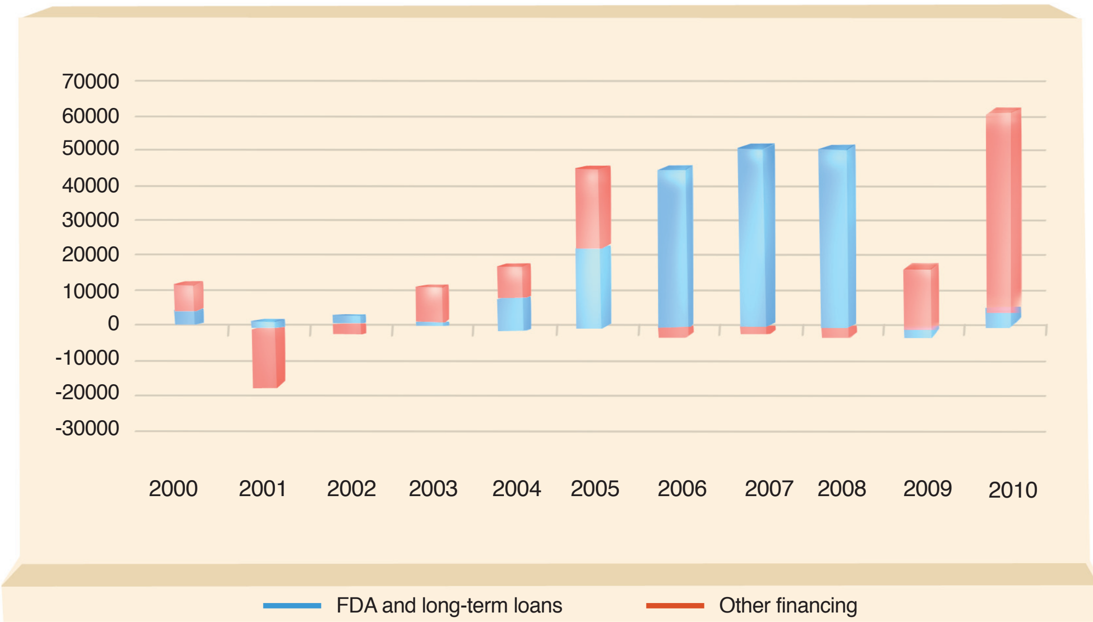
In addition to the level of the current account deficit, the nature of its financing was of concern. In international comparisons, the quality of financing of the current account deficit had been weak in Turkey. The relative shares of foreign direct investment (FDI) and long-term borrowing versus short-term and portfolio inflows had been low. Although foreign direct investment had increased significantly during the past decade, it had slowed starting in 2007 (Figure 12). Since 2008, there had been an overall deterioration in the financing of the current account deficit with sharp declines in long-term loans and increases in short-term loans and unidentified financing (positive net errors and omission) (Figure 13). These developments had made the financing of the current account deficit and hence economic growth more vulnerable to volatility, reversals, and roll-over risks.

Figure 12: Foreign Direct Investment (Percent of GDP)

Sources: International Monetary Fund, World Economic Outlook Database, September 2011 and Central Bank of Turkey.

25. References cited in this discussion were: Medina, L., J. Prat and A. Thomas (2010), “Current Account Balance Estimates for Emerging Market Economies”, *IMF Working Paper* WP/10/43; Lee, J., G. M. Milesi-Ferretti, J. Ostry, A. Prati and L. A. Ricci (2008), “Exchange Rate Assessment: CGER Methodologies”, *IMF Occasional Paper* No. 261; and Bussière, M., M. Ca’Zorzi, A. Chudik and A. Dieppe (2010), “Methodological Advances in the Assessment of Equilibrium Exchange Rates”, ECB Working Paper No 1151.

Figure 13: Financing of Current Account (Millions of US dollars)



Source: Central Bank of Turkey.

There were different perspectives on the evolution of FDI during the decade. For some, the growth in FDI from $100 million in 2000 to $20 billion in 2007 was a confirmation that Turkey had become more attractive to foreign investors. By 2006-07, FDI as percentage of GDP in Turkey had exceeded the average for emerging and developing economies. Contributing factors were seen as the more stable macroeconomic environment, strong growth potential, and an improved legal and institutional environment (including the passage of a new FDI law and the establishment of the Investment Promotion Agency). The movement toward EU accession after the Helsinki Summit and the governments' efforts to promote FDI had also helped.

Others did not see developments in such a favorable light. They noted that the increase in FDI had been from a very low base, and that the end of the decade had seen a sharp slowing (by more than the overall slowdown in FDI to emerging and developing economies). At the end of the decade, the share of Turkey in total net FDI to emerging and developing economies (2.4 percent) was below Turkey's share in the total GDP of emerging and developing economies. The slowdown in the latter part of the decade suggested that foreign investors still had concerns about Turkey's legal infrastructure, the extent of its unregistered economy, and its tax system. Critics also pointed to FDI outflows from Turkey, which had increased as firms moved their operations abroad to benefit from lower costs in host countries. Although the amount of such outflows had remained low, some viewed it as having entailing a loss in growth and job opportunities in Turkey.

In summary, most participants felt that large current account deficits financed too heavily by short-term capital inflows had, during the decade, become a serious vulnerability. They also were threats to the viability of the current high growth strategy. The problem was unlikely to disappear with time. Thus, a recipe for sustainable growth had yet to be found.

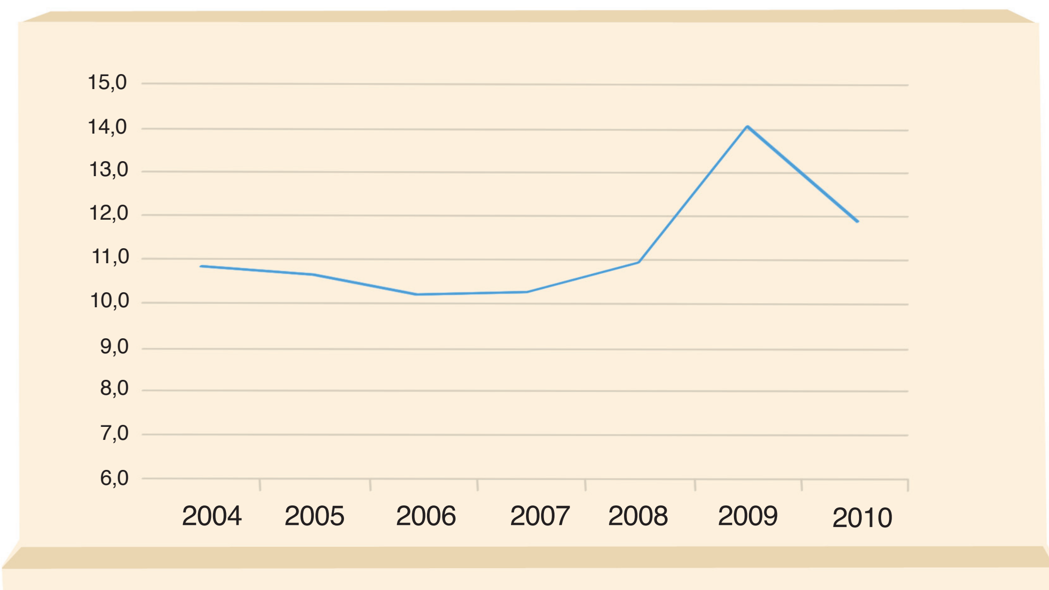
Chapter IV: The Labor Market

The struggle to fully employ Turkey's working age population has a long history. Perhaps the single best indicator of the economy's use of its human resources—the share of the working age population with jobs in the formal sector—has been on a downward trend for much of the post-war period. By the turn of the century, the employment rate had fallen to the lowest among the OECD countries and was also low compared to other major emerging market countries. Thus, there was consensus in all the workshops that a much needed complement to the stabilization of the past decade was a turnaround in employment trends. Until this was achieved, the continued underuse of the country's human resources would remain a binding constraint on the convergence of Turkey's income with that of advanced countries.

1. The Stylized Facts

The unemployment rate, after averaging about 7.7 percent in the 1980s and 1990s, increased sharply after the 2001 economic crisis. Subsequently, despite the strong pickup in economic growth during 2002-07, the unemployment rate remained above 10 percent (Figure 14). With the onset of the global economic crisis, the unemployment rate edged up again and rose to 14 percent in 2009. There was some decline with the recovery, but by the end of the decade the unemployment rate still remained well above the levels experienced in the 1980s and 1990s.

Figure 14: Unemployment
(Percent of total labor force)



Source: Turkish Statistical Institute.

But the unemployment rate does not capture Turkey's larger employment problem—a very large share of the population is not in the labor force and therefore is not reflected in the unemployment rate.[26] The already-low share of the population over the age of 15 that had jobs (about 50 percent in the late 1990s) fell sharply through the 2000-01 crisis and its immediate aftermath reaching an exceptionally low level of close to 40 percent.[27] After 2004 some recovery occurred.

2. Discussions on the labor market

The decade had seen little progress in tackling the enormous problems that stand in the way of full employment. The negative implications of these continuing problems were significant for the country's productive potential, its global competitiveness, and the personal welfare of Turkish citizens. Agreement on this point preceded substantial disagreement about how to characterize developments in the labor market, how to diagnose the nature of problems, and how to interpret the impediments to policy action that had been experienced.

A simple and popular characterization of the experience during the past decade was one of jobless growth. Supporters of this view pointed particularly to the period 2004-07 when GDP growth had averaged over 7 percent per year, while total employment had risen by only 1.8 percent per year, far below the growth of the working age population. Paradoxically, employment growth had actually picked up to over 2 percent during the global crisis, when GDP plunged. Although the reasons behind this development needed to be studied, an important contributing factor could have been a reversal of falling employment in the agricultural sector in response to a spike in global food prices.

This simple characterization of labor market developments was challenged by some who believed there had been a distinctive interaction between demographic factors and the post-2002 increase in economic growth. It was important to recognize that the agricultural sector at the beginning of the decade accounted for about 36 percent of total employment. Labor force developments during the decade, therefore reflected both an increase in rural-urban migration and more generally in the growth of the labor force.[28] Several participants argued that the strong growth of the economy during 2003-07 had strengthened expectations of finding jobs in

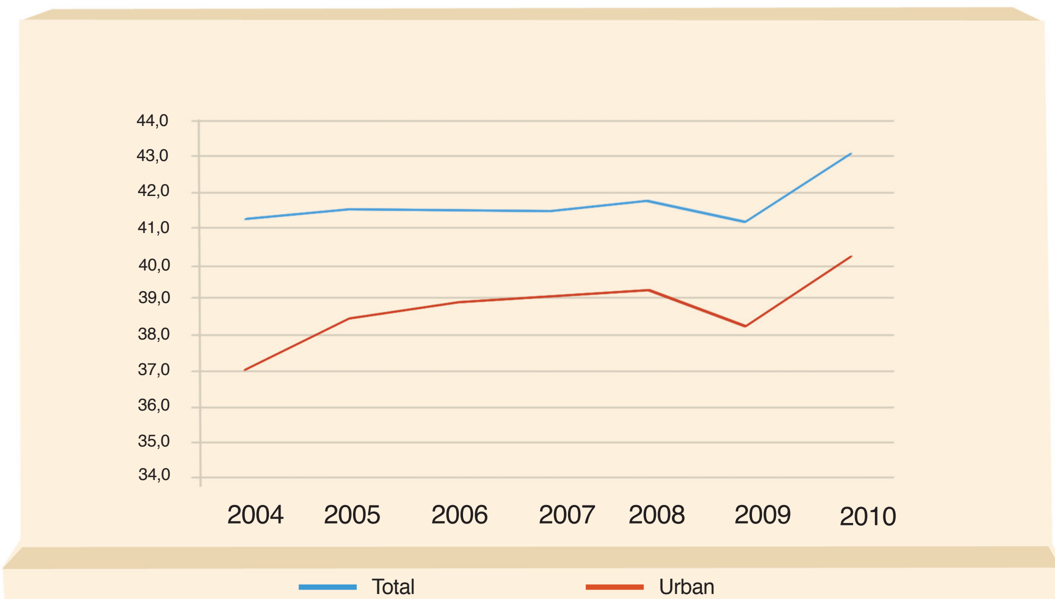
26. Data are taken from Türkstat, Statistical indicators, 1923-2010. The definition of the employment rate there uses the population over 15 years of age. Most other sources (such as the OECD) also exclude from the denominator the population over the age of 64. This means that the Türkstat data shown here has lower employment rates than often presented elsewhere.

27. Significant changes in Türkstat's methodology for collecting population and employment data in the first half of the decade prevent an accurate portrayal of trends in the labor market during this period. Fully consistent data start in 2006. It is clear that there was a turning point in the trend of the employment rate sometime in the first half of the decade, but it is not possible to identify the precise year.

