Turkey’s Troubles: Analyzing the Roots of the Looming Economic Crisis

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Turkey came a long way. During the 1990s income generated per person was only one third of the upper half of the OECD countries. The relatively fast growth of the economy in the twenty-first century had moved the GDP per capita to half as high as the upper half group. Material well-being is higher than the bottom seven of the 34 OECD countries but in terms of quality of life it shares the lowest rank with Chile (1). Turkey has shown that it can grow fast but it has been especially vulnerable to external debt and currency collapses.

Beginning economics textbooks list labor, capital, and technology as the resources that increase production. The environment these factors of production operate, facility of market formation and macroeconomic policies, determine their ability to produce, too.

Labor

Some three generations ago less developed countries were classified as surplus labor economies where the contribution of an extra worker to production in traditional occupations was zero (2). In fact, the Chinese transformation during the last thirty years can be viewed as a transfer of labor from traditional sector to the modern sector. Emigration from the agricultural sector to urban areas and outside of the country for the past fifty years eliminated the surplus labor in Turkey. Today, the size, the growth, the quality, the aspirations of the people will be the determinants of future well-being.

Turkey’s population of 80 million grows twice the pace of OECD. The population is young: 23% below age 15. OECD average is less than 18%. The proportion of children and seniors to 15-65 year olds (dependency ratio) is supposed to fall for a couple more years. After 2020, the falling birth rate and the aging population will start to edge the dependency ratio upwards. The unused labor resource can more than compensate for the rise in the dependency ratio. Only 51.7% of 15-

65 year olds participate in the economy (in January 2018 it was 52.1%) (3). The average for OECD is 71.7%. The participation rate of females has been consistently the lowest in OECD. One bright point is the rate increased from 33% in 1996 to 41% in 2016. Attracting the females into the labor force can enrich the families, taper existing wide income and wealth inequalities, and boost the growth of the economy (4).

Unemployment rate has been hovering around 10% in spite of an average growth rate of 6% between 2003 and 2008 and 7% between 2010 and 2017. In 2017 GDP grew by 7.4% and was at a fast clip in the first half of the 2018. Yet April 2018 unemployment rate was 9.6%; including disguised unemployment raises the rate to about 17%. In 2013, youth unemployment was almost 40%. Part of the persistent unemployment rate can be traced to the structural change that took place in the 2000s away from labor intensive and toward capital intensive sectors. In the wake of the 2001 crisis, the imperative to quash inflation and control government budget deficit meant tight monetary policy of high interest rates that appreciated the Turkish lira, made imports cheaper and traditional exports like textiles, clothing more expensive. Export sector became more import dependent and capital intensive, like automotive and consumer durables (5).

If quality of labor were reflected in educational attainment, Turkey's numbers would look good: Primary school completion rate was 95% in 1990, 99% in 2010, 92% in 2016. Secondary school enrollment rose from 51% in 1990 to 74% in 2000 to 84% in 2010 and 103% (includes overaged) in 2016. There are universities in every region providing access (6).

The largest growth of schools have been religious secondary schools rather than technology or science based schools. The Program for International Student Assessment (PISA) compares the 15 year-olds on mathematics, science, and reading. In 2015 Turkey scored in 420s putting it in the bottom fourth. These scores were lower than 2012 and 2006. OECD average was 490. Singapore scored the highest in all three categories, above 550 (7). Only 1% of the Turkish students performed at the top level compared to the 10% of OECD. Less than 20% of freshmen enroll in STEM fields (science, technology, engineering, mathematics) compared to 30% in OECD. Student-teacher ratios are twice as high in public schools compared to private ones. Public expenditure per student is lowest in OECD. Only 9% of 3-year olds are enrolled in preschool compared to 78% in OECD (8).

Labor productivity runs about one-third lower than OECD average and it is erratic. Third quarter of 2017 it grew by 6.51%; next quarter by only 1.68% (9). But in spite of the problems on the southern border and an attempted coup, the average rate of GDP growth between 2010 and 2017 has been around 7%. In sum, the labor resource is plentiful and underutilized providing opportunities for the future.

Capital

The resource capital includes tools, machines, equipment, buildings, infrastructure that allows the same unit if labor to produce more. In national accounts investments indicate replacement and additions to capital. In the past, a major impediment to capital availability was lack of financing. Opening the finance sector to foreign savings (globalization) removed the constraint of low domestic savings. Countries that have low private savings (income plus government transfers minus taxes minus consumption) and a government spending deficit (taxes below government spending) will have less resources for investment that increases capital. By running a trade deficit foreign savings can be attracted into the country in exchange for local assets like stocks, bonds, real estate. Since Turkey's full capital liberalization in 1989, the Turkish economy became highly vulnerable to short-term, speculative financial flows (10).

After the 2001 crisis, to fight chronic inflation and budget deficits both monetary and fiscal policy were kept tight. By keeping interest rates high foreign savings were attracted that overvalued currency and added to the current account deficit. Fiscal balance was achieved through indirect taxes that burdened the lower income classes more (11). In 2017, private savings were 23% of GDP, public savings 2%, and foreign savings (current account deficit) 5%. Private investments were 26% and public investments were 4%. Construction occupies a much higher percentage of investment compared to other OECD countries. During the last eight years its share in GDP rose from 12% to 17% (12).

