



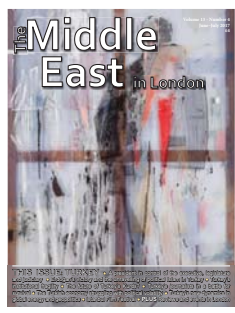
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June - July 2017

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# The Middle East in London

**THIS ISSUE: TURKEY** • A president in control of the executive, legislature and judiciary • Erdoğan's victory and the unravelling of political Islam in Turkey • Turkey's institutional fragility • The future of Turkey's Kurds? • Turkey's journalists in a battle for survival • The Turkish economy struggling with political volatility • Turkey's new dynamics in global energy and geopolitics • Istanbul Film Festival • **PLUS** Reviews and events in London



İrfan Önürmen, *Pose (detail)*, 2016. Textile materials, acrylic and layers of tulle on stretcher bar, 225 X 160cm. Courtesy of C24 Gallery and the artist

# The Middle East in London

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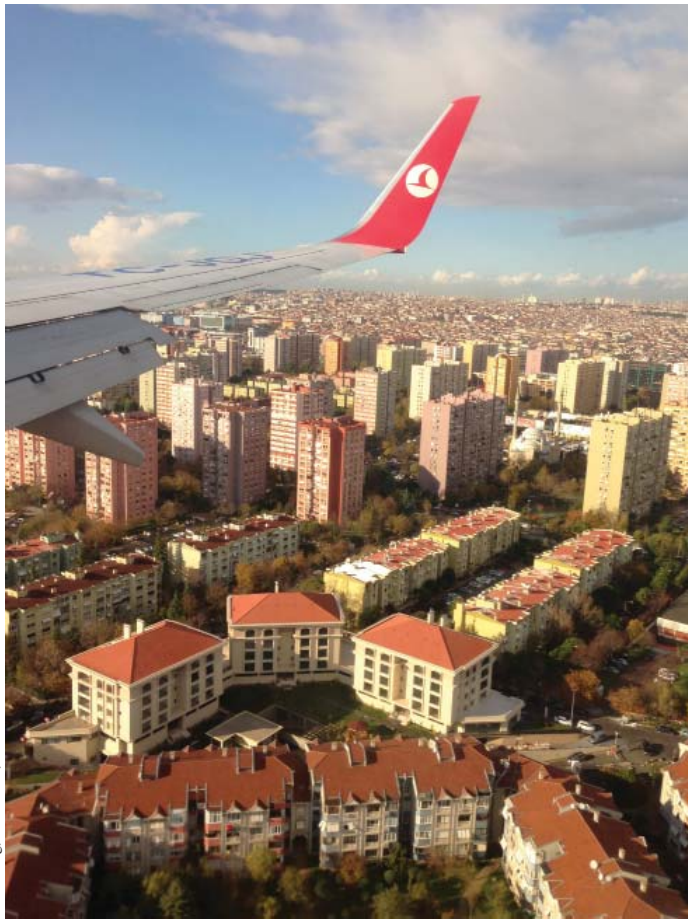
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**Mina Toksöz** explains why Turkey's current economic policy-mix is untenable in the long term

# The Turkish economy struggling with political volatility

Turkish Airlines flying over Istanbul. Photograph by LWYang



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Since 2015, the Turkish economy has had to cope with two general elections in rapid succession, the 2016 attempted coup in July and its fraught aftermath, and multiple terrorist threats. Yet, according to the latest data, the Turkish economy achieved a 2.9 per cent real GDP growth in 2016. According to the government, prospects in 2017 are positive: the recovery seen at the end of 2016 from the third quarter contraction is expected to continue with stronger EU growth supporting exports. Despite the damaging anti-EU political rhetoric from some Turkish ministers, the economic team has pledged to deepen economic relations with the renegotiation of the Turkey-EU Customs Union. Meanwhile, low international oil prices and a slow rise in US interest rates are expected to help manage foreign payments pressures – especially corporate debt repayments. Moreover, business mostly welcomed the depreciation of the lira for reversing its

real appreciation during 2003-2010. Thus, barring a major global financial crisis, the short-term outlook seems positive.

However, as seen in previous years, Turkey's geography and internal tensions pose risks to this benign outlook. Externally, potential mismanagement of the Syrian crisis, a sharp break in political relations with the EU or the unpredictable nature of the Trump administration in the US could all negatively impact the Turkish economy. Internally, political volatility was set to persist irrespective of the outcome of the April referendum on presidential powers. This is due to a constant 'election mode' mentality and the entrenched political rhetoric against common internal and external enemies – a feature of the Justice and Development Party (AKP) strategy designed to ensure the party remains in power. Another two referenda, one on the EU and another on capital punishment, are already being discussed.

In the face of this political instability,

economic policy is forced to be reactive to try to overcome domestic and regional shocks and the frequent crises with trading partners. This was amply demonstrated after a Russian fighter jet was shot down in 2015; as a response Russia temporarily banned tourist charter flights to Turkey. This negatively affected the tourism sector, which accounts for 13 per cent of export receipts. Macro-economic policy has mostly aimed to offset shocks to growth and to buy votes by offering consumer, credit and investment incentives. The downside of this policy stance includes chronic currency depreciation and rising inflation.