28. The annual average increase in the labor force (those in work and those looking for work) was 2 ½ percent during 2004-10 compared to 1.7 percent during 1990-1999. During 2004-10, the share of population living in province and district centers increased from 64 percent to 76 percent. The change during the full decade of the 1990s was from 59 percent to 64 percent.

cities. Rural dwellers, therefore, became more inclined to take on the fixed cost of migrating to cities, but not all were successful in finding a job immediately when they arrived in cities. Thus, the drop in rural employment had not been matched by an immediate rise in urban employment (Figure 15). A similar influence on female employment had likely occurred. Most women on farms were recorded as employed even when they were unpaid and had low productivity. After migrating to cities, women without skills might not even search for a job. This would then be reflected in a drop in female employment. Such structural factors meant that it would be more meaningful to cast generalizations about employment growth in terms of non-agricultural or urban employment only.

Figure 15: Employment Rate (Formal employment as percent of population over age 15)



Source: Turkish Statistical Institute.

In this light, a less gloomy view emerged of the response of job creation to output growth during the decade. During 2004-2010, non-agricultural growth had averaged 4.8 percent per year while non-agricultural employment growth had averaged 3.2 percent per year. This implied an elasticity of about 2/3. From this perspective, the notion that the decade had been one of jobless growth was a "myth".

Nevertheless, no matter what explanations for labor market developments were given, job growth had not been sufficient to make a much of a dent in Turkey's very low employment rate. In other words, the decade had not seen a decisive turnaround in the employment trend. The debate about what had held back job growth centered around four main issues.

The first concerned macroeconomic impediments to job growth generally. This part of the debate could be seen most starkly as between those who saw the roots in the new orientation of macroeconomic policies on the one hand and those who saw Turkey as succumbing to a middle-income employment trap on the other.

The explanation centering on the macroeconomic policies ascribed sluggish job creation to the constraining effect of policies that effectively held down Turkey's potential growth. Specifically, the policy emphasis on low inflation and fiscal sustainability had attracted capital inflows that had appreciated the Turkish lira. This in turn had hurt competitiveness particularly of labor intensive industries and encouraged absorption of imports, with obvious effects on job creation. Proponents of this view pointed to the lower annual average output elasticity of employment during 2004-10 (0.6) that was slightly lower than that during 1990-99 (0.7).

Another macro perspective, however, focused less on the effects of macroeconomic policies and more on what was described as the "middle income employment trap." In this situation, labor could not be absorbed in sufficient quantity in agriculture and low-wage labor-intensive industries. But institutions, capacity for innovation, and human capital were not up to the standards needed to move up the value chain. Such developments are not uncommon among Turkey's emerging market peers.

A second view of the labor market problem placed primary emphasis on micro-level impediments to job creation. In this view, labor market regulations, historically and continuing through the past decade, had been geared toward protecting jobs and incomes in the formal sector. These attempts to preserve the status quo had helped employment of prime-age males and hurt that of women and young people. The most obvious protection came from steep severance pay requirements (one month per year of tenure). But not all micro-level impediments to job creation stemmed from job/income protection. The relatively high minimum wage (measured in euros and adjusted for relative GDP per capita in purchasing power terms) and the fact that the minimum wage was undifferentiated by region had also discouraged employment especially in lower income regions, in export sectors where competition had been fierce, and of inexperienced youth.[29] High labor taxes were also seen as discouraging job creation in the formal sector and pushing jobs to the informal sector. Even more attention was placed on poor education and a latent skills mismatch.

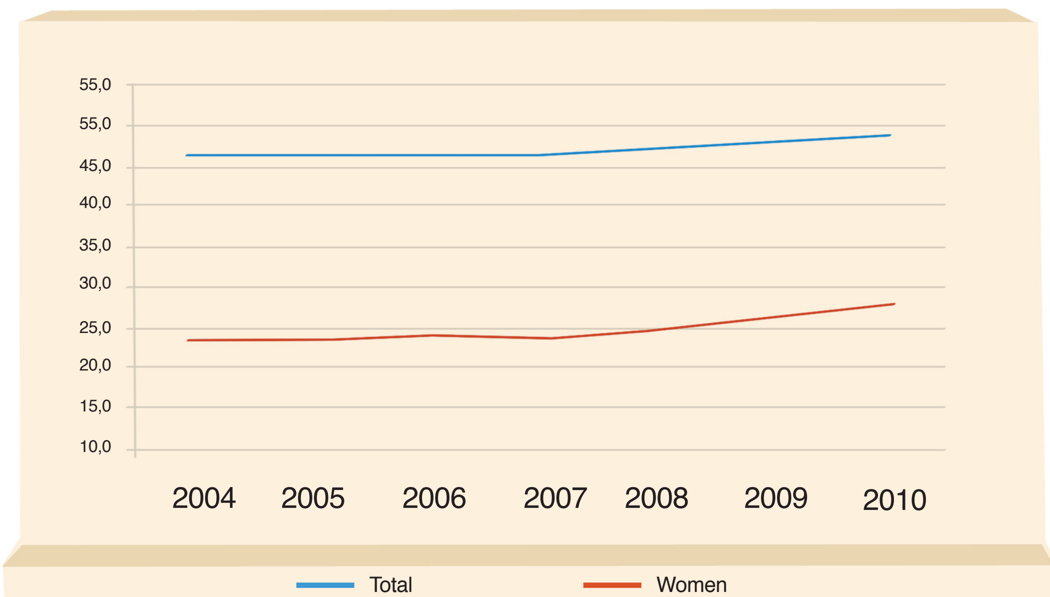
A third factor associated with labor market problems was globalization. In this view, globalization and higher foreign trade had increased specialization and pressures to adopt more productive methods, most of which were labor saving. Moreover, in these circumstances, when the skill mix of the labor force was not sufficient to make

29. In 2010, the minimum wage in Turkey measured in euros was higher than those in most Eastern European countries. The minimum wage adjusted for relative GDP per capita in purchasing power terms was higher than also those in a few Western European countries and the United States. However, this observation must be caveated by the point that because Turkey's relatively low employment rate makes per capita GDP a downwardly biased proxy for productivity, this measure probably overstates Turkey's position on the minimum wage spectrum.

Turkey competitive in higher technology production, employment growth suffered.

A fourth set of concerns focused on the labor force participation rate and its implications for the effective supply of labor (Figure 16). Three dimensions of this problem stood out, two of which—the low participation rate of older workers and of youth—were reasonably tractable. The former was seen as largely the result of the pension system which rewarded early retirement. A change in the pension system in 2003 had largely rectified the problem, though it would be some time before participation rates of older workers showed the effects. Low participation rates of 15-19 year olds had been in part due to an increase in the number of years of schooling. However "inactivity" (neither schooling nor work) rates were also high and were ascribed to inadequate preparation in school for the skills needed for jobs alongside the macro and micro constraints on labor demand. The period since 2004 had seen a welcome pick-up on participation rates of 20-24 year olds.

Figure 16: Labor Force Participation Rate (Percent)



Source: Turkish Statistical Institute.

Low participation of women, however, was seen as a more challenging problem. Though some saw it as partly a statistical artifice stemming from the rural-urban migration of women, all agreed that there had been a "Turkish Paradox". That is, for most peer countries, Turkey's combination of modernization, improvements in education, urbanization, and declining fertility would have resulted in an increase in female labor force participation. In Turkey, however, they had been accompanied by a drop from a level roughly comparable to several Western European countries in 1980 to the lowest level among the OECD countries by 1990. There had been some pick up in the past six years, but the share of women who worked had still remained exceptionally low.

No one disputed the main findings of recent research.[30] Specifically, three main factors had accounted for most of the low participation rate: (i) as women migrated from rural to urban living, low levels of educational attainment had significantly narrowed employment opportunities; (ii) under-educated women had therefore been limited to jobs in the informal sector, where wages were often below opportunity costs, especially in light of the high price of childcare and home production; and (iii) cultural attitudes toward the role of women had been a disincentive, though greater tolerance over the past decade for women wearing headscarves to work may have lessened this influence. Labor force participation among more educated women was substantially higher than for less educated women, though even it dropped off sharply with the 45-54 age cohorts. Moreover, women's participation and influence in policy making at national and local levels were severely curtailed.[31]

For the most part, the large absorption of workers into the informal sector during the decade was viewed as a serious problem. Businesses in the informal sphere paid poor wages, side-stepped the social security system (with implications for both social protection and fiscal revenue), typically were unable to access private credit markets, and often failed to innovate and expand so as to remain small enough to avoid regulation. The effects of the sizable informal sector had therefore been critical not just with regard to working terms and conditions, but also to the broader capacity for economic growth and innovation.

Informality was not a problem specific to the decade. The informal sector had grown over many earlier decades, and indeed, in the past few years, for reasons no one understood, employment in the informal sector appeared to have fallen rather steeply mainly in the non-agricultural sector. Still, informal employment (probably mainly in the agricultural sector) had played a substantial role as a buffer during the 2008-09 crisis, absorbing workers as they were laid off from formal sector jobs. In 2010, it accounted for about 43 percent of total employment, though less than 30 percent of non-agricultural employment.

For the most part, it was agreed that 2000-10 had seen virtually no change in approach to labor market problems. One small change early in the decade—the pension system reform which among other things had raised retirement ages and reduced pension replacement rates—would eventually help increase labor force participation. Also, quite recently, the government had enacted a permanent cut in social security contributions and a temporary cut in the payroll tax. Both actions had been aimed at bolstering job creation, especially during the global crisis.

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30. For example, Aran, M., A. Uraz, et al. (2009), *Recent Trends in Female Labor Force Participation in Turkey*, World Bank and Turkey State Planning Organization. Also see references therein.

31. The number of female parliamentarians increased after the 2011 elections.

But for the most part, insider workers had been a potent enough force to prevent any change in labor market regulations. The government attempted to incorporate in the 2003 reform of the Labor Code some scaling back of job security in exchange for better unemployment insurance and retraining programs, but had not been successful in bringing organized labor along. No one could explain why the government had been unwilling to expend the political capital needed to secure deeper reform. The discussion made clear that this unwillingness was not rooted in the absence of ideas for effecting change. The National Employment Strategy document had contained many labor market reform proposals, but the government had found it difficult to act on it. In the face of this stalemate, there appeared to have been some tacit increase in official tolerance for the informal sector. It was suggested that the government, unable to overcome the opposition of organized labor to labor market reform, had implicitly allowed the informal sector to play a larger buffering role in raising employment and containing costs for producers.

Chapter V: Economic Inclusion

The discussions about socio-economic dimensions of the "New Turkey" were guided by one overarching question: were trends in basic aspects of inclusiveness during the past decade suggestive of an ability of all Turks to partake of opportunities to contribute to economic prosperity and improve their material well-being? The discussions moved from the most general measures of inclusion (developments in income inequality, poverty, and social policies to help the weakest parts of the population) to education, and finally to the ways in which a generally rising expression of social conservatism may have constrained or expanded opportunities for greater economic inclusion and dynamism. It was agreed that the decade had seen a change in some of the most worrisome trends in inclusion and economic opportunity and that in some respects new approaches to social and education policies had been tried. However, all of these were in the very earliest stages, and where they would lead was not clear. Moreover the scale of the challenges remained large.

1. The Stylized Facts

After peaking in the mid-1990s, income inequality in Turkey fell rather steadily during most of the following decade and a half.[32] This was in sharp contrast to developments in other OECD countries: most experienced a shift to greater inequality and, compared to the handful that did not, Turkey's evening of income distribution was at the very strong end of the spectrum. Nevertheless, Turkey began the period with the third (after Chile and Mexico) most unequal distribution of income among the OECD countries and ended the period in the same position. In other words, even though most other countries experienced some increase in income inequality during the decade, Turkey's measures did not become enough more equal to move its relative position. This observation holds true for income inequality as measured by the Gini coefficient as well as by various dispersions

32. Strictly speaking, it is not possible to compare income inequality or poverty measures available at the end of the decade (2010 for income inequality or 2009 for poverty) with those at the beginning of the decade because of mid-decade changes in methodology that resulted in quite significant level changes as between the period of the old methodology and that of the new methodology. A high degree of confidence in the direction of change is possible, but not in the magnitude of change.

between low and high income groupings (Figure 17)[33]. On a broader basis of comparison, Turkey came 63rd of 129 countries included in the UNDP's Human Resource Index measure of the Gini Coefficient in the second half of the decade.[34]

Figure 17: Gini Coefficient

Source: Turkish Statistical Institute.