If recently announced government subsidies to pensions were to increase household savings and Turkey could raise the ratio of exports to GDP from 23% to the level of Poland and Portugal (40%), current account deficits would shrink and the need for foreign savings would fall. Excessive foreign debt reliance of Turkish firms may have improved their productive capacity the last decade but operates as a constraint for future foreign savings (13).

Technology

Countries that can raise their per capita income from low levels to around $10,000 might find this threshold limiting if they cannot diversify into high technology exports and raise the value-added in their production process. The share of medium to high technology goods in manufactured exports reached 39% in 2017, up from 26% in 2012. However, this is still low to become technologically sophisticated.

Productivity gaps between the large and small enterprises are very large. In Turkey, small firms (< 10 employees) achieve about one-fifth of the productivity of large firms (> 250 employees), worse than peer OECD countries. Turkey also has a larger informal economy (27%) than peer economies. A higher percentage of Turkish firms (46% - similar to Portugal) utilize web sites and social media than Czech, Polish, or Hungarian firms. But all the compared countries use more software at the enterprise level (14).

Turkey's reliance on low-technology construction sector and indifference to STEM education increase the challenges for technological sophistication. Financial market liberalization and Customs Union with the EU may have discouraged foreign direct investment (FDI) and its accompanying technology. Between 2000 and 2004 Turkey received only $10 billion, one-third the amount Poland received (15).

Occasionally textbooks identify entrepreneurship as a separate category of productive capacity. If we include it under the quality of labor here, the basic idea is summarized by OECD as Turkish people being very entrepreneurial and willing to undertake risks compared to peer countries but the institutions to support the entrepreneurial activities lack behind. Creative outputs index that ranks countries according to innovation capabilities and outcomes puts Turkey behind Czech Republic, Portugal, and China but above Poland, Hungary, Malaysia, Thailand, Mexico, Chile, Russia, Indonesia, Argentine, Brazil, and India (16).

Natural Resources

Some textbooks list natural resources as a factor to include in the future success of the economy. True, natural resources are gifts that can enrich a population. However, in the nineteenth century they were the cause of colonial exploitation and in the twentieth century we noticed that countries without definite natural resource to cash on could have easy access through free trade. Many countries (Japan, South Korea, Singapore) flourished without a definite natural resource. In fact, there is a curse called Dutch disease that comes with a natural resource. Reliance on one resource, especially if its world price is up, can appreciate the currency making other exports uncompetitive and making the country depend on a single primary product, hence increasing risk.

Although Turkey has ample land resources and some energy sources, lack of enough oil and gas has been a source of lament. The main natural resource might be its coasts, archaeology, and museums. Tourism constitutes one-fifth of the export sector. However, future growth is threatened by environmental stresses.

Market Facilitation

In order to encourage entrepreneurship and investment, the risk-takers should be confident about the rules of the game, clear and exchangeable property rights, stable legal system, reliable courts, and efficient enforcement. According to Transparency International, Turkey was ranked 81st out of 180 countries in 2017 with a corruption perception score of 40. Its score has been consistently going down from 50 in 2013. In press freedom Turkey regressed from 99th in 2002 to 154th in 2012. Turkey's "rule of law" and "control of corruption" measurements were already lower than peer OECD countries but it has been sliding down further (17). The last five years saw increasing control of the courts and security forces by the regime.

For markets to operate to the benefit of the society, monopolies have to be broken and competition promoted to approximate perfectly competitive environment. The more monopoly power exists in local and national markets, the less economic benefits will be disseminated to the whole society. Unfortunately, when politicians claim to be business-friendly, they imply creating small or large monopolies. The basis of crony capitalism is to curry favors to loyal followers and shield them from competition.

Turkey's privatization efforts started in 1984 at a slow pace and accelerated in the twenty-first century. The government raised a total of $ 60 billion (18). State-Owned Enterprises can be subject to government intervention in hiring, firing, pricing, investments and can become economical burdens and sources of inefficiency. Privatizing them, if done transparently and with concern about the health of the future economy, can boost an economy significantly (19). However, the lure of political gain is too strong to keep the transparency strong.

In Turkey about 8.5% of GDP is spent on projects through public procurement. This amounts to one-fourth of public spending. More than hundred thousand contracts are awarded to small and medium size enterprises. Municipalities are the largest procurer, followed by State-Owned Enterprises and Ministry of Health. They constitute more than half of the contracts. In order to minimize politicization and corruption, international organizations that had leverage over Turkey (EU, IMF, WB) all pressured to pass a Public Procurement Law that established an independent entity, emphasized transparency and allowed channels of complaints. The law was prepared before AKP won the 2002 elections and the pressure forced the parliament to pass it by 2003. However, from the beginning, AKP saw the public procurement as a vehicle for political leverage and between 2003 and 2015 the law was amended 150 times to give more discretion to political and bureaucratic authorities. In a survey of contracts worth above one-million lira between 2004 and 2011 it was found that out of the 49,355 contracts about 3/4 were awarded through open auction, not considered corrupt. Of the remaining 13,467 contracts two-thirds were awarded to firms with direct or some affiliation with the AKP worth 55% of the contracts (20).

