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Turkey: the most European among the emerging markets

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Turkey is often evoked as a classic example of the midsize emerging market, a phenomenon which most probably will leave an important imprint on the character of global economy in the 21st century.

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Indeed, Turkey as other emerging markets possesses strong points but also faces serious challenges. Its rise in coming decades can be even more spectacular than expected. On the other hand, Turkey can fall into the middle income trap and remain for ages an emerging market. Currently, Turkey finds itself between economies driven by low costs of labor and the most developed ones competing in the global arena through innovativeness.

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Nevertheless, Turkey stands out among the emerging markets because of its unprecedented economic ties with the EU. What is more important, Turkey is the most European among the emerging markets in regards to the structure of its economy. Last but not least, Turkey shares particular similarities with the Central European economies.

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An increase of economic cooperation between Turkey and the EU would be highly beneficial for both sides, a classic win-win situation. Deepening of the economic cooperation with the EU can boost Turkey's competitiveness by increasing its innovativeness. On the other hand, similarities of economic structures make Turkey and Central European countries natural partners in a process of catching up with the most developed world.

Over the last couple of years the acronym BRIC, whose members Brazil, Russia, India and China have been recognized as the largest emerging economies, has made a furor in the world. The BRIC's rise has resulted in a tectonic shift in the global economic order. However, focusing on the rise of China or India, we should not underestimate a phenomenon taking place behind the giants in the second league: an emergence of midsize economies. The most indicative exemplification of the above mentioned phenomenon was the establishment of the G-20 - a group of the world's twenty major economies and the coining of the new terms or abbreviations by firms such as the Goldman Sachs, PricewaterhouseCoopers or the Economist Intelligence Unit, aimed at describing the emergence of midsize economies (the Next-11, CIVETS, MIST). Certain midsize economies were even put in the same basket with the BRIC countries (the E-7) or with some of them (TIMBI- Turkey, Indonesia, Mexico, Brazil and India). Turkey as an economy whose GDP PPP approaches 1,2 trillion USD is a classic example of the emerging midsize market due to its "membership" in all of the above mentioned groups. Besides Turkey, only Indonesia has such a status. However, Turkey distinguishes itself because its GDP PPP per capita (15.3 thousand USD) exceeds decisively the average national per capita income of the emerging market economies. Moreover, Turkey's GDP PPP per capita is closer to the EU average than to the national per capita income of most of emerging markets. In fact, Turkey locates itself somewhere between the most developed economies and the emerging markets. The term "between" describes also the stage of development of the Turkish economy very appropriately. According to the Global Competitiveness Index 2013-2014 Turkey finds itself between a group of economies whose growth is driven by the low costs of labor and the group of economies whose competitiveness is based on the innovativeness.

In next coming years Turkey has to undertake a great leap forward and catch up with the innovation-driven economies. An alternative will be a fall into middle income trap.

During the last decade, Turkey achieved an impressive progress (a glass half full) but it still copes with serious shortcomings (a glass half empty). By default, current state of Turkish economy gives a mixed picture: on the one hand, a lot of hope in the further rise, but on the other hand, substantial worries concerning the sustainability of the Turkish economic "miracle".

A glass half empty

Turkey differs from Asian Tigers as far as macroeconomic sustainability of its economic development is concerned. In the case of Tigers, their raise was based on high level of savings and investment rate, huge foreign exchange reserves and current account surplus. Turkey's foreign exchange reserves constitute around 15% of its GDP. Gross national savings are equal to less than 15% of GDP and last but not least, the total investment rate exceeds slightly 20% of GDP. Turkey also has to cope with the structural and high current account deficit. In recent years it has oscillated averagely between 5 and 7 % of GDP. One of the main sources of the deficit is Turkey's dependency on the energy import. Around 70% of the energy consumed by Turkey comes from abroad. Consequently, in 2012, the cost of energy inflows reached 25% of the value of imports. By default, Turkey remains strongly exposed to the risks associated with a sudden increase in energy prices. Turkey tries to decrease its dependency on the energy export by implementation of the energy strategy that includes: a decision to construct two nuclear power plants and a huge refinery, development of domestic energy resources (renewables, coal, shale gas) and infrastructure (power plants, pipelines), increase of energy efficiency and liberalization of the electricity and gas market. Nevertheless, taking into consideration the long-term nature of these measures, they are unable to reduce Turkey's dependence on energy import in the medium term.

