

The New Turkish Economy and EU Accession Talks

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Brief Analysis

Now that negotiations toward full Turkish membership in the European Union (EU) have begun, what are the prospects for the Turkish economy? In particular, could Turkey attract significant global investment and take off economically as happened in Spain, Portugal, and Greece in the 1980s and Poland, Hungary, and the Czech Republic in the 1990s when those countries negotiated for EU accession?

Background

Turkey has been proceeding toward membership in the EU since the 1963 Ankara Agreement between the EU (then the European Economic Community) and Turkey, which targeted both a customs union and full EU membership for Turkey. However, little progress was made towards integrating Turkey into the world economy until the early 1980s, under the leadership of Turgut Ozal as prime minister and later president. As that process advanced, Turkey eliminated capital restrictions and declared the Turkish lira a convertible currency in 1989. One of the most important steps was Turkey's entry into a customs union with the EU in 1996.

Yet for a long time, international investment in Turkey was dismal. In 1992, for instance, international investment amounted to just \$77 million, mostly in Turkish securities. Although Turkey has a dynamic economy with many potential opportunities, it lacked visibility in the international investment community and it was perceived as a high-risk emerging economy. Accordingly, Turkey was able to attract only "hot money" from short-term investors, who were attracted by the Turkish government's strategy of financing government debt with short-term borrowings, culminating in high inflation and high interest rates. This left the Turkish economy susceptible to sudden capital movements caused by "hot money" flows. The worst episodes were two devastating economic crises in November 2000 and February 2001, touched off by perceptions of political instability and corruption. These episodes forced the governments to face Turkey's economic problems, including fiscal mismanagement, corruption of the banking sector (and subsequent inability of that sector to meet financial obligations), and the need to undertake structural reform.

Postcrisis Progress

Accordingly, after 2001, Turkey embarked on a new economic program under International Monetary Fund (IMF) supervision. Reforms started by the coalition government, led by Kemal Dervis, who left the World Bank to become minister of economics, have continued under the current Justice and Development Party (AKP) government. Turkey has achieved macroeconomic stability by following tight monetary and fiscal policies; focusing on structural reform and privatization programs; improving public finance discipline; achieving transparency in budget expenditures; making the Turkish Central Bank fully autonomous; and cleaning up the banking sector. Inflation rates have dropped from the yearly average of 70 percent in the 1990s to less than 8 percent, its lowest level in thirty-five years. This has brought Turkey much closer to the EU's Copenhagen Criteria for newly entering countries, which at present set a maximum of 4 percent annual inflation. Symbolically, the new Turkish lira was instituted in January 2005, dropping six zeros from the old lira; the new lira is now worth \$0.73.

Meanwhile, due to lower exchange-rate risk and improved public confidence, interest rates have dropped from 49 percent in 2002 to 14 percent in October 2005. The decreasing interest rate has reduced the cost of the Turkish treasury's domestic borrowing. The government has used a budget surplus to pay off public debt. Turkey's ratio of public debt to gross domestic product (GDP) fell from 91 percent to 64 percent in 2005, coming very close to the Copenhagen goal of a 60 percent ratio.

In short, Turkey has already come close to satisfying the EU's economic criteria for membership, an amazing feat given that Turkey is obliged to meet these criteria only at the end accession talks, which are likely to continue into the next decade. Further, because of these developments, the private sector has become more dynamic. GDP rose 8.9 percent in 2004. Over the next three years, economic growth is forecast to average 5 percent per year.

Remaining Challenges

Despite Turkey's great strides since the crises of 2001-2002, the country still faces significant economic challenges.

Unemployment. Despite high growth, which has created many jobs in recent years, unemployment remains a major problem for the Turkish economy, standing at 9.1 percent in June 2005. Unemployment is particularly high in urban areas and among young people, reaching 22.5 percent among urban youth. Moreover, the fact that the agriculture sector employs almost 40 percent of the labor force, and with significant job losses expected in this sector during Turkey-EU accession talks, creating high employment will remain a serious challenging for the AKP government.

Trade deficit. Turkey's foreign trade deficit was \$29 billion in the first eight months of 2005, which is unsustainably high. Export growth is stagnant and imports are surging, driven by oil prices. Overvaluation of the new lira, especially as the euro depreciates against the dollar, is an important reason for this deficit. The surging foreign trade deficit is pushing up the broader current-account deficit (which also includes services, such as tourism); it is expected to reach \$21 billion in 2005, far above the government target of \$15 billion.

Regulatory environment. Despite increased financial transparency and recently accelerating deregulation efforts, Turkey remains more restrictive than most Western industrial countries in product and market regulations; state control; and barriers to entrepreneurship, foreign trade, and investment. These regulations constrain competition while reducing Turkey's competitive position and growth potential. Recent deregulation of the banking and agricultural sectors; electricity markets; and the oil, gas, telecommunication, sugar, and tobacco industries, in accordance with Turkey's efforts to move into convergence with the EU, have addressed these issues for some industries, but problems remain in gas distribution, agriculture, and other sectors.

Prospects for Attracting Foreign Investment

Since the December 2004 announcement that accession talks would begin in October 2005, Turkey has begun to benefit from the same boom in foreign investment seen by recent candidate countries such as Poland, Hungary, and the Czech Republic. In the first eight months of 2005, Turkey attracted \$2.9 billion in direct investment and \$3.3 billion in investment in stocks, impressive figures compared to a total \$13.7 billion in foreign direct investment in the previous decade. Further, in October 2005, foreign investors owned 66 percent of the value of shares on the Istanbul stock market, a record high.

Excellent prospects exist for attracting more foreign investment. In the 1990s, Ankara missed the international privatizations trend. However, during the first nine months of 2005, privatization revenues have topped \$15 billion, compared to a total of \$8 billion over the preceding twenty years. Having privatized Turk Telekom, the Turkish Petroleum Refineries Corporation (Tupras), and the Ereğli Iron and Steel Works (Erdemir), Turkey is seeking to privatize the Petkim petrochemical producer, Turkish Airlines, ports, cigarette factories, the Turkish National Lottery Administration, power distribution companies, power generation firms, and others. If the planned privatization agenda is completed, Turkey could easily achieve foreign direct investment inflows of more than \$20

billion in 2005-2007.

Meanwhile, international banks are showing great interest in Turkey. Today, most private Turkish banks are either in alliance partnerships or in negotiations with mostly European banks. For instance, HSBC purchased Demirbank; BNP-Paribas bought 50 percent of the Turkish Economy Bank; and UniCredito purchased 50 percent of Kocbank. The new banking situation offers good prospects for small- and medium-sized enterprises, which make up the majority of Turkish private firms but which have in the past had little access to bank financing.

To be sure, there is more room for Turkey to improve its investment climate by amending the tax codes, reforming the public sector to increase governmental transparency and diminish bureaucracy, removing regulations that block economic growth, and restructuring trade regulations.

Overall, Turkey has the capacity to receive long-term commitments from global investors, bringing in fresh capital, technology, and management skills while creating employment. Turkey has an excellent growth potential and a strategic location between the European, Central Asian, and Middle Eastern markets. By the time the EU negotiation process ends in the middle of the next decade, Turkey will be a substantially more prosperous country.

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