Like income inequality, the incidence of poverty in Turkey—affecting 17 percent of the population in 2010—is at the very high end of the OECD spectrum, yet most measures had fallen rather sharply through 2008. Small upticks in 2009 were presumably in response to the crisis and therefore temporary. Several characteristics of Turkey's poverty as of 2009 stand out: while the incidence is relatively high, poverty is not particularly deep on average (the poverty gap, or the extent to which mean income of the poor falls below the poverty threshold, is in the mid-range of OECD countries and by 2009 the share of people living on below $1 per day had fallen to zero); the share of individuals in nuclear families with children living in poverty (16 percent) is the highest of all OECD countries, while poverty among people of retirement age (15 percent) is low by OECD standards; the incidence of poverty rises with the size of households (9.5 percent of individuals in households with 3-4 people live in poverty, while 24.5 percent of individuals living in households

33. The Gini Coefficient is a measure of the degree of income inequality in a country. The higher the coefficient (within the range of 0-1), the greater is the extent of inequality. A value of 1 would indicate that all income goes to one person, and a value of 0 would indicate that all residents earn identical incomes.

34. http://hdr.undp.org/en/statistics/

with 7 or more people live in poverty); in sharp contrast to most other OECD countries, joblessness in households was not particularly strongly related to poverty (only about 12 percent of poor people live in households without any worker); and poverty is, however, far more prevalent in rural (38.5 percent) than urban areas (9.5 percent).[35]

Another perspective on inclusiveness shifts the focus from measures of households' current situations to measures of equality of opportunity. In this connection education is the lynchpin. There was some progress during the decade in addressing longstanding deficits in the education system. In the area of basic education, trends in the past several decades had continued: both primary school enrollment rates and literacy rates continued to climb, each reaching about 95 percent by 2008. Gains in secondary, tertiary, and vocational education were less impressive: although secondary school enrollment rose from 62 percent in 2000 to 74 percent in 2008, it still lags all other OECD countries; and results on the best international comparator of educational achievement for 15 year olds—the Programme for International Student Assessment (PISA) scores—rose between 2003 and 2009, though Turkey's relative standing within the countries covered was broadly unchanged.[36] Educational achievement of girls improved (primary school enrollment rates for girls rose from 85 percent at the beginning of the decade to 98 percent in 2010), but overall women still accounted for 82 percent of the illiterate.

Understanding the complex issues bearing on economic inclusion would not be complete without considering the influences of the population's deep-seated social conservatism. Survey results suggest that the expression of social conservatism and religiosity has become more open and therefore may have a stronger imprint on decisions with implications for the economy.[37]

2. Discussions on economic inclusion

The discussions covered developments through the decade in inequality of actual circumstances, in education, and in social conservatism, with an emphasis on the changes that had occurred and the place each occupied on the policy agenda during 2000-10.

35. Data are from Türkstat, Press Release, January 2011, Results of the 2009 Poverty Study. Publication of the results of the 2010 Poverty Study was delayed until February 2012.

36. The PISA program is coordinated by the OECD. Through the results of standardized tests, it aims to compare the skill levels of 15 year old students in three categories of learning—science, mathematics and reading. The first set of comparisons was done in 2003 for 40 countries (including Turkey), the second in 2006 and the third in 2009 (when the sample was expanded to 65 countries).

37. Çarkoğlu, Ali and Kalaycıoğlu, Ersin, *The Rising Tide of Conservatism in Turkey*, New York: Palgrave-Macmillan, May 2009

Income distribution and poverty

For several reasons, income distribution and poverty had taken on increased urgency during the decade. The 1999 earthquake and the 2000-01 crisis had had more severe and deeper consequences on social fabric of the society than other disruptions since the Second World War. But the change also reflected the cumulative and ongoing pressures from large scale rural-urban migration—the growing incidence of rural poverty that drove the migration and the increasing burden of the urban influx on social services. These pressures could not be met through the rather haphazard mix of channels for social services that characterized social policy at the beginning of the decade. Indeed, pressures for a reorientation of social policy had already been acute in the mid-1990s. But fiscal constraints and bureaucratic limitations had prevented the reorientation of policy objectives needed for a more active and focused role of government. Moreover, until 2000, social policy had been subordinated to the objective of nation-building and had not matured to encompass clear and independent objectives.

Driven in part by this legacy and these pressures, the 2002 party program of the new government had laid out a new vision of the public sector in social policy. Attention was called to three key parts.

• The program was firmly and explicitly rooted in a commitment to secure social objectives (providing social services, protecting vulnerable groups of the population and the poor, and redistribution) within the constraints of a functioning market economy.

• As such, the new government's program did not aim to ensure income equality in the sense commonly associated with a welfare state.

• Subsidiarity[38] was to guide changes, so as to limit centralization and bureaucratization while promoting local, private, and family unit initiatives. Some functions, such as the financing of healthcare, were to be centralized while others, such as financing and provision of child and elder care, were to be decentralized or provided by families.

This broad characterization of the new approach to social policy could be understood more for its differences with those in other emerging markets—especially Latin America—than for its similarities. Most pointedly, in Latin America—Brazil under President Lula was mentioned specifically—the left-of-center approach relied heavily on state-sponsored redistribution targeting the poor. Turkey's approach should be seen as a right-of-center one, relying far more on informal and indirect modes of encouraging and empowering private and civil society to address social problems on their own.

38. Subsidiarity is the principle that policy should be set and/or executed by the smallest or least central unit of government possible.

Paradoxically, the 2006 Life in Transition Survey of the Turkish population had revealed that a large majority of respondents agreed or strongly agreed with the statement that the gap between the poor and the rich should be reduced.[39] A smaller, but still substantial majority saw a role for the state in addressing income inequality. These results put Turkey on the very high side, in terms of concern about income distribution, among countries covered by the survey. In response to the question "Why were people not better off?" the most frequent reason given was "injustice" and the second "laziness". Somewhat puzzling, however, were preliminary results of a 2010 update of that survey showing a sizable drop in the prevalence of those sentiments: there had been less concern about income inequality and more people had seen "laziness" and "lack of will power" as accounting for why people were not better off. Presumably this was an indication that people saw less of a role for the state in addressing inequality than they had earlier.

Near unanimity about the characterization of the shift in the conceptual framework for social policy did not carry over to views on the effectiveness of its implementation. Two views came out of the discussions.

One held that the new social policy had made a credible start in moving to a more rational footing and had scored some clear successes. The flagship achievement recognized by critics and supporters alike had been the reform in 2004 of the Green Card system for financing healthcare for the poor. Access to healthcare among the poor had risen from 24 percent in 2003 to 80 percent in 2007 and the longstanding link between employment and healthcare access had been broken. This had been particularly important in protecting the poor and newly unemployed through the 2008-09 crisis. However, the Green Card System was seen as having had a negative effect on labor market participation.[40]

Other accomplishments that had received somewhat less headline attention had also occurred. Housing policy, particularly the removal of urban shanty-towns and accompanying urban renewal, had made real and lasting change for the good.

Municipalities provided many services, facilities, and cultural activities to low income families. Moreover, not withstanding severe fiscal constraints, overall spending on social programs had risen considerably. Indeed, even critics felt that any faster rise would have exacerbated already worrisome concerns about politically motivated spending.

Those who advocated this view felt that outcomes spoke for themselves. Many indicators of social well-being of the disadvantaged had improved: income distribution, poverty, wages, literacy, infant mortality, urban housing, the provision of municipal services, and transfers to households. True, some of these improvements might have reflected as much the effect of better performance of the macroeconomy

39. EBRD and World Bank, Life in Transition Survey, 2006 and 2011.

40. In 2012, the Green Card System was integrated into the General Health Insurance System, standardizing benefits and administration.

(lower inflation, lower interest rates, stronger output growth, and more investment) as the effect of social policies per se. But improvements through either channel were commendable. Moreover, accomplishments overall had to be seen in the context of social problems that had been part of the culture for decades. These deep roots not only made the problems complex and difficult to tackle, but they also contributed to a stock-flow issue. For example, even if educational outcomes had improved, this would help future generations, but not the large numbers of older disadvantaged people.

And to the argument that perceptions of improvements might well have been stronger than actual improvements in social conditions, the reply of this group was that perceptions were important, if only for the degree of optimism about the future. Here, the strong polling of the party in power throughout the period in rural and urban populations suggested that key parts of the underprivileged population supported the new approach to social policy.

Another group, however, was highly critical. In this view, the provision of social services had shifted from haphazard mechanisms of a dysfunctional, populist welfare state to an odd mix of institutional welfare systems based on rising social assistance and strong reliance on family self-help and private charities (a continuing feature of the traditional bulwark of social protection in Turkey). This could be seen as progress only insofar as it involved experimentation with new channels for social policy with more cash support and a clearer conceptual framework.

In this negative view, the implementation of the new approach was beset by problems. True, the roots of inequality and poverty were deep, complex and highly interwoven with basic cultural and institutional characteristics. These created difficult challenges for designing social policies, but there had been little progress in meeting them. Objectives (as opposed to the conceptual framework) for social policy generally and for income inequality in particular remained poorly defined. Several participants expressed concern about four separate problems.

First, social assistance mechanisms had been poorly targeted, exacerbating adverse fiscal effects on inequality from the large share of indirect taxes in total revenue. Even substantial increases in social assistance spending during the decade had not made a dent on social exclusion. Important factors underlying this apparent paradox had been the absence of data for mapping the poor, the lack of clear guidelines on what defines the deserving poor, excessive concerns about any possible abuse of social assistance systems, and the retreat of the state from some critical social concerns such as protection of the elderly and childcare.[41] Moreover, some social transfers had not had a redistributive role. About 45 percent of pensions and survivors benefits had been received by the richest quintile.

Second, family care and employment had remained the main forms of social

41. In 2011, the government took some steps to address this problem by introducing a system (in cooperation with the Scientific and Technological Research Council of Turkey) to map the poor.

protection. Turkey indeed had a more prevailing cohesiveness of family structure than most other countries. Surveys showed that over 80 percent of the population shares a meal with their extended family almost every day of the week. Yet with urbanization, family structures had been breaking down leaving more unrecognized vulnerabilities. Also pressures on women to stay home to care for children and the elderly had biased decisions against female labor force participation. The employment channel for social protection also had its limitations given the high unemployment rate and large informal employment. There was a broad agreement that informal employment had failed to provide adequate wages to lift workers out of poverty and that poverty and unequal income distribution had had fundamental links to informality. Unless labor market policies addressed informality, it was unlikely that substantial progress could be made in reducing poverty.

Third, the configuration during the decade of poverty and economic exclusion was rooted in regional and ethnic inequality. The government had neither recognized the magnitude of the problem nor addressed it. There was little data to pinpoint the dimensions of the regional and ethnic aspects of poverty, exclusions, and income inequality. One participant, however, referred to survey results reporting a strong sentiment among Kurds and Alevis living in the Eastern and Southern parts of the country that they had not had adequate access to healthcare and that the quality of the healthcare and schooling was below that in other regions of the country. In this perspective, addressing poverty and inequality was less a question for conventional social policy mechanisms than one for regional policies.

Fourth, critics tended to view continuing gaps in opportunity as diminishing the significance of any successes in reducing inequality, poverty, and social exclusion. Here, recent research had found a strong causality running from the circumstances into which children were born and ultimate economic outcomes. World Bank (2010) reported that one third of the disparity in wealth in the households in which children lived was linked to the region into which the children were born and the educational attainment of their parents.[42] These types of disparities in opportunity were fundamental signs that the roots of social exclusion were deep.

Education

Addressing the deep flaws in Turkey's educational system was seen as the issue with the most cross-cutting importance to political economy challenges. The objectives of reducing skills mismatches (particularly in the face of changes in the structure of production) and drawing a greater share of Turkey's population into economic activity required a fundamental revamp of the educational system. The benefits of moving up the technology ladder could only be realized if the work force was endowed with sharper critical thinking skills. And the vitalizing role of social

42. World Bank, Report No 48627-TR, *Turkey: Expanding Opportunities for the Next Generation A report on Life Chances*, February, 2010. http://siteresources.worldbank.org/TURKEYEXTN/Resources/361711-1270026284729/ExpandingOpportunitiesForTheNextGeneration-en.pdf

mobility could only be realized with a more level playing field in terms of access to quality education.

The progress with educational reform had to be seen against the cultural and political roots of existing policy. Reflecting attitudes dating back to the beginning of the Republic, the education system had been crafted as an instrument for building the nation-state and loyalty of the citizenry. Education policy was tightly managed by the Ministry of National Education, even the name of which signaled the predominance of the nation-building objective.[43] Centralized control over the content of text books, curricula, and the skills and conduct of the "Öğretmenler Ordusu" (army of teachers) all contributed to the social engineering designed to create and later strengthen the nation-state. To be sure, access to schooling and literacy rates had improved. But the pace had been slow, and by the beginning of the century, Turkey had remained at the low end of OECD countries in term of measures of educational attainment. Any accomplishments had to be viewed against the continuing emphasis on learning by rote and fostering national pride—objectives that subordinated the needs of the individual student and of the economy.

