



TURKISH INDUSTRIALISTS' AND BUSINESSMEN'S ASSOCIATION
WASHINGTON OFFICE

**AKP'S IMF DILEMMA
AS THE ECONOMY STAGNATES AND ELECTIONS APPROACH**

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The Justice and Development Party (AKP), the current governing party in Turkey, is at a critical point. On the one hand, the global economic crisis is slowing down the Turkish economy; on the other hand, AKP has to face an upcoming local election in March 2009. In Turkey, as well as in all other democracies, it is a proven fact that the majority of the voters prefer the candidates who appeal to their wallets. This was also the case in the July 2007 general elections, during which the AKP's popular support expanded to 47 percent from 35 percent. The factor that played a major role in this surge was the high economic growth seen in the period 2003-2006. However, today, the economy is stagnating with increasing unemployment rates and decreasing domestic and foreign demand. Until recently, the AKP government extenuated the impact of the global economic crisis in Turkey. They hesitated for a long time to sign a new stand-by agreement with the IMF, fearing that it would impose limits on populist expenditures. Finally, considering the dramatic loss of confidence observed among consumers and investors, the AKP government decided that the political cost of a non-agreement would be higher than that of an agreement, and it has made a compromise to sign an agreement with the IMF.

Leading Indicators Forecast Stagnation

Even before the global economic crisis, the Turkish Economy was stuck with a low growth rate. The growth rate was 3.5 percent during the second half of 2007 and 4 percent during the first half of 2008. These growth rates are usually considered low for developing countries like Turkey. The 7 percent growth rate seen in the period of 2002-2006 was not sustainable since it depended on domestic demand and an overvalued Turkish Lira. Therefore, the current account deficit inevitably grew and impaired high growth dynamics. In May 2006, the Turkish Lira lost 20 percent of its value. Increasing exchange rates triggered inflation. In order to reach its target inflation, the Central Bank of the Republic of Turkey was forced to impose an increase on interest rates as a shock therapy, which eventually slowed domestic demand. With lack of competitive power, Turkish exports decreased. Therefore the growth rate inevitably fell.

The growth rate fell to a mere 0.5 percent in the third quarter of 2008. This dramatic slowdown was caused mostly by the collapse of domestic demand. Private investments decreased by 10 percent and the private consumption increased less than 1 percent. The situation appears to be more serious during the 4th Quarter. It is clear that the Turkish economy has been shrinking. An 8 to 10 points decline in the consumer and real sector confidence index indicates the deepening of stagnation in domestic demand. Starting from October, the reduction in the European markets has affected the Turkish economy more severely than expected. On an annual basis, the industrial production dropped by 8.5 percent during October. The capacity utilization rate fell by almost 6 points in October and 10 points in November. During the last two months, exports decreased over 20 percent. The figures of the automotive industry, the engine of exports in Turkey, look very pessimistic. Domestic and foreign demand decreased by half. Large factories may go bankrupt, one after another, due to this demand crisis.

In the middle of October, YTL lost around 30 percent of its value against foreign currencies. We already know that the depreciation of YTL and unstable exchange rates affect investments negatively. We also know that the depreciated YTL boosts exports, decreases imports and therefore stimulates growth in the economy. It should be remembered that the 1994 and 2001 economic crises came through after the practice of such policies with high hopes of stimulating the economy. But this time, the situation is different. The currencies of all the countries that the Turkish exports compete with also lost value. Moreover, everyone is trying to export to shrinking markets, with the exception of China. Chinese Yuan, pegged to the American dollar, increased in value and the Chinese are trying to stimulate domestic demand. But, how much of the goods that Turkey used to export to Europe could be exported to China?

Unemployment is a great threat

The unemployment rates were rising right after the 2001 crisis, but we later observed a decrease, which lasted until last year. However, this decrease stopped last year, and now we are seeing an

increase in the unemployment rate again (Table 1). Moreover, it is expected that in 2009, the unemployment rate will accelerate further. Public opinion polls indicate that unemployment has become a top priority among social issues after terrorism and inflation rates. Unemployment, due to its structural elements, presents itself as a difficult problem to tackle. In addition to the structural factors, now we also have to face the impact of a negative business cycle. In the near future, unemployment may become a problem that threatens social stability.

A major indicator of unemployment is non-agricultural unemployment. In 2000, the non-agricultural unemployment rate was 9.3 percent and the unemployed were estimated to be around 1.4 million. After the 2001 crisis, this number reached approximately 2.3 million and has been around the same figure up to 2007. The unemployment rate dropped from 14.5 percent to 12.6 percent (Table 1). The major reason of this limited improvement, was not due to “growth without employment” like some argue, but due to an increase in the labor force.

Starting from 2004, high growth created about 1 million 680 thousand jobs in the following three years, excluding the agricultural sector. In return, the number of people working in the agricultural sector was reduced by 1.2 million. During these years, the reason why non-agricultural employment had very limited improvement was the high increase in labor supply. As a matter of fact, population growth, increase in the participation of women in the work force and migration from rural to urban areas led to a rapid increase in the labor force. During the period 2000-2007, the annual average increase was around 3.2 percent. In figures, this is an estimation of 550 thousand people. In order to stabilize the number of unemployed, it is necessary to create that many net jobs in the non-agricultural sectors.

How could this be done? The basic way is economic growth. In two research studies conducted jointly by TUSIAD and Bahçeşehir University Center for Economic and Social Research (BETAM), we estimate that, in order to create more employment in the next five years, an annual average of 6.5 percent economic growth in the non-agricultural sectors is needed. When we include the agricultural sector, the economic growth rate should be around 6 percent annually to meet the minimum requirements to fight against unemployment.