Macroeconomic Environment

Macroeconomic environment is inflation, unemployment, interest rates, exchange rates that can make the members of a society live their lives pleasantly or with difficulty. Government policies that achieve low inflation, low unemployment, low real interest rates, and stable exchange rates will contribute to the well-being of the common people considerably.

Turkey experienced back-to-back crises in November 2000 and February 2001. GDP shrank by 7.4%, wholesale inflation rose to 61.6%, the currency lost half its value, unemployment rose by 5% in two years, real wages fell by 20%. In the aftermath of the crisis, the reliance of the economy on the external finance meant protection of creditors that imposed contractionary monetary policy to raise interest rates to attract foreign exchange and limit the public sector to curb its reliance on external finance. Contractionary monetary and fiscal policies were successful in reducing consumer price inflation down to 6.5% by 2009 (21).

During the last five years inflation rate has been rising; it is around 16%, but nowhere near the rates in the past. Typical cure to inflation is raising interest rates, curbing credit, slowing the economy. After the 2001 crisis, especially with the urging of international organizations, Turkish Central Bank had acquired independence from the government. In accordance with the international experience, independence contributed to the control of inflation significantly. The new constitution, however, gives sweeping powers to the President including hiring and firing of Central Bank governors. If international experience is a guide, future Turkish inflation rates are expected to be high. The President is a believer of growth through construction projects and an enemy of high interest rates. If, as expected, the independence of the Central Bank is curtailed, future inflation will be higher because higher interest rates will not be implemented.

Instead of curbing household credit in September 2016, loan-to-value of housing loans, the maturity limit of consumer loans, and the installment limit of credit cards were increased significantly which gave a boost to housing demand and construction. At the end of 2017, there were still a million unsold housing stock units but state banks extended the concessional rates in Spring 2018 giving a boost to demand (22). According to a study published in 2016, current account deficit, corporate bank credit, private bank credit did not predictor severe crises in Turkey. The determinants were were (1) rise in global stock index by making foreign assets more desirable for foreign savings, and (2) increase in household credit (23).

Unemployment rate has been stubbornly high even during the high growth periods of recent past. Slowing the economy to combat inflation will push the rate higher. The Achilles' heel of the economy is the external debt.

Borrowing is not necessarily a bad thing. As long as the borrowing can generate income that can pay the interest and the principal and still has something left over, it is a positive sum game - everyone gains. If, however, as the local currency loses value, the debt keeps increasing and payments overwhelm the debtors, the game becomes a negative game - everyone loses.

In 2008, the external debt of Turkey was $281 billion, $52.5 billion of which was short term. From 2008 to 2012 external debt increased by $55.8 billion, $18.5 billion by the public sector and the remaining $37.3 billion overwhelmingly by financial institutions. Current account deficit running around 6% and mostly financed by portfolio investments and unrecorded capital inflows (net errors and omissions) exploded the short-term debt (24).

Corporate foreign currency debt is equal to 40% of GDP and for every $3 debt the corporate sector has only $1 assets. 85% of the debt in March 2018 was due by 2300 firms owing more than $15 million each and 50% by around 500 firms indebted by more than $100 million (25).

From late 2017 to early 2018 risky loans increased from 4% to 7%. Total debt (domestic debt + external debt) has been stable at 200% of GDP since 2010, comparable to OECD average. Turkish banks borrow foreign currency at low interest, convert to Turkish lira and lend at high interest. This is how Thai baht collapsed some twenty years ago.

Turkey is viewed more risky than the peer economies. By middle of 2018, Turkey's credit risk premium was close to 5%, while Mexico's was 3%, Chile's 1.5%, Poland's under 1%, and Czech Republic close to zero. Private debt-to-equity ratio is much higher than OECD, with non-financial firms having the highest ratio in OECD. Price earning ratio for Turkey during first half of 2018 was under 10. For Mexico it was 20; for Poland 13 (26).

Between July 25, 2017 and July 25, 2018 Turkish currency depreciated 36% against the USD (TRY 3.56 to TRY 4.83) (27). By August 17th the currency had depreciated another 25% (TRY 6.05). An open economy with increasing indebtedness will be hurt from depreciation in a major way. To pay the huge increase in external debt Turkey has to increase its exports, decrease its imports, curb consumption, raise savings not to undertake investments but to pay debt. And because imports are a major part of the economy, currency depreciation will make them more expensive, fueling inflation. All of these will impose huge pressures on the population.

Turkey has gone through severe crises in the past. The experience during and after the World War I was the severest of all. In the wake of these crises it did bounce back and sometimes fared rather well. The upcoming crisis will be weathered eventually, too. What is tragic is people who will suffer through the crisis have only one life to live. To condemn their only life to misery is the most satanic thing the leaders have done.

FOOTNOTES:

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