Nevertheless, participants felt that a number of improvements in both effort and outcomes during 2000-10 were significant. Most noteworthy, in their view, were the achievement of near universal access to primary school and especially the higher enrollment of girls; the increase in the literacy rate; the substantial rise in spending on education by government and private foundations; and the improvement in conditions for students (physical condition of schools, teacher student ratios, and access to internet). Though modest, the initiation during the past decade of efforts to decentralize decisions on educational issues, improve curricula, and open a dialogue with civil society was also seen as promising.

But optimism about these accomplishments was tempered by the view that over the decade the government had not reconsidered the fundamental objectives of education and therefore did not have a cohesive program of reform. Indeed, the broad sense was that the decade had been a major missed opportunity. This critique focused on four key faults in the education system– quality, equity, politicization, and underlying cultural paradoxes—for which a clear reparative strategy had not been formulated.

Despite the substantial accomplishments in access to education, quality remained weak. The PISA results were the starkest evidence of poor quality. A variety of causes contributed to this poor showing, a few of which were the recurring themes in the discussions.

Propagating nationalist perspectives had continued to take precedence over open inquiry. Curricula and textbooks, tightly choreographed centrally and prepared with the objective of nation-building, emphasized learning by rote at the expense of creative thinking. Poor training of teachers reinforced this deficiency. High

43. The only other ministry with "national" as part of its name is the Ministry of National Defense.

school, again with an emphasis on learning by rote, was a major lost opportunity for inculcating analytical thinking and transferable skills essential for higher education or entry into the work force. The overriding importance for students aiming to proceed to university of preparing for multiple choice national tests further undermined the value of the high school years. Universities suffered from the poor analytical skills of incoming students, yet for the most part were ineffective in redirecting students to more critical approaches to their disciplines.

Equity was also a weak point in the system. Two observations by participants on equity were telling. First, strong empirical evidence indicated that student achievement—specifically PISA scores—was driven predominantly by students' socio-economic and regional background. Second, that same background was the main determinant of access to the best quality educational institutions. Language exacerbated the problem in Eastern and Southern regions. It was broadly agreed that bilingualism in schools was a critical issue. The issue had been taboo for years but recently had at least been put on the table for discussion. All of these concerns about the forces standing in the way of equity in educational opportunity and achievement were seen as crucial for social mobility. Indeed, there was substantial concern that not only had the education system not been a channel for social mobility, but it had actually reinforced the existing structure of social stratification.

Politicization had been a multidimensional problem. It had stood in the way of a reexamination of the basic objectives of education and systematic decisions about how resources were allocated. Concerns were naturally anecdotal and not necessarily particular to the past decade. Another problem, also not particular to this decade, had been the centralization of responsibility for the planning, coordination, governance, and supervision of higher education in the Council of Higher Education (YÖK). This centralized set-up had limited the ability of universities to adapt to changing demand for research and skills.

The discussion also explored the impact of the increasingly open expression of conservative social values and religion on national objectives and expectations for the education system. Prior to the decade, a key objective of the education system was to create a secular Turkish nation. Nevertheless, historically Turkish laicism had admitted a role for Sunni Muslim religious teaching. With the rise of a socially conservative middle class, a new focus had arisen: creating a socially conservative Turkish nation. The broad consensus was that this had gradually—starting even before the decade in question—become a definite influence in the education policy. This prompted concerns among most participants that the objective of creating a socially conservative nation was inhibiting a refocusing of the curriculum on critical thinking skills essential for economic dynamism.

At an even more basic level, the decade had seen slow, if any, progress in coming to terms with several paradoxes of Turkish society. These paradoxes placed as-yet unresolved divergences between pressures for educational reform and the willingness of the population to accept educational reform. The long tradition of centralized formulation and uniform implementation of education policy was clashing with divergent regional needs. Parents' middle class aspirations for economic opportunity for their children were not necessarily consistent with their support for the inculcation through schools of conservative cultural and religious values. Gender issues exemplified this tension. Polls suggested that support for educating girls had grown—both prior to and during the decade—but considerable ambivalence still existed about both coeducational facilities and large-scale participation of women in the work place. Moreover, the content of education continued to promote traditional gender roles.

Social Conservatism

Social and cultural evolution, stretching back even before the past decade, were seen as having had important implications for the economy. Most interest centered on questions about how an increasingly open expression of longstanding socially conservative values affected economic inclusion, the approach to policies to support a market economy, democratization, gender issues, and the acceptance of globalization.

Social conservatism and Muslim identity, though conceptually distinct, were considered to be closely linked in Turkey. The sense underlying the discussions was that a societal shift from a long-suppressed role of religion in the public sphere to a more open expression of Muslim identity in daily political, social, and economic life had occurred. This shift went hand-in hand with at least a greater visibility of, if not an actual strengthening, in the prevalence and commitment to socially conservative values. Those values were understood to encompass attitudes toward gender issues, role of religion in schools, tolerance for non-Turkish or non-Muslim identity groups, use of alcohol, and expressions of religiosity.

Those who drew on poll results to characterize social conservatism tended to have a rather negative view of the characteristics of social conservatism in Turkey. One large polling exercise that was discussed identified a number of factors that distinguished socially conservative people in Turkey from the rest of the population.[44] This survey found that people identified as socially conservative were significantly more politically intolerant, sympathetic to authoritarianism, xenophobic, dogmatic, anomic and religious than the general population. They tended to harbor more traditional values on gender issues and to have lower self esteem. And among them intolerance of uncertainty was high. While these differences were statistically significant, the gap they suggest between social conservatives and the rest of the population was far smaller than the gap (according to the same measures) between the Turkish population as a whole and the populations of other countries. In

44. Results here drew on Çarkoğlu, Ali and Ersin Kalaycıoğlu, *The Rising Tide of Conservatism in Turkey*, New York: Palgrave-Macmillan, May 2009.

other words, the country as a whole (not just those who self-identified as social conservatives) was very conservative by standards of other countries.

There was no uniform view from polls on how social conservatism plays out in the economic and political arenas. On the economic side, the Çarkoğlu poll indicated that the Turkish population as a whole (not just those identifying as social conservatives) were unconvinced of the virtues of liberal economic policy. Voters typically opposed privatization and favored state involvement in economic affairs. In these polls, protection of the domestic market, and negative feelings about foreign investment and globalization prevailed.

On the political side, the World Values Survey (which has covered Turkey since 1991 and includes a battery of values issues) found that respondents in Muslim-majority countries generally (including in Turkey) favor democratic governments.[45] However, this survey found that respondents in Muslim majority countries (including in Turkey) favored less regulation of private behavior and less freedom for women to participate in social and economic activity than respondents on average in non-Muslim majority countries. Many of these results had not changed much from those obtained when the poll in World Value Survey first started in Turkey in 1991. Some therefore felt that the seeming increase in religiosity and socially conservative values had not been the result of a change in attitudes of the population. Rather, it had been result of government exercising less resistance to or even some encouragement of underlying attitudes.

But some participants took issue with the rather negative messages drawn from the polling results. Two broadly complementary perspectives were expressed on how the evolution and more open expression of Turkish Islam during the decade had supported economic inclusion and Turkey's global economic aspirations. The two perspectives also portrayed the adaptation of Turkish Islam to the changing economic aspirations of the burgeoning middle class.

One perspective was that during the decade a new form of secularism had emerged. Previously, secularization had been taken to mean that religion exist in the private sphere, outside the public domain to the extent possible. By perpetuating traditional and conservative values among practitioners, this had tended to make religious practices very static. Because even private religious beliefs were inextricably linked with personal identity, certain religious and ethnic groups had faced severe constraints on their economic participation and their political power. As pressures arose for greater economic inclusiveness, the strategy for secularism had to change. Groups with a Muslim identity gradually became more involved in the public sphere. In the new secularism, religious convictions openly informed morality and daily life. This new morality would allow people to act out of religious motives but for the benefit of an open and liberal state. In this view, the government had driven the process, but had also been the result of the process.

45. World Values Survey http://www.worldvaluessurvey.org/index_findings .The most recent (5th) Survey was conducted in 2005-08 covering 54 countries. The 6th Survey is being conducted during 2011-12.

A second, and closely related, perspective saw the past decade as an inevitable cultural transformation. Whereas the Kemalism had drawn certain boundaries between the state and private lives and between Islam and politics, this was essentially unsustainable in a country where religion and social conservatism played a central role in the lives of a large portion of society. Accordingly the polity—the political will of a broad swath of society reflected in the state and its institutions—had begun to redraw those boundaries. Kemalism had sought modernization without Islam. The transformation sought modernization with Islam.

This process had run up against a fundamental challenge. Was it possible for a society that embraced the moral and ethical code of Islam (and accompanying expressions of social conservatism) to operate a successful market economy? The experience during the decade suggested that the answer was "yes" for two reasons. First, while expressions of religiosity and social conservatism had grown, Turks had been building the institutions of a liberal market economy. Second, capitalism was at the same time changing the face of Turkish Islam. One needed to look no further than the socially conservative new middle class to see that their economic aspirations were creating a new Islam with emphasis on hard work, frugality, and competition.

Some participants were less sanguine about the compatibility of Turkish Islam and economic dynamism. Indeed some questioned whether the much-touted prosperity of the heavily religious and socially conservative heartland was less the result of a new "capitalist" ethos in Turkey's emerging middle class and more the result of a shift in the beneficiaries of political cronyism.

But even the optimists saw three serious fault lines in Turkey's mix of religiosity, social conservatism, and economic ambition. The most obvious arose with gender inequality. Turkey's low rankings in international comparisons of gender gaps (the difference between female and male opportunities, status, and condition) placed it in the middle of the pact of the world's worst-performing countries.[46] In almost all of these, common cultural biases were seen as the most important influence. An additional contributing factor had been the rural-urban migration which had strengthened the presence of traditional views on gender roles in the cities. But this was at most an ancillary consideration. The economic relevance of a gender fault line could not be underestimated. On a purely practical level, Turkey was unlikely to be able to support a strong growth rate with sufficiently strong demand or savings, or to compete effectively over time with such low participation of women in economic life. Equally ominous were the implications for democratic development. Cross-country evidence pointed to respect for women and self-expression as two consistently important elements of strong democracies.

A second serious fault line concerned the integration of minorities in the political and economic fabric of the country. Traditionally, secular nationalism had been

46. In the World Economic Forum report on broad-based measures of gender gaps, Turkey ranks, in 2010, 126 of the 131 countries with adequate data to measure the basic concepts. http://www3.weforum.org/docs/WEF_GenderGap_Report_2010.pdf

the primary tool for efforts to hold diverse elements of the country together. Now commonality, for example between Turks and Kurds and Sunnis and Alevis, needed to be sought in the presence of additional dimensions of Turkish society—growing affluence, a rising middle class, and a more open role of religion and socially conservative values. There was little optimism that commonality would be adequate for overcoming disparate interests. Although it was recognized that the rights of minorities had improved, at least partly in the context of EU-related reforms, concerns were voiced about Alevi-Sunni relations and progress toward inclusion of all segments of the society in Turkey's economic prosperity.

A third fault line was the lack of creative thinking. Historically, this lack of critical thinking had resulted from the subjugation of education to nationalist goals and the reluctance to part with traditional ways of educating. But even as other influences had developed alongside the "glue" of nationalism, they had not changed the powerful forces against making creative thinking a more prominent goal in education. In principle the opening of the economy to global influences should have focused the attention of schools and universities on creative thinking. But in fact, despite significant improvements in access to education at all levels, the underlying quality of education and the development of critical skills were still weak.

Chapter VI: The Imprint of Globalization: Exports and the EU

Globalization has presented challenges for Turkey along several dimensions—diplomatic, cultural, and economic—all of which have been complex and overlapping. The discussions focused on two of the most important challenges during the decade in the economic sphere: the ability of the export sector to compete and thrive on the global stage and the course and ramifications of Turkey's long quest to accede to the EU.

The environment for exporters changed quite substantially during the past decade. Intense global competition, especially from producers in other dynamic emerging market countries, and the sizable appreciation of the TL had added to existing difficulties stemming from labor market rigidities and weaknesses in the education system. At the same time, however, the stabilization of domestic macroeconomic conditions and the strong growth of global demand improved the environment for making investment decisions. On the whole, participants felt that exporters had been reasonably successful in navigating the terrain. There was, however, agreement that the record could have been even better had policies been more supportive.

