



# The Turkish Economy



## GENERAL OUTLOOK



Since the Second World War the Turkish economy has been transformed by the steady growth of industry and services. Turkey's economic growth rate has been one of the highest in the OECD.

In the early 1980s, Turkey launched a program of structural change and liberalization to alleviate the recession of the late 1970s. The program proved to be quite successful in terms of restoring economic growth, improving exports and reducing the inflation rate. Within this context, Turkey's economy grew by 7.5% between 1981 and 1985. However, since 1986, the achievements of the stabilisation program in question have been overshadowed by high inflation rising from gradually increasing public sector deficit.

Nevertheless, Turkey was able to realize an average growth rate of 6% during the period of 1985-1992. 1992 was the year in which economic activity recovered strongly from its stagnant condition of the previous years, which was largely the result of the Gulf crisis. Uncertainties and unfavourable external conditions related to the Gulf War led to a sharp contraction in economic acti-

vity. Its adverse effects on Turkish exports to the Gulf region are still a major problem. Expansionary policies pursued in 1992 and 1993 kept the growth rate relatively high, but created expensive macroeconomic imbalances. Briefly, the fluctuation in the economy till 1992 can be summarised as stop-and-go cycles, which were mainly initiated by domestic factors.

High inflation and the devaluation of the Turkish Lira resulted in difficult economic conditions for the year 1994. A series of negative developments such as rising interest rates, stagnation in credit markets, and volatility in foreign exchange, an unanticipated inventory build-up and a resulting contraction in domestic demand led the Turkish Government to introduce a Stabilization and Structural Adjustment Package on April 5, 1994.

The Government's main policy objectives for 1995 focused on public sector deficit reduction, which would subsequently alleviate inflationary pressures. Economic growth, as opposed to the significant contraction in 1994, resumed much faster than anticipated, experiencing an unexpected growth of 8% in 1995. This growth stemmed mainly from the revival of domestic demand.

The Turkish economy grew far more than expected in 1996. The rate of growth almost doubled the official target of 4.5% and equaled 7.1%. The expected rate of growth was relatively lower mainly due to two factors. First, it was supposed that the introduction of the Customs Union with the EU would slow down the rate of growth by

means of increasing competitive imports. Second and most importantly, general elections at the end of 1995 increased the possibility of putting the long-awaited stabilisation policies into effect via a new government. Imports, especially those of consumer goods, increased remarkably driven by a live domestic demand supported with expansionary policies, and the real growth rate remained high.

In 1997, GNP increased by 8.3%. Regarding the sub-sectors, industry was the best performing sector with a growth rate of 10.2%. This sector was followed by the services sector, which had a growth rate of 9.0%. While the construction sector growth rate reached 5.0%, the agricultural sector recorded a narrowing down of 2.2%.

The macroeconomic performance of the Turkish economy in the period of 1995-97 can be best described as strong output growth backed with fiscal expansion and an accommodating monetary policy. Strong domestic demand driven by a number of factors, including the role played by the large unrecorded economy and high interest rates on government securities held by the private sector, all contributed to the high growth performance.

In 1998 growth appeared to be slowing significantly mainly due to a contraction in private consumption and investment resulting from the economic crisis in the Russian Federation. GNP growth rate was realised at 3.9%.

Despite the positive signs of overcoming the effects of the Russian crisis at the beginning of 1999, the earthquakes of August 17 and November 12, continuing high interest rates and increasing domestic taxes deepened the declining trend in GNP. Thus, the growth rate was realised as -6.1% in 1999, which was the greatest decline observed in GNP since the years of the Second World War.

By the end of that year, taking into consideration the effects of high inflation and interest rates on Turkey's economic performance over the last 25 years, the government focused on an econo-

mic program which aims to free the country from inflation and enhance the prospects for growth and for a better standard of living for all parts of society. Thus, a disinflation and fiscal adjustment program was initiated on December 22, 1999 supported by a stand-by arrangement (SBA) with the International Monetary Fund.

The program rested on three pillars: Up-front fiscal adjustment, structural reform, a firm exchange rate commitment supported by consistent income policies. This firm exchange rate commitment and consistent income policies were needed to lead inflation and interest rates down more rapidly, particularly in the first phase of disinflation.

Within the framework of the program, GNP growth in the range of 5-5.5 percent in 2000, partly reflecting the rebound from the negative growth in 1999 was projected and in line with the measures, in 2000, a recovery was observed in the economy and GNP showed an increase of 6.3%.

Significant progress has been made towards achieving the program's goals. Following the second review, progress in the implementation of the undertakings has become more apparent. These results have been achieved through the strict implementation of the policies, which have garnered credibility in both domestic and international financial markets, as also reflected in upgrades by major credit rating agencies.