Turkey is forced to cover the big current account deficit and the gap between investment and savings with an inflow of hot money (portfolio investment) and a fast credit growth of private sector. In consequence, the external imbalances increased significantly and their short-term financing makes Turkey vulnerable to sudden changes in global investor sentiment. Short term external debt plus external debt payments are around 1,5 larger than foreign exchange reserves of Turkey and its sovereign-wealth-fund assets.

> In September 2013, The Capital-Freeze Index powered by the Economist Intelligence Unit recognized Turkey as the emerging market most vulnerable to sudden stop in capital inflows.

(The Economist used following variables: current-account balance, credit growth, short-term gross external debt and external debt payments as percentage of reserves and financial openness).[1] Vulnerability of Turkish economy confirms also fluctuations of the 10-years bonds of Turkey. They failed from almost 19 points in 2008 to a record low level of 5.1 in May 2013 but increased to 8.8 in following months. The exchange rate of the Turkish national currency (lira) has fallen down versus the US dollar more than 10% between January 2013 and November 2013. This depreciation gives another evidence of Turkish economy's volatility. Summing up, in the short term, the Turkish economy could be held back by the increasing costs of financing of its debts – whether because of lira weakening or the rise of interest rates.

[1] The Economist, The capital-freeze index, 19.09.2013. http://www.economist.com/news/finance-and-economics/21584993-which-emerging-markets-are-most-vulnerable-freeze-capital-inflows-stop

On the other hand, Turkey faces also serious long term challenges related to the social and political spheres. The economic activity rate in Turkey is one of the lowest in Europe. It exceeds slightly 50%. It is particularly low among women. Their economic activity rate does not exceed 1/3. The agriculture sector comprises 25% of the employment. The contribution of this sector to the GDP- below 10%- shows that its efficiency is rather modest. The informal economy accounts for more than 25% of Turkish official GDP which is a substantially higher indicator than in case of the EU average. More than 35% of labor force still works in that sector. Another challenge to the sustainability of Turkey's economic development stems from its insufficient political stability. According to the Index of Failed States 2013, the internal situation in Turkey has been evaluated as between warning and stable. In Europe only Belarus, Bosnia, Moldova and Russia obtained slightly worse scores. An unresolved Kurdish issue and deep political polarization of Turkish society create the main challenges to the political stability and indirectly to the economic development.

Turkey is also lagging behind with regard to the innovativeness of its economy. According to the Innovation Union Scoreboard 2013 published by the European Commission Turkey got the worst score after Bulgaria. The EU average is 0.544 and in case of Turkey it is 0.214. The low level of innovativeness is correlated with a rather poor quality of education. The enrollment rate of 15-19 year-olds has more than doubled in the last decade from 30% in 2001 to 64% in 2011 but is still well below the OECD average of 84%. The compulsory education was extended from 8 to 12 years only in 2012. Participation in higher education remains low by international standards.

A glass half full

Despite all above mentioned hurdles, Turkey achieved an impressive pace of the economic growth since 2002 which resulted in a substantial advance of Turkish society. Between 2002 and 2007, the Turkish economy grew at an annual rate of more than 7%.

> After a slowdown in GDP growth to just 0.6% in 2008 and a subsequent contraction in 2009 (-4.6%), the Turkish economy strongly rebounded with 8.8% growth in 2010 and 9.2% in 2011, respectively.

In 2012 the pace of growth slowed down to 2.2% and almost 4% in 2013. According to the IMF projections Turkey will grow at the average rate 4.5% between 2014 and 2018. Taking into consideration the conservatism of the IMF estimations in the past decade, it can be expected that Turkey will outperform and achieve a higher pace of growth (slightly above 5%). The pace of development of infrastructure was particularly impressive in the past decade. For instance, between 2002 and 2012 Turkey constructed almost 5700 km of motorways and state highways (dual carriageways). By comparison, in the same period Poland managed to build 1,500 km of highways and expressways.

Turkey's macroeconomic improvements in certain spheres were also truly spectacular. After the crisis in 2001 the Turkish banking system underwent a very comprehensive reshuffle. According to the Progress Report on Turkey 2013 published by the European Commission, since 2001 "the financial sector has performed well and has continued to demonstrate resilience".[2] The foreign exchange reserves increased almost 60% between the end of 2011 and the middle of 2013. Turkey's public debt burden has fallen since 2002 by around 40 percentage points from almost 80% of GDP to around 35% and it is expected to decline further. Turkey's gross foreign debt is relatively low. It slightly exceeds 40% of GDP. Between 2001 and 2012 the inflation decreased from almost 70% to 6%, though it is still above the world's average. The proportion of informal sector vs. the official GDP decreased from 32% in 2003 to 27% in 2012. Turkey has attracted an unprecedented inflow of FDI since 2005. The FDI stocks increased from almost 11% of GDP in 2004 to around 25% in 2013. Certainly, the vulnerability of Turkish economy to sudden stop of capital inflows is worrying. However the Turkish economy would derail only if the negative coincidence of several factors occurs, a scenario that is not highly probable.