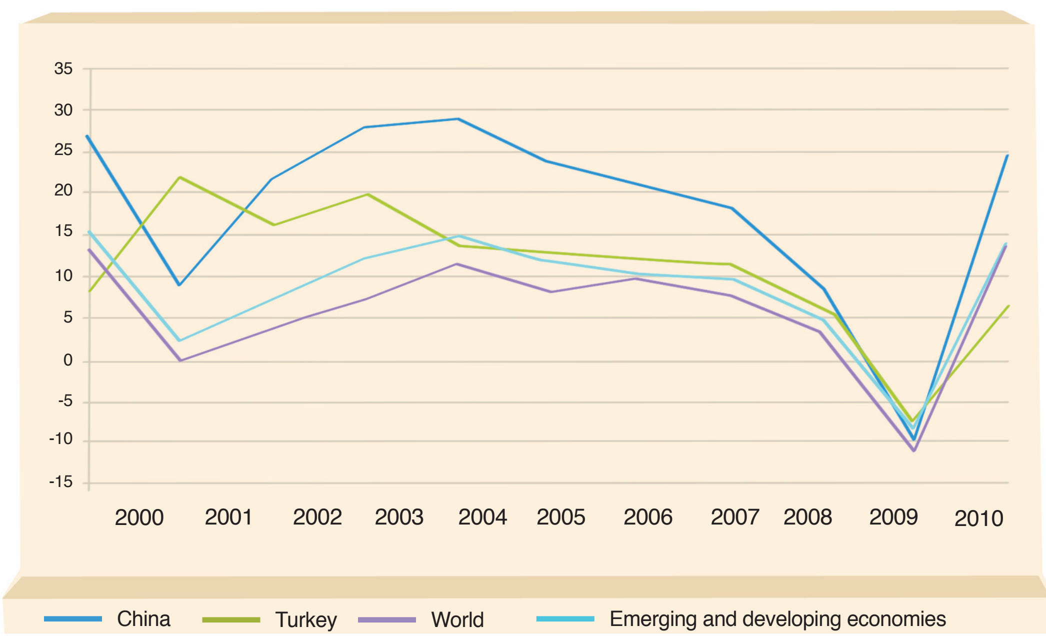
Turkey's relationship with the EU took several turns during the decade—at times appearing to flourish and at times clearly floundering. The discussion addressed the ways in which relations with the EU influenced the evolution of Turkey's political economy: how the engagement with the EU had led to changes in developments and institutions in Turkey, how to characterize the state of Turkey's EU membership process as of the end of the decade, and how Turkey's own economic evolution during the decade had changed the calculus of costs and benefits of EU accession. The broad sense was that relations with the EU had been an important marker throughout the decade: at times hastening some policy changes and at times pushing Turkey to consider its national interests in a scenario without EU membership or with a long-delayed accession process.

1. The Stylized Facts

Historically, Turkey has been a trading nation. As far back as the golden years of the Ottoman Empire, periods of prolonged prosperity have often coincided with those when trade was vibrant. But, as in many other emerging markets, the immediate post-war decades saw an embrace of import-substitution industrial development. This strategy produced a short period of strong growth, followed by a weakening of productivity and job growth. Subsequently, as in many other countries, there was a shift away from the import substitution strategy. Since the 1980s, a stronger outward-orientation has been reinforced by geopolitical developments (the end of the Cold War, the EU bid, and closer regional ties) supporting exports.

During 2000-10, the annual average growth in Turkish exports in volume terms was almost 11 percent (Figure 18). This performance was impressive when compared to the average growth in world exports (less than 6 percent) and exports of emerging and developing economies as a group (about 8 percent), and produced an increase in Turkey's global market share. This performance, however, does not confirm a start of a new era for exports in the Turkish economy when compared to annual growth in exports (albeit from a lower base) of 18.5 percent in the 1980s and 9.7 percent in the 1990s. Moreover, it did not match the export performance of the most dynamic emerging market economies.

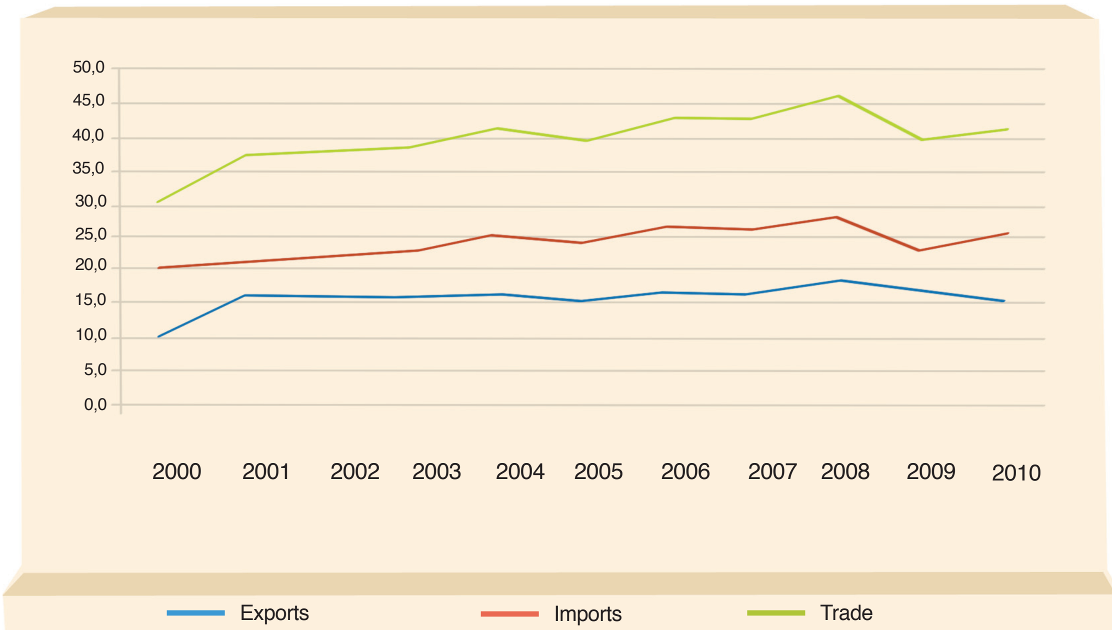
Figure 18: Export Volume Growth (Percent)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

According to common openness indicators for trade, the economy became more open to influences of globalization during 2000-10, compared to the previous decade (Figure 19). Most of the increase in openness took place at the beginning of the decade.

Figure 19: Trade Openness (Percent of GDP)



Source: Turkish Statistical Institute.

Turkey's road to EU membership has been a long and slow process, spanning more than half a century. Turkey applied for associate membership in the European Economic Community in 1959, became an associate member in 1964, signed a customs union agreement with the EU in 1995, applied for formal membership into the EU in 1987, was officially recognized as a candidate for full membership in 1999 in the Helsinki Summit, and started negotiations in 2005. To access to the EU, Turkey must complete negotiations with the EU on the 35 chapters of the EU law and subsequently the member states must unanimously agree on granting Turkey membership to the EU.

After being recognized as a candidate for full membership in 1999, Turkey undertook reforms starting in 2001 to harmonize Turkish legislation with that of the EU: amending part of its constitution, enacting international human rights legislation, abolishing the death penalty, improving women's rights, reforming the prison system, curtailing restrictions on freedom of expression and association, reducing the influence of the military over the civilian government, and improving the rights of minorities.

The reform process was derailed to some extent after 2005 because of various EU related as well as domestic factors. Subsequently, Turkey's accession came to a halt in December 2006, with the EU freezing talks in 8 of the 35 key chapters under negotiation. Meanwhile, there was a dramatic drop in domestic support for EU convergence (from 73 percent in 2004 to 50 percent in 2010).

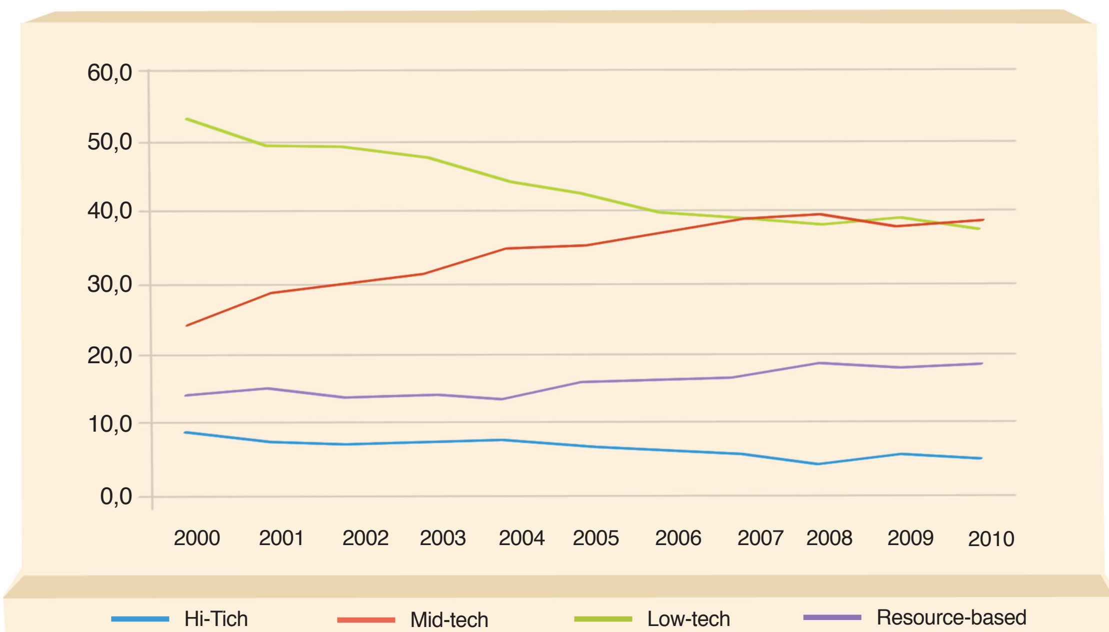
2. Discussions

How did the export sector change during 2000-10?

There was an agreement that the export sector had changed in a number of substantive and largely positive ways during the decade.

There had been significant changes in the commodity composition and structure of exports. The share of traditional exports such as textiles and garments had declined, while the share of motor vehicles, basic metals, and machinery and equipment had increased. In parallel, there had been a change in the technology content of exports with transformation from low-tech manufacturing products to medium-tech products, whose share increased from less than 25 percent to almost 40 percent (Figure 20). As Turkey's traditional exports had competed mainly on the basis of low costs rather than quality and technology level and were losing markets to exports from Asia, the change in the composition and technology level had been a significant boost to export growth.

Figure 20: Export by Technological Content (Percent of total export)



Source: TEPAV.

This move up the technology ladder had illustrated the importance of making the right strategic and investment decisions. The contrasting experiences of the automobile and television industries were held up as examples. In the move to medium-tech products, the automobile industry had been among the most dynamic sectors building on its past successes throughout the decade. Early in the decade, the industry had benefited enormously from increased competition and the greater access to the European market after the Customs Union agreement with the EU. As the decade wore on, significant investments had been undertaken to sustain and then increase productivity and competitiveness. The television industry had taken a far less favorable course after starting the decade as an export leader. As the liquid-crystal display (LCD) and plasma technology had squeezed out the old tube television receivers, the industry had decided not to undertake the necessary investment spending for LCD panel production. Exports had dwindled during the second half of the decade. This contrasting experience had been a lesson in the importance of carefully anticipating shifts in demand and responding rapidly and proactively to them.

Concerns about the substantial import content of exports varied. It was generally acknowledged that the export sectors that had grown fastest during the decade—many of them were medium-tech industries—had been relatively import-intensive in production. Even though some—such as the auto industry where domestic production of inputs had grown rapidly—had substantially reduced the import content, the fact that these fast-growing sectors used imported inputs intensively meant that the overall import content of exports rose. Some saw this as a sign that there had been insufficient investment in backward linkages and, therefore a failure to take advantage of the potential for faster growth of net exports, employment and output.[47] The recently announced Input Supply Strategy project was intended to address this problem.[48] Others, however, saw the increase in the overall import-content of exports as the natural outcome of a move up the technology ladder while globalization was heightening the incentives for specialization. This development was not unique to Turkey and was happening in many successful emerging market economies. In this view, sectors like the auto industry, even with its relatively high import dependence, had created the potential for spillovers and backward linkages in investments. Some of these had already materialized.