However, the crises experienced in November 2000 and February 2001 have increased the vulnerabilities of the economy and especially the banking sector and caused serious fluctuations with instability in the financial markets. A new package of measures named as "The Transition Program for Strengthening the Economy" is introduced in April 2001. Main targets and measures of the new program were to restructure the economy and achieve lasting stability. In spite of these efforts, in 2001, GNP in current prices was realised as US\$ 148 billion with a decrease of 9.5% while per capita income amounted to US\$ 2 160.

Despite some progress achieved through the

se stabilization programs, Turkey continued to face difficult macroeconomic and structural policy challenges, including a substantial public debt burden, high inflation, banking sector difficulties, and extensive state involvement in the economy. To tackle these problems, Turkish government has decided to adopt a new strengthened medium-term economic program and in January 2002, a new Letter of Intent was sent to IMF and a new Stand-by Agreement including 2002-2004 was demanded. Consequently, in February 2002 a new three-year Stand-by Agreement took place of the previous one. This new accord also included the floating currency policy, tight fiscal measures and structural reforms.

Thanks to commitment of government to the structural reforms and economic program, economy rebounded in 2004. In 2004, GNP reached to US\$ 299 billion with an increase of 25 %. This significant rise in the amount of GNP was mainly a result of increase in export production due to rising demand for Turkish products in international markets. Per capita income rose to US\$ 4 172 in the year 2004.

In 2004, Turkey realized 9,9% GNP growth rate driven by increase in private consumption and private investment in machinery and equipment. Turkey's growth rate reached to 9.9 % in

2004, the highest ever recorded in Turkey. In 2004, services with its share of 68.2% remained to be the most important sector in Turkish economy. Services sector was followed by industry, which has a 18.9% share in GDP. Agricultural production on the other hand, constituted 12.9% of GDP in 2004.

In 2005, the growth of GNP realized as 7.6 %, as lower than 2004 but still high in with respect to previous years. The GNP per capita also rose considerably from \$US 4 172 to high \$US 5 008 in 2005. With respect to sectoral developments, there has been growth observed in agriculture compared to previous year from 2.0 % to 5.6 %. But there was a slow down in industry growth rate from 9.3 % in 2004 to 6.5 % in 2005. There was slow decline of growth rate observed in services sector from 8.1 % in 2004 to 7.4% in 2005. The developments in monetary policy was also interesting as the new Turkish Lira experienced first year by 2005 and it was kept still strong with the exchange rates being almost stable throughout the year. However, this strong YTL did not ban the development of Turkish exports but increased the imports revealing higher foreign trade deficit. Nevertheless, this deficit was compensated with the support of the developments in other sectors like tourism.



## MAIN ECONOMIC INDICATORS OF TURKEY

	1999	2000	2001	2002	2003	2004	2005*
GNP (US\$ million)	185 266	201 439	148 215	180 892	239 235	299 475	262 452
Real GNP Growth Rate	-6.1	6.3	-9.5	7.9	5.9	9.9	7.6
- Agriculture	-5.6	3.8	-6.0	7.4	-2.4	2.0	4.6
- Industry	-5.1	5.6	-7.4	7.9	7.3	9.3	5.1
- Services	-8.3	6.5	-6.1	6.0	5.1	8.1	5.9
Per Capita Income (US \$)	2 879	2 965	2 123	2 598	3 383	4 172	5 008
EURO Exchange Rate (Annual Average)	-	-	-	1 435 000	1 687 000	1 773 000	1.586
US\$ Exchange Rate (Annual Average)	419 500	626 500	2 288 000	1 511 000	1 495 000	1 421 000	1.327

\* Turkish Lira was replaced by New Turkish Lira by 2005 as six digits of zeros deleted from the currency.

**Source:** Undersecretariat for Foreign Trade, State Institute of Statistics and State Planning Organization



## GDP BY SECTORS (at current prices, %)

	1999	2000	2001	2002	2003	2004	2005
AGRICULTURE	16.0	15.4	12.8	13.4	13.4	12.9	11.6
INDUSTRY	19.0	20.0	21.1	18.5	18.5	18.9	29.1
SERVICES	64.9	64.6	66.1	68.2	68.2	68.2	59.2
GDP(factor cost)	100.0	100.0	100.0	100.0	100.0	100.0	100.0

**Source:** Undersecretariat for Foreign Trade

## Customs Union with the EU

The Customs Union, which entered into force on January 1, 1996, constitutes the most important step for the modernisation of the Turkish economy and its integration into the world trade system. The Customs Union between Turkey and the EU is the most important development affecting the Turkish economy as a whole since the liberalisation measures launched in 1980. Simultaneously it constitutes a cornerstone in Turkey's relationship with the European Community which dates back to the 1960s. The framework of the Customs Union was drawn with the Ankara Agreement of 1963 and details were laid down by the Additional Protocol, which entered into force in 1973.