Daniel Domby, a correspondent of "the Financial Times" in Turkey, rightly points out on his blog:

> "The private sector accounts for about $140.5bn of the total [external debt ($164.5bn)-AB]. Seen from another angle, banks (including state banks) owe about $93bn and the rest of the corporate sector (including non-bank financial institutions) about $63bn. [..]The big totals can be sliced and diced with relative ease. Take the banks. Almost $24bn of their short-term debt corresponds to accounts in branches and affiliates abroad and $10bn to foreign exchange accounts (which are easy to open in Turkey). It is true that the biggest single component of the banks' short-term foreign debt is $44bn in credits, reflecting in part their habit of getting financing from international banking syndicates. Still, Turkish banks are well capitalized and no-one at present is suggesting they are not going to be able to roll over their debt (rather than having to pay more interest on it). Instead, some economists say, the corporates are the concern. So what of them? In fact, $33bn of the non-bank sectors' debt is due to trade credits and another $7.5bn corresponds to affiliates abroad. Neither category necessarily sends out warning flags and, if both are subtracted from the non-banking sector's short-term FX debt of $63bn, it leaves around $22bn to $23bn – not such a scary number. The picture one is left with is not of the Turkish private sector pushed to the brink because of its dollar liabilities – though individual companies could still find themselves in that position."[3]

[2] The European Commission, Turkey Progress Report 2013, http://ec.europa.eu/enlargement/pdf/key_documents/2013/package/tr_rapport_2013.pdf

[3] Daniel Dombey, Turkey's short-term debt: it's big, but how problematic?, 24.09.2013 http://blogs.ft.com/beyond-brics/2013/09/24/turkeys-short-term-debt-its-big-but-how-problematic/?Authorised=false#axzz2l8IP9tPK

In consequence, Turkey's credit ratings have been increased by rating agencies in recent years. In November 2012 Turkey received its first investment-grade rating in 18 years from Fitch Ratings. In March 2013 the S&P raised Turkey to just below the investment grade. Moreover, in May 2013 Moody's lifted Turkey's government bond ratings by one step to the lowest investment grade. It was Turkey's the first investment-grade rating from Moody's in almost two decades. Currently, the rating agencies maintain the stable outlook for Turkey.
As far as education is concerned, Turkey is amongst few countries who achieved an impressive score improvements in the recent decade in the PISA, a worldwide study by the OECD evaluating a performance of 15-year-old school pupils on mathematics, science, and reading. Turkey's score in mathematics rose from 423 in 2003 to 445 in 2009. Meanwhile, science score increased from 434 to 454 and reading score from 441 to 464 in the same period. According to Naveed Hassan Naqvi who is a Senior Education Economist at the World Bank:

"Our analysis finds that Turkey's performance in PISA is higher than would be predicted, taking into consideration its level of economic development and income. At around 450, Turkey's PISA scores in reading, math, and science are better than average, when its level of GDP per capita is taken into account. The average PISA score of Turkish students in 2009 was approximately 10 points above that predicted by its income level. This performance looks even more impressive once the socioeconomic level of students, as well as the level of per capita GDP, is taken into account. By factoring this in, Turkey achieves almost 70 PISA points above average. In fact, in these terms, Turkey's performance is nearly the highest among the 65 participating countries, on par with Korea or Singapore."[4]

[4] Naveed Hassan Naqvi, Closing the Gap in Turkey: Evidence of Improved Quality and Reduced Inequality in an Expanding Education System, 17.07.2013 http://blogs.worldbank.org/education/closing-gap-turkey-evidence-improved-quality-and-reduced-inequality-expanding-education-system

Taking into consideration the level of socio-economic development, Turkey is also outperforming with regard to the quality of higher education. Five Turkish universities founded a place in The Times Higher Education World University Rankings 2013-2014 powered by Thomson Reuters (the highest rank 199, the lowest grade 276-300). By comparison, only one Polish university managed to be admitted to this exclusive club (the place 301-350). An impressive pace of growth can be noticed also in the R&D sector. According to The Innovation Union Scoreboard 2013 between 2008 and 2012 the Turkish growth rate approached 3.6%.
By comparison, the EU average was 1.6%. Only three member states of the EU experienced the faster pace of growth.
The Turkish economy achieved also an important progress in labor market. The labor force has increased around 5% since 2009, particularly strong growth can be noticed among women. The labor productivity per person employed increased in Turkey in comparison to the EU 27 average from less than 50% to almost 72% between 2002 and 2012.
By comparison, Poland, even though it is substantially richer than Turkey, has a minimally higher rate and its pace of growth was considerably slower. The share of agriculture sector in the employment in Turkey decreased from almost 42% in 1999 to 25%. The employment in informal sector fell down from 48% in 2005 to 37% in 2013.