In contrast to the shift into medium-tech products, the move to the higher reaches of the technology ladder had been far slower and more difficult. Indeed, while there had been change in the composition of exports in favor of medium-tech products, such a transformation was not achieved in the case of high-tech products. Exports

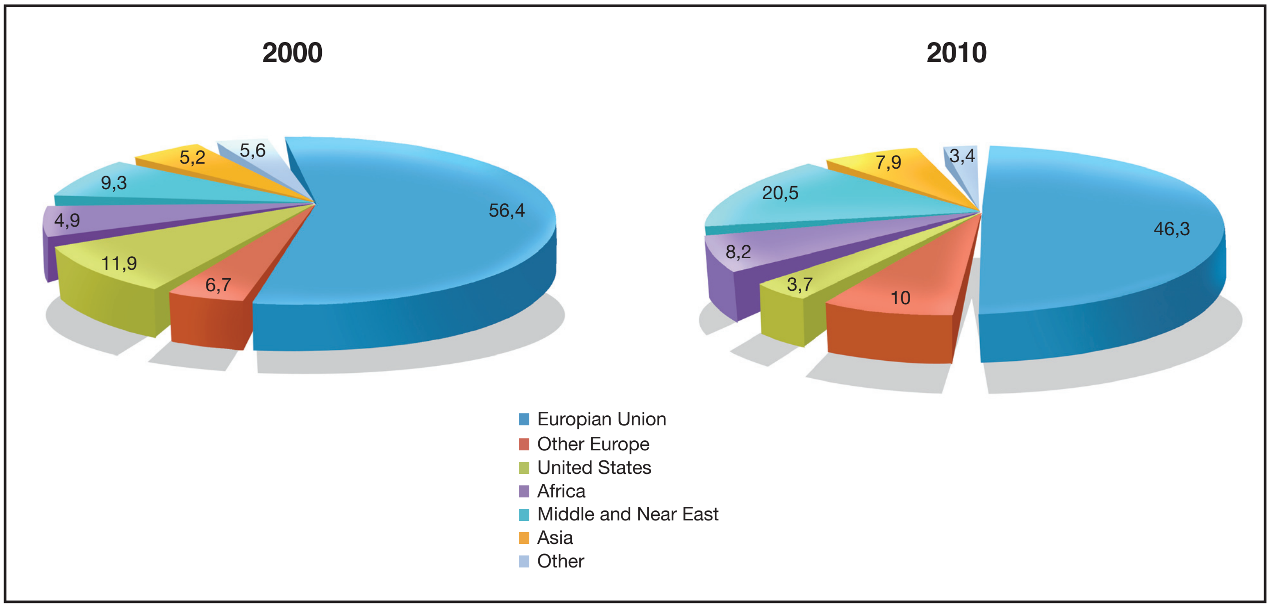
47. The reference cited in the discussion was Saygılı, Şeref, Cengiz Cihan, Cihan Yalçın, and Türknur Hamsici, 2010. "Turkiye İmalat Sanayiin İthalat Yapısı," Working Paper 10/02, Research and Monetary Policy Department, Central Bank of the Republic of Turkey.

48. Input Supply Strategy, known as GITES, aims to address the dependency of production on imported inputs. It targets secure and sustainable supply of inputs with non-distorted prices as well as higher domestic value added and stronger competitiveness in exports. It has been coordinated by the Ministry of Economy.

of high-tech products had increased modestly in absolute terms, but their share in total exports had declined during the past decade. Thus, Turkey had continued to specialize in export products/sectors that were viewed as having low growth potential. It was pointed out that according to several academic cross country studies, the degree of sophistication of Turkey's exports was still not as high as in several high growth emerging market economies.[49]

Even more successful than product diversification had been export market diversification (Figure 21). Indeed, market expansion and changes in the relative importance of various export markets were considered the most significant development in contributing to the growth of Turkish exports. Exports to the Middle East and North African countries as well as to Central Asian countries had increased considerably during the decade owing to extensive outreach efforts toward these regions. This diversification in export markets had been important not only in cushioning the impact of depressed demand in Europe in the latter part of the decade, but also in providing markets for low-tech exports. Exploiting the opportunities for more South-South trade had been particularly important for gaining time for transition from low-tech to high-tech exports. Turkish exports, however, had not been able to penetrate the fast-growing Asian markets. This meant that while penetration of new markets had been highly favorable for exports during the decade, it had not positioned Turkey particularly well to take advantage of markets with the most growth potential.

Figure 21: Export Markets Shares
(Percent of total exports)



Source: Turkish Statistical Institute.

49. Indicators of the degree of sophistication of exports and their messages for Turkey can be found in Hausmann, Ricardo, Jason Hwang, and Dani Rodrik, "What you export matters," *Journal of Economic Growth*, Springer, vol. 12(1), pages 1-25, March 2007; and Hausmann, Ricardo and CA Hidalgo, "Country Diversity, Product Ubiquity and Economic Divergence" *CID Working Paper 201*, 2010.

Diversification in the sourcing of exports within Turkey was also believed to have been significant during the decade. In the past exports came from firms in major Turkish cities, but during the past decade an increasing number of small and medium size enterprises from all parts of Anatolia had started to export. These enterprises had been particularly successful in penetrating the markets in neighboring countries—markets where demand was primarily for low and medium technology products and where close proximity and low transportation costs gave Turkish exporters a comparative advantage. Indeed, because these enterprises had mainly been exporting to neighboring countries, their production and hence employment had not suffered greatly from the contraction in the EU market, as did those of large exporting firms in big cities.

All of these quite substantial changes in the structure of exports had occurred despite the significant appreciation of the Turkish lira. The real effective appreciation of the Turkish lira of about 30 percent during 2000-10 had been a serious challenge for exporters. As Turkey was considered largely a price taker in international markets, the appreciation of the lira had mainly squeezed profit margins. This effect had been most harmful in the low-tech and labor intensive sectors, such as ready-made clothing and fruits and vegetables. Markets for these goods had increasingly gone to lower-wage Asian producers. Higher tech sectors, that were able to offset a profit squeeze by investing in new technology or increasing productivity more generally, had fared better. Some felt that through this channel, the appreciation had been an influence accelerating the structural transformation of Turkey's exports.

It was also noted that some Turkish exporters (except during the global crisis) had benefitted from the appreciation of the euro against the dollar. Specifically, some of the sectors whose export share had grown most in the past decade were also those that used a high ratio of imported inputs and intermediate goods for production. By importing raw materials and inputs from Asia and other parts of the world in dollars and exporting a large part in euros, Turkish exporters had been able, temporarily, to protect their profit margins and stay competitive despite the real appreciation of the Turkish lira. However, particularly as global pricing adjusted to the change in exchange rates between currencies of large countries, the strategy of gaining competitiveness through the import in dollars and export in euros would obviously be short-lived.

While the change in the structure of exports during the decade had had a favorable impact on export performance, it had also brought new challenges. With the lower share of traditional exports and the higher share of medium-tech exports, the new structure had substantially increased the foreign income elasticity of demand for Turkey's exports. This in turn had made the transmission of demand shocks from trading partners to the Turkish economy stronger and faster. Indeed, the recent worsening of economic conditions in the EU had had a significant impact on Turkey's exports. Also with the move up the technology ladder, technology cycles had become shorter and staying ahead of the cycle had become more challenging. The dangers of slow or inadequate responses were evident in the experience of the production and exports of color television receivers.

The structure of exports in terms of the technology content and the degree of sophistication of products had implications for future growth of economies. One participant presented data on two indicators of the degree of sophistication of exports.[50] One indicator was the so-called EXPY index, which measures the per capita income of other countries that export the same products as the country in question. The idea here is that a high per capita country exports goods that other high per capita countries export. The other indicator was the average ubiquity, which measures the number of countries that exported the main exports of the country in question. The idea here is that as countries develop and increase their capabilities, they will produce and export products that are exported by fewer countries. The ubiquity typically falls (or shows a shift in production to exports with less competing exporting countries) as a country's per capita GDP rises. Both indicators have been seen in other countries to be predictors of future growth potential in so far as they measure the likely supply conditions for a country's exports—put simply, "a country becomes what it exports." For Turkey, the EXPY index based on data for 1995 and 2009 had increased over time, but still was lower than for a number of comparator countries such as Mexico, China, and Romania. The average ubiquity based on data for 2009 was high in Turkey for its level of per capita GDP. This suggested that the decade had not seen as large a shift in the structure of exports as in other countries at its stage of development.

Many participants felt that the comparatively slow pace of change in the structure of Turkey's exports pointed to an inadequate response of governments to the challenges of competing in a dynamic global economy. Views were sharply divided on whether not having had a more active export policy, which got into the domain of industrial policy, represented a missed opportunity.

Those who felt that the governments had missed an opportunity were of the view that targeted industrial policy could have been a powerful tool in moving to high-tech production and exports. In this view, the exchange rate, even if it had not appreciated during the past decade, would not have been an efficient instrument for pushing exports up the technology ladder because it would have promoted production of tradables across the board. They pointed to the experience of some other countries that had been successful in moving into high-tech sectors with the help of targeted government interventions and felt Turkey would have benefitted from more use of similar policies. Such intervention in Turkey could have been in the form of tax breaks, subsidies, industrial zones and other preferential government support for investments in high-tech sectors. To this end, what would have been useful was a process through which the public and private sectors jointly identify the micro market failures, binding constraints to moving up to high-tech products, and effective instruments of intervention.

50. Indicators of sophistication of exports included: (i) the EXPY index developed by Ricardo Hausmann, Jason Hwang, and Dani Rodrik (2007); and (ii) the average ubiquity suggested by R Hausmann and CA Hidalgo (2010).

Those who were against using targeted industrial policy to move exports up the technology scale argued that a country's physical and human capital, natural resources, and institutions determined its pattern of specialization. Attempts to reshape the production structure in a way different than suggested by these fundamentals would have failed. This was same for any product whether it was exported or not. There were structural impediments that hurt competitiveness and the government should have put its efforts to removing them. More specifically, what exporters had needed was efficiency enhancing structural reforms in the labor markets, the education system, and the regulatory framework and a better infrastructure. Then given the stable macroeconomic environment and openness of the economy, comparative advantage would have directed the resources and the transformation would have taken place. In a targeted industrial policy, there would also have been the issue of which sectors and firms to help. Not only efficiency but also non-economic considerations could have come into play, and the government could have made costly mistakes. Therefore, the government had been right not going down this route.

Turkey and the EU: the Path and Power of a Fraught Relationship

The EU membership process had had important effects in three interrelated spheres: economic, democratization, and political.[51]

In the economic sphere, the engagement with the EU had contributed to Turkey's successes. The boost to exports had been formative. The establishment of the Customs Union in 1995 had given Turkish exports (except agricultural goods) free access to the European market. This had spurred growth of the industrial sector and the shift in the structure of exports from low-tech to medium-tech products. Particularly in the aftermath of the Asian crisis, access to the EU markets had facilitated a niche role for Turkish producers of importing goods from Asia, adding value and re-exporting to the EU. More generally, the step-up in competitiveness and competition standards after 1995 had boosted Turkey's ability to compete on world markets more generally. All of these influences had contributed to the relatively strong response of exports following the 2001 devaluation and were critical to the speed of the recovery following the collapse of domestic demand in 2000-01.

The EU anchor had also helped encourage the building of modern institutions and infrastructure. Among these, the establishment of a stronger rule of law had been particularly important for providing a good environment for investment—on the part of both domestic and foreign nationals. Not surprisingly, therefore, the opening of the accession negotiations had been accompanied by increases in FDI inflows, especially in the first half of the 2000s. These inflows, even though not very large relative to those

51. With regard to social programs, it was noted that the EU process did not have a direct effect as the negotiations on chapters related to social reforms have not been initiated.

to many other successful emerging market economies, helped to some extent in the financing of the current account deficit without adding to external debt.

Engagement with EU had been neither the only nor the determining factor in Turkey's success in the past decade. Other factors which were considered more important included the opening of the economy during the 1980s, the implementation of radical macroeconomic reforms after the 2001 crisis, the relative political stability with the coming into power of single party governments, the rise of a large and dynamic entrepreneurial business class outside the big cities, increasing opportunities for economic engagement with Turkey's neighbors, and a favorable global economic environment until the latter part of the decade.

Although the undisputed benefits of the engagement with the EU were seen as one factor underlying the impetus for reform and structural change during the decade, there had been costs. The customs union with the EU had constrained Turkey's policy options toward non-EU countries as Turkey had no say in EU's trade relations with other countries. In the event the accession negotiations do not restart and the membership perspective disappears, Turkey should renegotiate the terms of its customs union with the EU. A free trade agreement (FTA) with the EU that would allow Turkey to set its own tariffs with third countries would be more suitable than the current customs union arrangements.

On democratization, some argued that reforms associated with Turkey's bid to join the EU had played a key role. The EU requirements for democratizing had spurred reforms that laid the political and institutional foundations of a new modern Turkey. These included most importantly a "civilianization" of Turkish politics and stronger rule of law. Also as part of the accession process, the EU had pushed Turkey to address the claims and grievances of minorities, including Kurds and Alevis, and improve women's rights. Some others were of the view that most of these reforms had already been on the agenda of the governments. EU requirements had not been the reason they were initiated, though those requirements had given them greater weight in the policy agenda and had facilitated moving forward with them. At the extreme, there was even an argument that the EU had lost its relevance for Turkey in the democratization process, Kurdish issues, and civil military relations.

On the political sphere, there were differences of view on the role of the EU in the increasing assertiveness and independence of Turkey's foreign policy during the decade. Some felt that obstacles that had arisen (from the EU side) to Turkey's accession had led to a decline in public support for EU membership. This in turn had increased domestic support for a less Western-oriented foreign policy. In the meantime, the distinction between domestic and foreign policy had become more blurred and the government had become more accountable and sensitive to public opinion in foreign policy decisions. Under these circumstances and with fading prospects for early EU membership, Turkey had moved away from its Western oriented foreign policy and had pursued a multidimensional, more assertive, and more independent foreign policy.