Political risk and a large foreign payments gap (around 25 per cent of GDP) keep the Turkish lira under pressure. Despite the tightening of monetary policy, inflation topped 10 per cent for the second month in March due to depreciation (its effects on import prices and hence on overall prices) and periodic fiscal stimulus. Monetary policy is caught between international markets seeking more decisive action and domestic political pressures to maintain growth. The central

*Economic policy is forced to be reactive to try to overcome domestic and regional shocks and frequent crises with trading partners*

*In the long term, a growth model less reliant on domestic demand and, given the low savings rate, less reliant on capital inflows is necessary*

bank seems to be trying to dampen speculative volatility while accepting lira depreciation caused by global forces, such as fluctuations in the US and capital flows. Meanwhile macro-prudential policy is used to manage the domestic impact of the weaker currency. Given Turkey's limited foreign currency reserves, this is not an unreasonable position. However, in order to work, rather than repeatedly resorting to a populist fiscal stimulus to overcome political shocks, it needs a tighter fiscal stance to contain the pass-through of currency depreciation on inflation.

The other weakness of the current policy-mix is that growth has been driven by domestic demand since the global financial crisis. This has been accentuated by the slowdown in the global economy and the negative impact on Turkish exports of regional conflicts. This has led to an accumulation of potential financial imbalances. Credit has grown rapidly; relative to GDP it has almost doubled in the past decade to around 80 per cent. There is more scope for credit growth in an economy the size of Turkey's, but its rapid pace holds risks in cyclical sectors such as construction and property. Although the public debt is low, the increasing state-investment guarantees associated with the long list of mega-infrastructure projects suggest that contingent liabilities need monitoring. Downgrades of Turkey's hard-won investment grade sovereign ratings in 2016 cited weakened institutions and policy effectiveness as risks.

**...taking a leaf out of China's book**

More broadly, economic policy seems likely to follow the new global trends – more statism, crony capitalism and selective protectionism – while politics continue in an authoritarian direction. Taking a leaf out of China's book, there is more emphasis on import substitution through domestic content rules, pressure on foreign investors to share technology,

and the provision of credit incentives via the newly established Credit Guarantee Fund. These are policies that are found in the agendas of Asian-style developmental states. However in Turkey, as seen in Asia, where the state steps in business circles which are close associates of the AKP follow – bringing with them increased governance problems and corruption.

**...and needing a new growth model**

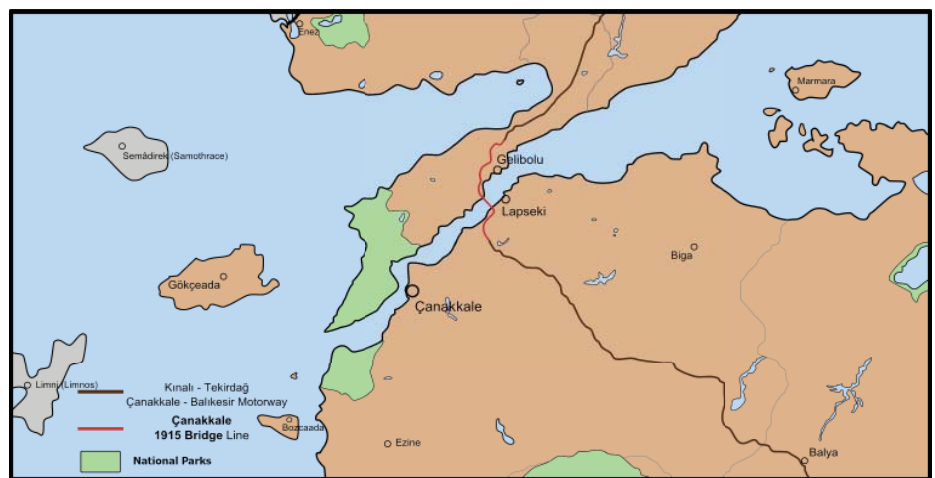
The Turkish economy's resilience to volatility is based on several structural strengths. These include its large internal market, diversified economy, relatively well regulated banking sector, and low public debt. Growth will also be supported by the large infrastructure investments in energy, transport and health that are expected to be funded by PPP-type project finance, Islamic finance and the new Turkish Wealth Fund.

Yet, in the long term, a growth model less reliant on domestic demand and, given the low savings rate, less reliant on capital inflows is necessary. Drivers of growth need to change from extensive growth (more resources used in the same way) to higher productivity/higher technology growth, possibly led by strategic sectors such as the defence, automotive, transport, telecoms, engineering and logistics industries. One way of achieving this, as suggested by a recent OECD report on the Turkish economy, is via increased global integration with global value chains (GVCs) to overcome the 'middle income trap'.

With per capita income stagnating at around \$10,000 for the last decade, the government has taken these suggestions on board. Using extra powers available under Emergency Rule in the fraught political atmosphere of 2016, the government of Prime Minister Binali Yıldırım managed to pass a number of difficult structural reforms to convert Foreign Direct Investment (FDI) into GVCs. In December 2016 this included intellectual property rights legislation that had languished in Meclis committees since 2013. But passing legislation is one thing; implementing it is another. Technological upgrading to exit the middle-income trap is not merely a technical matter. It requires a complex combination of conditions, including improved competition and macro-economic stability. Yet Turkey faces persistent political and policy instability, and deteriorating trends in political accountability and the rule of law hamper competition. Under these conditions, upgrading to higher productivity is likely to be intermittently pursued and only partially achieved, even if the structural strengths of the Turkish economy support modest growth in the coming years.

*Dr Mina Toksöz is an Honorary Lecturer at the University of Manchester Business School and an Associate Fellow of International Economics at Chatham House. She is a specialist in country risk analysis. Her book The Economist Guide to Country Risk was published in November 2014*

Planned construction line for the North Marmara Motorway (Kınalı-Tekirdağ-Çanakkale-Balıkesir) and Çanakkale 1915 Bridge which will connect Europe and Asia. Image by BERKAYSNKLF



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