With the decision signed during the Turkey - EC Association Council meeting on March 6, 1995, Turkey completed the transitional phase in its integration with the EC as foreseen in the Ankara Agreement and Additional Protocol, and the final phase in Turkey-EU relations entered into force. After a transitory stage of 22 years, during which essential measures were put into force towards trade liberalisation and greater reliance on market forces, parties decided that conditions had been fulfilled for the establishment of the Customs Union.

The Customs Union covers only industrial and processed agricultural products. Traditional agricultural products are outside the scope of the Customs Union. Concerning processed agricultural products, the parties have agreed on the establishment of a system in which Turkey would differentiate between agricultural and industrial components of the duties applied on these products, similar to the model applied in the Community.

The main characteristic of the Customs Union is that industrial goods move freely between the

EU and Turkey without being subject to customs duties or quantitative restrictions. With the entry into force of the Customs Union, Turkey has eliminated all customs duties and charges having equivalent effect, as well as quantitative restrictions applied on imports of industrial products from the Community. For products imported into Turkey from third countries, Turkey started to apply the rates of protection specified in the Community's Common Customs Tariff, except for those products classified as sensitive. Custom duties on the sensitive products are eliminated beginning from January 1, 2001.

As a consequence of the Customs Union, the average of Turkey's weighted rates of protection through custom duties in industrial imports from the European Union and EFTA countries dropped from approximately 10% to 0. For products imported from third countries, the average decreased from approximately 15% to 5.6%. As the European Union applied further Uruguay Round reductions, Turkey's average rates for third countries were lowered again to 3.5%.

The definition of the Customs Union has evolved beyond the classical concept in line with improvements in the process of European integration. Turkey's adaptation to the Community's Common Commercial and Competition Policies has, therefore, a great importance for the proper functioning of the Customs Union.

In order to prevent any possibility of trade diversion, Turkey is now taking steps in order to adopt the EC's preferential trade agreements. In addition to the Free Trade Agreement signed with EFTA countries in 1992, Turkey has signed Free Trade Agreements with Israel, Romania, Hungary, the Czech and Slovak Republics, Lithuania, Estonia, Slovenia, Latvia, Bulgaria, Poland, Macedonia, Croatia, Bosnia-Herzegovina Palestine and Morocco. Negotiations with Egypt, Faroe

Islands, Lebanon, Albania and Tunisia are still continuing. Draft texts of agreements have been sent to Jordan, Malta, South Africa, Algeria, Syria, Chile, Mercosur, Serbia and Montenegro and Mexico.

These Agreements primarily aim at the establishment of long-term economic relations and the improvement of bilateral commercial relations. The economic growth of Turkey primarily depends on increasing exports through access into new markets, the improvement of present market access conditions and the diversification of export products. In this context, Free Trade Agreements are invaluable in carrying out these requirements for developing export performance. Moreover, these Agreements will enable the parties to create joint investment possibilities in third countries through the improvement of cooperation opportunities.

With regard to the adaptation of Turkish legislation to the EU Competition Policy, a great degree of progress has been achieved; laws on protection of competition and consumer protection as well as decrees on patents, copyrights, trademarks and industrial designs entered into force, and a Competition Authority has been appointed.

Turkey adopted other arrangements for harmonisation to the Community's Common Commercial Policy including common rules on imports and exports, inward and outward processing, standardisation of foreign trade and administration of quantitative restrictions. In this context, as an indispensable condition to prevent trade diversion towards the Community, Turkey had the obligation of adopting a similar system in her imports from third countries. Consequently, negotiations were started with 38 countries subjected to quantitative restrictions or surveillance measures by the EU. As a result of these negotiations

quotas have been introduced in the framework of a bilateral control system with 13 countries on the imports of some textile and ready to wear products, while quotas on the same product group have been introduced on a unilateral basis for 25 other countries. Imports of the same product group from 17 countries are under a unilateral surveillance system.

With these arrangements Turkey has taken important steps towards fulfilling its obligations not only for the Customs Union, but also in line with the conclusions of the Uruguay Round, and parallel to its policy of full integration into the world economy.

After almost 40 years from the beginning of bilateral relations, Turkey was granted candidate status to the EU at the Helsinki Summit (December 1999) in Finland. According to the decision, Turkey is a candidate state destined to join the EU, on the basis of the same criteria applied to the other candidate states. Within the framework of the candidate status, Turkey's adaptation efforts gain a new dimension with an enlarged perspective.

EU-Turkey Accession Negotiations launched on 3 October 2005. The Council approved a framework for negotiations with Turkey on its accession to the EU, as mandated by the European Council last December, thus enabling the negotiations to begin immediately after the meeting.

Turkey's accession to the European Union would mark perhaps the most significant enlargement so far, extending EU borders to Iraq, Syria, Iran and the Caucasus and bringing in for the first time a huge country with a largely Muslim population. Screening Process also started with EU immediately. Turkish experts from relevant ministries and institutions are ready to contact with European Union bureaucrats for the screening process.