Others, however, did not attach an important role to the EU process in shaping Turkey's foreign policy. Since 2002, Turkey's foreign policy had been driven by concepts of "strategic depth" and "zero problems with its neighbors". The objective had been to reach out to non-western regions to complement Turkey's ties to the West, not to replace them. In the meantime, economic performance and political stability had fueled a sense of self-confidence and pride in Turkey and had led to a more independent, nationalist, and proactive foreign policy. Not only the EU but more broadly the West no longer had the influence they previously had in Turkish foreign policy.

The accession process was seen as having come to a standstill by the end of the decade. As the obstacles to restarting the process were substantial, EU membership was not a realistic scenario in the near future. Indeed, the decade had thrown up a number of hurdles—with both external and domestic roots—that needed to be overcome to move forward even in the longer term.

On the external side, EU skepticism about Turkey's membership had become increasingly apparent. After the commencement of the accession negotiation and Turkey's initial reforms, underlying concerns in the EU about Turkey's membership had come out in the open. Though EU governments had been unanimous in voting for Turkey's full integration in the European structures, some European leaders had almost immediately begun speaking about shifting to a "privileged partnership" as the objective. Moreover, obstacles had been put in the way of negotiations by blocking some of the chapters of the acquis communautaire that were relevant to the accession process.

Skepticism on the EU side was seen as a reflection of the view that Turkey was "too large, too poor, and too different". Among these three characteristics, most participants thought that "too different" was the main issue and that the EU was opposed to Turkey's membership because of Turkey's so called "Muslim identity".[52] A few participants felt that hostility towards Turkey had become entrenched. Moreover, some participants felt that Turkey and the EU were drifting apart culturally: Turkey was becoming more socially conservative, at least in the open, while Europe was becoming less religious and more secular.[53]

But factors of domestic origin were also seen as having contributed to the stalling of the EU accession process. Concerns about Turkey's membership in the EU on

52. This assessment is also in line with the survey findings in "Transatlantic Trends 2011" by the German Marshall Fund of the United States. Survey results indicate that of the people living in the EU, 35 percent believe Islam, 32 percent believe poverty, and 27 believe size as reasons to keep Turkey out of the EU.

53. References cited in this discussion were: Çarkoğlu, Ali and Ersin Kalaycioğlu, *The Rising Tide of Conservatism in Turkey*, 2009 and interview with Yilmaz Esmer (coordinator for World Value Survey) in Turkish Daily News, August 19, 2011.

the grounds of its size, income level, and cultural difference had always existed. Yet it had not prevented the accession process from moving forward during 2000-05, which was described as the "golden age of integration". Thus, the change may have reflected as much a change in Turkey's commitment as in the overt expression of doubts in the EU itself. At one extreme of this view was the position that Turkey was no longer fully committed to the EU accession process. But a more moderate view, shared more widely among participants, was that Turkey's commitment to the EU process during the second half of 2000s had simply diminished. As confirmation of this view was the fact that the last major reform package had been in 2004, a full-time EU negotiator had not been appointed until 2009, and the Turkish Ministry of EU Affairs had not been created until 2011. Several reasons for this diminution were adduced.

Domestic disruptions. The setbacks had been partly due to a series of domestic disruptions: a public threat of intervention by the military in 2007; a discovery which seemed to have been part of a plot to topple the government in 2007; the judiciary's case to close the ruling party in 2008; renewed clashes between the Turkish army and militants of the Kurdish Workers' Party (PKK); and efforts to push through legislation to lift the ban on headscarves in universities.

Nature of remaining reforms. The reforms that were implemented in the first part of the 2000s had not been difficult. The EU process had lost its momentum because the remaining reforms had been more costly financially and more challenging to implement politically. In the absence of deadlines which had previously driven the reform agenda and no improved signals regarding prospects for membership, there was no urgency for the Government to move forward with the remaining EU-related reforms. More recently, a new generation in the Turkish bureaucracy, rather than the EU, had been directing and prioritizing the reforms.

Public opinion. The mixed signals from the EU and openly-voiced concerns by member states about Turkey's membership had led to a dramatic drop in support for EU convergence in Turkey and discouraged the government from proceeding with Turkey's EU-related transformative reforms.

By the end of the decade, the EU had become immersed in its own problems and it was fair to say that Turkey's membership questions were far from a priority. Moreover, with enlargement fatigue still apparent within EU circles, it had been difficult to generate political support for Turkey. Particularly with the forthcoming assumption of the rotating EU presidency by Cyprus scheduled for mid-2012, matters were unlikely to move for the foreseeable future.

Chapter VII: Conclusions

The overall sense of the discussion was that the decade had indeed witnessed a "New Turkish Economy". The country was more prosperous at the end of the decade than at the beginning, the decision-making environment was more stable, a middle class with a stake in continued stability was stronger, and the export culture had continued to develop. There had been important missed opportunities to do better, most seriously from an economic perspective in reforming labor markets and creating an effective education system. There had been the beginnings of some potentially major transformations, such as the freer expression of religiosity and social conservatism and the EU accession process, with as yet unclear economic implications. But there had also been distinct policy successes—most clearly, regaining control over the chaotic fiscal, monetary and financial sector policies during the previous decade.

It was certainly too soon to tell whether the achievements would be permanent. Self-sustaining credibility comes with longer records of success, and a decade is still a short period from this point of view. Moreover, with successes came higher expectations and greater ambitions for the speed of income convergence with advanced countries and for the inclusiveness of prosperity. These ambitions can be channeled into plans for faster reform to address the missed opportunities or they can undermine resistance to unsustainable policies with short-term growth dividends. And then there are vulnerabilities which, if not managed with determined caution, raise the risk of conflagration even when a record of success has been achieved.

Most of the discussions focused on considering the changes in the political economy over the past decade. However, they also touched on the challenges for the next decade. The rest of this chapter lays out some of the key forward-looking points that were raised.

Managing macroeconomic policies

Maintaining macroeconomic and financial stability was considered the sine qua non for continued prosperity. Primary fiscal balances would need to be held in balance or small surplus over the cycle, the public debt ratio would need to be kept at or below current levels, inflation would need to be in the mid-single digits, and financial institutions would need to be strictly supervised and regulated to ensure strong balance sheets and capital buffers.

Particularly on the fiscal and monetary dimensions, developments in 2010 and 2011 were a significant concern. Although most measures of capacity utilization (unused capacity in the manufacturing sector, calculations of the gap between actual and potential output, and unemployment) had only recovered since the 2008-09 crisis to 2007 levels, the speed of the recovery and other indicators of excessive demand pressures that emerged by late 2010 and continued into 2011 were a concern to most participants. The consensus was that as the new decade began, rising inflation and the sharp widening of the current account deficit were clear signs that the economy was overheating. This would be an important testing ground for the commitment to macroeconomic stability. The critical question for the near-term was whether the institutions and conventions put in place during the past decade would prove sufficiently robust to rein in overheating pressures and secure expectations that economic conditions would remain stable. Both were essential to sustain even growth rates around the average of the past decade.

On fiscal policy, it was suggested that a firmer anchor or rule was needed. The government had asserted that the introduction of formal medium term fiscal plans would be a strong disciplining influence on the overall fiscal envelope, but there were doubts about the efficacy of this approach. A commitment to a specific rule—whether it be applied to overall spending or the fiscal balance, on a nominal basis or a cyclically-adjusted basis—would send a clearer message on intentions and would be a more visible standard against which to judge outcomes.

On monetary policy, recent developments raised questions among some about the independence of the central bank and about the targets and tools used in monetary policy. On independence, a concern was that some recent statements had left the impression in markets that there was scope for political interference in monetary policy decisions. The government should act quickly to dispel this impression. On the operation of monetary policy, it was recognized that there are no magic bullets. Given the multiple objectives of preventing undue changes in competitiveness, targeting low inflation, protecting financial stability, and avoiding high interest rates that would attract short-term capital inflows, the operation of monetary policy would remain exceptionally difficult. The debate broadly came down to a preference for conducting monetary policy with conventional (interest rate) instruments with the inflation target as the sole objective versus a preference for heterodox tools that might be more successful at achieving multiple objectives. With the switch to heterodox tools in the recent past, upward pressure on the Turkish lira in exchange markets had been reversed, but inflation was rising.

Managing vulnerabilities

Turkey was likely to remain vulnerable to external and domestic events that could trigger a crisis. True, macroeconomic and financial sector stabilization during the decade had significantly reduced several important vulnerabilities that had plagued the preceding few decades. But new vulnerabilities alongside some old ones that had not been successfully addressed were seen as having changed the form, more than the seriousness, of Turkey's vulnerabilities. This view resonated with the recent decisions of rating agencies. Despite favorable perceptions of improvements in macroeconomic and financial policies, rating agencies' judgment was that Turkey had not been able to cement reforms and contain its external imbalance. Most felt that in a forward-looking perspective, the message from the rating agencies was apt: there remained significant vulnerabilities.

In the near-term, the priority was to address the most immediate vulnerability—the large current account deficit that had its origins in cyclical overheating, highly liquid global financial markets, and the longstanding problem of low private savings rates. The immediate priority was to cool the economy through macroeconomic policy adjustments. The turnaround in the Turkish lira appreciation in 2011 had gone a substantial way toward reversing what was seen as an excessive appreciation during the decade and would therefore spur private savings. More active measures—even unconventional measures—to discourage capital inflows would need to be kept under consideration should appreciation pressures recommence. The longer term structural causes of low private savings would have to be addressed with deep reforms to change the incentives to work, the availability of jobs, and the motivation to save. The promotion of private saving was an extremely complex undertaking that would need to be at the center of broad macroeconomic and structural policy choices throughout the next decade.

But the new decade would undoubtedly bring new vulnerabilities. Turkey still had a long way to go in addressing its structural weaknesses and proving the durability of stronger institutions. Susceptibility to shocks and crises was, therefore, likely to remain part of the economic fabric. Preventative strategies would be critical for minimizing these risks and would need to inform the government's ambitions for closing the income gap with advanced countries. Such strategies would need to encompass the specification of clear rules to govern fiscal and monetary policies, cautious supervision of the financial sector, and progress in removing the structural and institutional obstacles to stable growth.

Managing growth potential and inclusive growth

In the short-term, rates of growth similar to the average for the past decade were seen as possible assuming a benign global environment with abundant external financing to support growth. A scenario with a growth rate of 5 percent, inflation rate of 5 percent, and current account deficit of 5 percent of GDP was put forth as viable, although immediate adjustments to contain overheating would be necessary for achieving it. The estimated configuration of growth, inflation, and current account as a share of GDP as the new decade started—roughly 9 percent for all three—was considered not only unsustainable but also fundamentally risky. The high dependence on potentially volatile capital inflows, amidst rising risk premiums on Turkish debt, held the seeds of another capital flow-driven correction in the economy.

But there were questions about whether Turkey could even sustain growth as high as 5 percent over the longer term, and outright skepticism about the feasibility of higher rates, without reforms to remove supply side constraints. Such reforms would present complex challenges and require action in many complementary areas. Essentially, participants noted that the two drivers of the rapid pace of growth during 2002-07 had been total factor productivity together with the absorption of labor into non-traditional manufacturing. Structural reforms would be needed to reignite these sources of growth. Two particular challenges, which many felt to be among the most important for future growth as well as inclusiveness and equality of opportunity, were taken up in discussions. These centered on improving the use and quality of Turkey's human capital, through reform of the labor market and of the education system.

Despite signs of life in employment growth during the decade, Turkey faced challenging labor supply dynamics. In addition to new entrants, the ongoing rural-urban migration and the existing large economically inactive population meant that exceptional job growth would be necessary to more fully employ the population.

The most important direct reforms were considered to be well-known, but bold political action to implement them had been lacking. Minimum wages needed to be differentiated by region so as to attract investment to high unemployment pockets of the country. Labor market regulations, especially those fixing severance pay requirements, needed to be eased. Payroll taxes needed to be reduced permanently. The latter two reforms were widely recognized also for their importance in cutting incentives for production in the informal sector. As long as such incentives remained in place they posed a constraint on the efficient expansion of small firms that needed to escape onerous labor market regulations and taxation to remain profitable. Reforms to eliminate or ease them would remove not only the drag on employment creation but also constraints on productivity enhancing investment and expansion.

But as important as these direct measures were, a range of other measures, outside the direct gambit of labor market reforms, were needed to promote the economic vibrancy necessary for job creation. One important such category of policies was to support the competitiveness of exports (including through preventing excessive appreciation of the Turkish lira). Another was policies to facilitate greater female labor force participation. This was a complex area that would require action on many policy fronts: for example, ensuring adequate childcare options, providing adequate social services so as to remove pressure on women to provide care for the sick or elderly at home, and leading, through public sector example, a change in social attitudes toward working women. But undoubtedly the most important indirect approach to employment creation would be education reform.