Turkey and the EU: still important

Turkey's performance in the long term will strongly depend on its ability to strike a proper balance between the necessity to reach out to non-European emerging and growth leading economies and on the other hand to maintain strong economic cooperation with the most developed parts of the world: the US, Japan and especially the EU. Despite the tendency to suggest a decline of the EU's relevance for Turkey, the relations with Europe still have an enormous importance for the Turkish economy. The EU remains Turkey's most important trading partner, even if its share in the Turkish trade in goods fell from almost 55% in 2003 to less than 40% in 2013. The EU share in the Turkish trade service in 2011 exceeded 55%. According to the World Tourism Organization, tourism generates indirectly and directly approximately 10% of Turkey's GDP. The EU tourists' share in the number of arrivals approaches 55%. Their contribution to the revenues coming from this sector is even higher. What's most important, the EU constitutes the main source of the recent FDI inflow to Turkey, with a share in the FDI stocks surrounding 75%. The inflow of the FDI has a key importance for Turkey's economic stability and even more importantly, it contributes greatly to the increase of Turkey's innovativeness (transfer of technologies and R&D). In the context of further rise of Turkish innovativeness, it should be remembered that the EU consolidated in recent years its position as the number one destination for the Turkish students studying abroad and the second one after the US for the Turkish scientists working on the foreign universities and research centeres.

After the euro zone crisis, distancing from the EU as a declining economic power became quite fashionable in emerging and dynamic Turkey. Some Turkish politicians or experts positioned Turkey as a per se different economy from the European markets. However, economies of the Central European members of the EU are among few most similar markets to Turkey's economy with regard to structure, advantages, level of development and challenges.

> It is very indicative that the IMF puts Turkey in the category of Central Eastern Europe together with Bulgaria, Croatia, Hungary, Latvia, Lithuania, Poland and Romania.

In fact, the Turkish GDP PPP per capita is slightly higher than Bulgarian or Romanian one and Turkey locates itself on the global ladder of national per capita income just behind Latvia, Croatia, Poland and Hungary.

> Poland as a middle income country with the size of GDP measured in the PPP exceeding 800 billion USD is particularly similar to Turkey.

Turkey has also very similar credit rates to several Central European economies (Bulgaria, Croatia, Hungary, Latvia, Lithuania and particularly Romania).

When it comes to strong points, in past decade the pace of growth of some Central European countries was on more or less the same level as Turkey's one. Moreover, the performance of some of the Central European countries (i.e. Lithuania, Latvia, Slovakia) will be probably just slightly slower than the Turkish growth rate. The IMF projections suggest that in coming years the Central Europe's growth will be slower than Turkey (the average growth around 2,5%) ,but it will still grow much faster than the Western Europe.

As far as challenges are concerned, Poland, Romania and to a lesser degree Hungary occupy positions just after Turkey in the above mentioned Capital-Freeze Index. Turkey struggles with relatively low level of total investment and savings like many of Central European countries do. The size of Turkish informal economy locates Turkey almost in the Central European average. For instance, the Polish informal sector accounts for 25% of official GDP. The Central European countries have also considerable problems predominantly with the low level of economic activity rate. The percentage of labor force often varies between almost 55% to below 60%, slightly exceeding the Turkish level. Romania distinguished itself by an even larger share of the agriculture sector in the employment than Turkey's percentage. Meanwhile, Poland and Croatia possess also huge agricultural sectors (the share in employment at the level of 12-14%). Turkey shares serious shortcomings with the majority of Central European countries concerning the insufficient innovativeness of their economies. In the Innovation Union Scoreboard 2013 Turkey occupied a place just behind Romania and Latvia, chasing Poland and Lithuania. On the other hand, the fast growth rate of innovativeness puts Turkey in the same basket with Latvia, Lithuania and Slovakia.

Summing up, Turkey should perceive the EU not only as a source of FDI or as the most important trade partner but also as an organization that Central European members can establish a close cooperation with Ankara due to geographic proximity and common fate (challenges and advantages), which would be beneficial for both sides: a classic example of win-win situation.

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