If the prices are stabilized; in other words, if the high interest rates fall, if the new reforms aimed at increasing efficiency are completed and if the Turkish economy can reach a competitive power that enables it to limit the current account deficit, then a 6 percent annual growth rate could be achieved. However, the Turkish economy is still too far from that point. My projection is that, in 2008, the increase in the non-agricultural employment will be around 250 thousand. If my projections are correct, in 2008, the number of unemployed will exceed 2.5 million and unemployment in the non-agricultural sector will rise to 14 percent.

In 2009, the economic situation will become worse. The IMF and the OECD countries, with optimistic outlooks, forecast that the recovery will begin in the second half of 2009. If this timing is correct, we could also expect the Turkish Economy to head towards growth around the same

time. Within an optimistic framework, this growth rate could go up to 2 percent; which implies practically a zero increase for employment. Even if we think that the work force will increase by nearly 550 thousand annually, the estimated number of unemployed will exceed 3 million, and the non-agricultural unemployment rate will exceed 16 percent possibly and reach a historically record level in 2009. Such economic developments will inevitably have devastating political and social implications.

High inflation does not allow Keynesian Economics

It does not seem plausible to end this economic crisis through foreign demand unless western economies, especially European economies, get out of this stagnation. What is left is domestic demand. Grievances such as: “Everyone is preparing expenditures packages to stimulate domestic demand. What are we waiting for?” are becoming more vocal each day. Could Turkey follow Keynesian monetary and financial policies? Hardly! We found ourselves in this global economic crisis before we paid our dues on past populist actions that increased inflation. The inflation rate is still around 11 percent, and the Central Bank of the Republic of Turkey has to reduce this rate to at least 9 percent in 2009. Otherwise, it will risk credibility and face even more complicated issues. The global deflation can only offset the inflationary impact of the exchange rate increase. Indeed, the domestic demand puts no more pressure on prices and this allows the Central Bank to relax monetary policy moderately. But, it is clear that monetary policy does not provide an answer.

Fiscal policies could not provide much of a solution either. At the end of the summer, the government, through a naïve thinking process, thought that the Turkish economy would not be affected by this economic crisis. Now they have a tight budget plan prepared. Although the 2009 budget plan with the assumption of a 4 percent growth rate is not credible, there is not enough room to increase the current account deficit fiscally, it has been forecasted as 1.2 percent. The ratio of public debt to GDP has improved in recent years and fallen to 30 percent. However, domestic real interest rates are still high at around 8 percent, despite the recent loosening of monetary policy. The cost of borrowing from international markets has increased as well. If the budget deficit increases, the ratio of public debt to GDP will increase again; this would, in turn, affect inflation expectations negatively. Exchange rates, and therefore inflation could get out of control. We may deepen the crisis when trying to battle stagnation through Keynesian policies.

The hardships of coming to terms with the IMF

The IMF stand-by agreement, which had been in effect since 2002, ended last May. It had been implemented successfully. In the following months, the government lost a considerable amount of time trying to figure out how not to sign an agreement with the IMF. However, the situation of the Turkish economy coupled with global stagnation would be far worse than what the AKP government expected. For this very reason, the AKP government started to consider coming to

terms with the IMF. The government became especially worried with the rapid depreciation of the Turkish Lira. The possibility of further depreciation of Lira and an increase of inflation forced the government to turn back to the IMF.

The central issue here is the fiscal conditions that the IMF will impose over the economy, which will cause AKP to lose votes at the upcoming elections. It is not a mystery that the IMF expects a revision of the unrealistic 2009 budget. I expect that the target growth rate will be withdrawn to 2 percent. Tax revenues will be in line with this growth rate. Since the IMF will be opposed to increasing the budget deficit, there will be cuts on spending. The question is: what expenditure items are going to be cut? Civil servant salaries and national defense expenditures cannot be reduced. What are left are the social expenditures, investments and funds intended for local governments, items that are critical for a government heading for elections.

Of course there is the option of not signing with the IMF if Turkey is ready to face a depreciating Turkish Lira. Additionally, considering the likelihood of a sharp drop in “hot money” inflows as well as hedge funds leaving the Turkish market, the Turkish economy may face serious problems financing current account deficit. With an optimistic calculation, I estimate that a minimum of 50 billion dollars are required to stabilize the 2009 balance of payments. It is uncertain how Turkey will generate this amount without loans from the IMF or, more importantly, in the absence of an agreement that would generate the badly needed confidence. The only option left is a very hard lending that will balance the current account deficit. “The hard lending” means a greater depreciation and a deeper recession.

With these options, AKP will lose more votes in the upcoming March 2009 elections. This explains why the AKP government has made a compromise and decided to work with the IMF after long hesitations.

Table 1: Labor force, employment and unemployment: 2000-2007

	Non agricultural labor force	Non agricultural employment	Non agricultural unemployed	Non agricultural unemployment rate (%)	Agricultural employment
2000	14293	12960	1332	0.093	7290
2001	14392	12607	1785	0.124	7591
2002	15251	13040	2211	0.145	6999
2003	15221	13121	2101	0.138	6724
2004	15758	13505	2253	0.143	6944
2005	16892	14595	2297	0.136	6093
2006	17439	15241	2197	0.126	5713
2007	17835	15588	2247	0.126	5601
2008	18406	15838	2568	0.140	

Source: TÜİK & BETAM