The outlook for education reform was seen as somewhat more promising than for labor market reform insofar as the first steps toward change had started in the past decade. But they had been timid. A far bolder effort was needed both to realize the potential of the population and to address the enormity of the existing inequality of opportunity. Education reform was by its nature complex, and the discussions touched on the priority areas rather than the specifics.

Five such areas stood out. The first was shifting the emphasis in education from inculcating nationalistic values toward teaching critical thinking skills. Among other objectives, this was essential to build the skill base to move the structure of production up the technology ladder. The second was putting in place the main levers for making this shift: specifically, revising the curriculum and training teachers in the pedagogy of critical thinking skills. A reconsideration of role of national testing, particularly for university entrance so as to use the high school years more productively, should accompany these changes. The third was experimenting more widely with decentralization of decision making. This would facilitate better curriculum development and much needed scope for experimenting with bilingualism. In the same vein, the role of YÖK needed revision to give universities greater autonomy in management and administration. The fourth was introducing as a priority in the allocation of spending on education the achievement of more equitable quality of education. It was essential that students from inherently disadvantaged parts of the country not be held in their place by below average quality of education. Lastly, the higher education and vocational training systems needed a fundamental rethinking to ensure that the quality and breadth of their instruction met the country's needs.

The challenges in social policy also remained substantial. Certainly, the approach to and spending on social policies had changed during the decade, and some notable successes had been achieved. But some participants felt that the objectives and policies behind the increase in social spending had not been developed clearly enough to ensure that improvements in outcomes would be commensurate with additional resources allocated.

There was not, however, a consensus on the how the government might delineate such objectives. A few participants felt strongly that the government should have specific standards and targets for what was called basic income security. But most participants did not voice support for such an approach, implicitly accepting that some mix of moderately redistributive policies, reliance on family and charitable networks for support, and market-based reforms to hasten growth would be more in keeping with Turkey's cultural climate and economic constraints. That said, there was broad support for actions—ranging from enabling policies such as bilingualism in schools to regional differentiation of the minimum wage and fiscal support for tax-free processing zones—to address Turkey's a serious regional inequalities. Looking even further ahead, the need for expanded government-funded safety nets in urban areas would probably become more pressing as the growth of urbanization diminished the role of the family in providing care and assistance to the needy.

The rising expression of social conservatism was another development that would continue to interface with the economic aspirations and development. There were dynamics that pushed Turkey towards more conservatism as well as those pulling it towards more open and progressive stances. Both dynamics were expected to continue in the near future. How they were handled and reconciled would determine whether Turkey would have a more peaceful and democratic society with economic prosperity or face polarization of the society along ethnic and religious lines with adverse consequences for economic efficiency and prosperity.

Grasping the opportunities of globalization

The past decade had seen significant achievements in the productivity and diversification of the export sector. But the record was by no means exemplary and left very substantial challenges for the next decade.

The future of exports would depend on two main developments. The first was cost competitiveness. Turkey was likely to remain largely a price taker in its export markets. With little market power, export profits would remain closely linked to exchange rate fluctuations and domestic labor costs after accounting for productivity changes. Certainly the substantial reversal since late 2010 of the almost decade long real appreciation of the Turkish lira would be a boost to exporters for some time to come. But this boost would be sustained only if wage inflation did not erode it. This pointed to a critical role for monetary policy in containing inflation pressures.

The second ingredient for strong export growth would be policies that would support and promote private investment in export capacity. The structure of exports needed to push further and faster up the technology ladder, exports needed to penetrate more dynamic markets, more FDI needed to be attracted into the export sectors, and Turkey's labor force needed to be better trained for and more intensively employed in export production.

The strategic question for export policy was how to achieve these goals. Should

Turkey have an activist approach of picking and subsidizing winners? Or should it simply concentrate its efforts on reforms that indirectly help the export sector? Certainly there was broad support for these latter types of reforms: removing inefficient features of labor markets, improving education, and experimenting with other microeconomic reforms, for example in the areas of tax reform and investments in infrastructure that complement private investment in export capacity. But the age-old question of whether more targeted policies were needed was not resolved. Some felt that such policies were essential for meeting the global competition and realizing externalities from a more rapid push into higher tech sectors. Others pointed to the possibility of costly mistakes and the scope for poor decisions in response to political interference. Regardless of the path taken, Turkey would obviously need to remain in compliance with its WTO commitments.

Whither relations with the EU?

Given the economic, political, and social transformations in Turkey and its changing role in the global economy during the past decade, a central question arose: Does Turkey need to accede to the EU?

The majority view was that though integration with the EU had been important to Turkey's success of the past decade, it was less important now to near-term prospects. After the major transformation since it first applied for membership, Turkey was now the world's 17th largest economy, had a stronger voice in world affairs, and was a regional leader. Given these developments and the current dynamism of the Turkish economy, the economic benefits from EU membership, such as development aid, increased investment from Europe, and even migration privileges, were seen as less critical than before. In fact, it was even argued that in the short term Turkey would be better off delaying the adoption of some parts of the acquis communataire (such as more stringent environmental and more generous labor standards) that could impose costs.

In the longer term, most agreed that accession to the EU would be beneficial to both sides. This was why both sides were not calling off the accession process. Although the strength of the Turkish economy had given it options that it had never had before (more favorable financing terms, expanded commercial ties with neighbors in the East and South, and, as part of G-20, a greater voice in worldwide affairs), its relationship with the EU, by far its largest trading partner as a bloc, was still important. Turkey would have a large representation in the European Parliament and therefore a strong direct voice in EU policies. The prestige, regionally and internationally, from membership would translate into investment and trade opportunities. Moreover, the still-substantial reform agenda for Turkey to realize its economic and democratic potential would be helped by continued engagement with the EU. In the absence of prospects for membership and the related accession process, a few participants argued that needed regulatory changes might be slow in coming. For these reasons, preserving the goal of EU integration was seen as a major driving force for a stronger economy.

Still, the reality was that considerable question marks hang over accession even in the longer term. These question marks were not all of EU making. Turkey itself was not unified on the membership issue. There were groups for and against in all political camps. The assessment on the Turkish side of the pros and cons of joining the EU was expected to evolve on the basis of domestic economic, socio-political, and foreign policy developments. But much would also depend on the course of relations within the EU. For example, if tensions from the euro crisis and movement toward fiscal federalism were to split the EU into a tightly-bound core and a looser non-core group, the latter might prove a good fit for Turkey. In these circumstances, Turkey, with its preference for retaining some aspects of sovereignty, might be interested in forging a different relationship from full membership.

In any event, no immediate progress on membership was expected. The EU is now immersed in its own problems. As it struggles with its member countries' economic problems, Turkey's membership issue will not be a priority. And with Cyprus scheduled to take over the rotating EU presidency in mid-2012, relations between the EU and Turkey are likely to be frozen. Yet, changes in the course of the euro crisis or in governments in member countries that have strongly opposed Turkey's membership could suddenly bring fresh momentum to the accession process. But even then, a key question will persist: would the Turkish people and their political leaders recommit to the process for membership?

Regardless of the course the process takes, several participants felt that the government needed to give more attention to guiding public opinion through a better communications strategy. Domestically, there was a need to explain the potential contribution of EU membership to Turkey's economic and social development as well as to its relations with other countries. In parallel, an external communication strategy should be developed to better inform the EU public on how Turkey would contribute to the Union and the future prosperity of Europe.

Annex I: Participants at the Workshops in İstanbul (October 3, 2011), Brussels (October 6, 2011), and Washington D.C. (October 13, 2011)

1. Emiliano Alessandri, German Marshall Fund
2. Jeffrey Anderson, Institute of International Finance
3. Meltem Aran, Oxford University
4. İzak Atiyas, Sabancı University
5. Gordon Betcherman, University of Ottawa
6. Benu Bidani, World Bank
7. Ali Carkoğlu, Koç University
8. Mine Eder, Boğaziçi University
9. Can Erbil, Brandeis University
10. Asım Erdilek, Case Western Reserve University
11. Üstun Ergüder, Sabancı University
12. Hasan Ersel, Sabancı University
13. Tom Glaessner, Gavea Investimentos
14. Rauf Gönenç, Organization for Economic Cooperation and Development
15. Öner Günçavdı, İstanbul Technical University
16. Refet Gürkaynak, Massachusetts Institute of Technology
17. Seyfettin Gürsel, Bahçeşehir University
18. Yeliz Hacıosmanoğlu, European Parliament
19. Fadi Hakura, Chatham House
20. Marcus Jeager, Deutsche Bank
21. Bahadır Kaleağası, Turkish Industrialists' and Businessmen's Association

22. Christian Keller, Barclays
23. Ziya Öniş, Koç University
24. Maureen McLaughlin, United States Department of Education
25. Kamer Özdemir, World Bank
26. Şevket Pamuk, London School Economic
27. Serdar Sayan, TOBB University of Economics and Technology
28. Gunther Seufert, German Institute for International and Security Affairs
29. Vefa Tarhan, Loyola University
30. Ömer Taşpınar, Brookings Institution
31. Tosun Terzioğlu, Sabancı University
32. Gönül Tol, Middle East Institute
33. Gökhan Tuncer, Humboldt's University
34. Murat Üçer, Global Source Partners
35. Dirk Verbeken, European Commission
36. Hakan Yavuz, University of Utah
37. Erinç Yeldan, Bilkent University
38. Kamil Yılmaz, Koç University
39. Mehmet Yörükoğlu, Central Bank of the Republic of Turkey
40. Murat Yülek, TAIB Bank

Annex II: Selected Economic Indicators, 2000-2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP growth (percent change)	6.8	-5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.7	-4.8	8.9
Savings (percent of GDP)	17	17	17.3	15.1	15.7	15.4	16	15.2	16	12.6	13.6
Investment (percent of GDP)	20.8	15.1	17.6	17.6	19.4	20.0	22.1	21.1	21.8	14.9	20.1
Inflation (percent change)	55	54.3	45.1	25.3	8.6	8.2	9.6	8.8	10.4	6.3	8.6
Current Account balance (percent of GDP)	-3.7	1.9	-0.3	-2.5	-3.7	-4.6	-6.1	-5.9	-5.7	-2.3	-6.6
Volume of imports of goods (percent change)	30.7	-24.8	20.5	24.8	20.5	12.3	8.5	12.8	-2.1	-13.2	21.4
Volume of exports of goods (percent change)	8.3	22.1	15.9	19.5	13.8	12.3	12.2	11.3	6.1	-8.1	6.3
FDI net (percent of GDP)	0.04	1.46	0.40	0.40	0.50	1.90	3.60	3.10	2.20	1.12	1.06
Government overall balance (percent of GDP) 1/	-9.8	-15.4	-9.3	-7.2	-3.6	-0.3	-0.6	-1.8	-2.8	-5.6	-2.9
Government primary balance (percent of GDP) 1/	2.3	4.0	3.3	4.8	5.5	5.0	4.5	3.2	1.6	-1.0	0.8
General government gross debt (percent of GDP)	51.3	77.6	73.7	67.4	59.2	52.3	46.1	39.4	39.5	46.1	42.2
General Government net debt (percent of GDP)	57.5	75.6	70.2	63.6	54.7	45.6	38.5	32.2	32.8	38.5	36.0
GDP (billions of US dollars)	266.4	195.5	232.3	303.3	392.2	482.7	529.2	649.1	730.3	614.4	735.5
GDP per capita (US dollars)	4026	2906	3396	4365	5559	7180	7775	9422	10475	8710	10309

Sources: Central Bank of Turkey; and International Monetary Fund, World Economic Outlook Database, September 2011 and Article IV Consultation Reports (various issues).
1/ There is a discontinuity in the data series between 2000-02 and 2003-10 because of a change in the content of government category.

About the Authors

Sena Eken is an economist with extensive experience in the formulation and implementation of macroeconomic, financial, and structural reform policies related to developing, emerging market, and advanced countries. After receiving her B.A in economics from Robert College in Turkey, she did graduate studies in economics at the University of Essex in the U.K., and received her Ph.D. in economics at the University of Pittsburgh in the U.S. She is currently an independent consultant. Her professional experience includes senior positions at the International Monetary Fund, including as Assistant Director in the Middle East and Central Asia Department; an advisor to the Governor of the Central Bank of Turkey; and scholar positions at the Foreign Economic Relations Board in Istanbul and at the Middle East Institute in Washington D.C. In these capacities, she led or participated in missions to over 35 countries, undertook policy-oriented research on a wide range of country-specific and regional issues, and published over 30 articles and books.

Susan Schadler is a Senior Fellow at the Centre for International Governance Innovation in Waterloo, Canada and a non-resident Senior Fellow at the Atlantic Council in Washington D.C. She also consults with a variety of international organizations. She is a former Deputy Director of the International Monetary Fund's European Department. In this position she led surveillance and lending operations to many European countries, including Turkey, and managed research teams working on European economic issues.

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