Ekonomi-tek Volume / Cilt: 1 No: 1 January / Ocak 2012, 41-61

The Turkish Economy after the Global Financial Crisis*

*Dani Rodrik***

Abstract

The global financial crisis has demonstrated that a financially open economy has many areas of vulnerability. Even when a country keeps its own house in order, it remains at the mercy of developments in external financial markets. So, one lesson to bear in mind is that policymakers need to guard against not just domestic shocks, but also shocks that emanate outward from financial instability elsewhere. To accomplish this, complete financial openness is not the best policy. A second lesson is that Turkey's prevailing growth strategy can neither be sustained nor generate enough employment. Therefore, it would be a mistake for the country to return to the *status quo ante* and resuscitate a model that fails to make adequate use of domestic resources. Most importantly, Turkey has to learn to live with a reduced reliance on external borrowing. The paper discusses the needed realignments in fiscal and exchange-rate policies.

JEL codes: F41, G01, G15

Keywords: Turkish economy, financial crisis, financial open economy, fiscal and exchange-rate policies.

---

* This is the revised and updated version of a paper prepared for the occasion of the 80th anniversary of the Turkish Economics Association. I thank Ercan Uygur for the invitation and for his suggestions and insights.

** Harvard Kennedy School, Cambridge, MA 02138.

1. Introduction

Turkey has emerged from yet another financial crisis. This one may not have been its own doing, but that has not lessened the pain. In fact, in many ways, Turkey was hit harder by the global financial crisis of 2008-2009 than by any of the previous instances of a sudden stop in capital inflows. And this happened despite the admirable resilience of domestic banks and the dramatic cuts in interest rates that the Central Bank undertook. Unemployment reached historic heights, and the drops in GDP and industrial output were exceptionally severe.

Macroeconomic instability has long been the bane of Turkey's economy. In the past, the culprits were easy to identify. One could blame irresponsible monetary policies, unsustainable fiscal expenditures, poor financial regulation, or inconsistent exchange-rate policies. It is to the country's credit that, as it came out of the 2001 crisis, Turkey succeeded in fixing these traditional sources of fragility. Monetary policy is now pursued within an inflation-targeting framework and governed by an independent Central Bank. Fiscal policy has been generally restrained, and the public debt-to-GDP ratio is stable or declining. Banks have strong balance sheets, and regulation and supervision are much tighter than before. The currency is floating. When it comes to macroeconomic management, Turkey has adopted all the best practices.

The crisis has demonstrated that a financially open economy has many areas of vulnerability. Even when a country puts its own house in order, it remains at the mercy of developments in external financial markets; crises and contagion are endemic in an era of financial globalization. So, lesson number one is that policymakers need to guard against not just domestic shocks, but also shocks that emanate outward from financial instability elsewhere. This has important implications for those responsible for deciding on the optimal degree of financial integration to aim for in middle-income countries like Turkey. In particular, it suggests that complete financial openness is not the best policy. A counter-cyclical approach to the capital account—encouraging inflows when finance is scarce but discouraging them when finance is plentiful—is needed.

A second lesson has to do with Turkey's growth strategy. The Turkish economy grew at quite rapid rates in the years before the most recent crisis, and it has quickly reverted to respectable growth rates following the rebound. This can be interpreted as the reward for the solid macro-economic policies pursued since 2001. However, there are too many disconcerting elements in this economic picture. In particular, domestic savings have fallen (instead of rising, as they should have done in an environment of increased macro-

stability and confidence), and unemployment has remained stubbornly high. The external deficit has kept on widening. Investment has remained lower than required. All of these factors put the sustainability of the economic boom into question. Even if the sub-prime mortgage crisis had never taken place, Turkey's traditional pattern of growth would have run into problems. Therefore, it would be a mistake for the country to return to the *status quo ante* and resuscitate a model that fails to make adequate use of domestic resources. Most importantly, Turkey has to learn to live with a reduced reliance on external borrowing.

I begin this paper by comparing the present crisis to the two previous ones (in 1994 and 2001) Turkey went through since having become financially globalized. By juxtaposing the trends in the major economic indicators during these three crises, we can discern common elements as well as important differences. The main point that emerges from this comparison is that Turkey is exiting the present crisis with a significantly higher level of unemployment and a greatly overvalued exchange rate in real terms.

Next, I present two growth narratives that differ in terms of the constraints they assume restrict the Turkish economy and thus have conflicting implications for policy. The first narrative views financing as the key constraint, while the second one emphasizes a profit squeeze in tradables. Depending on which of these one views as the dominant narrative, the resulting approach to adopt to the external accounts and exchange-rate policy would take very different forms. Unfortunately, a quick overview of the evidence does not allow a clear-cut conclusion to be reached, since the Turkish economy presents elements of both types of constraints. Nevertheless, it is possible to draw some broad policy conclusions, and I will close the paper with these.

2. How does the present crisis compare to previous ones?

Financial crises in emerging markets may be sparked by various causes, but they tend to follow similar scripts. They begin with a sharp turnaround in financial flows—what Guillermo Calvo has memorably called a "sudden stop." This drying up of credit, in turn, sets off a chain of events: the value of the domestic currency collapses; domestic banks are starved of liquidity, so they begin to call in their loans; and firms need to retrench and lay off workers. The economy needs to generate an external surplus in short order, which requires a sharp fall in domestic demand. This now adds a demand shock to the initial supply shock, and this further aggravates the cost to output. Eventually the depreciated currency helps revive demand for domestic tradables, the panic subsides, and capital begins to move in again.

Turkey has gone through three of these crises since it opened up its capital account in 1989. The first instance was 1994, when a misguided attempt to keep domestic interest rates low led to a sudden capital outflow. The second was in 2001, when a minor political crisis threw the sustainability of an exchange-rate-based stabilization program into question and led to a massive withdrawal of funds. And the third happened in 2008 as a result of the global flight to safety that the US sub-prime mortgage crisis sparked.[1]

Since the turnaround in capital flows was the instigator of each of these crises, it is useful to look at these episodes against the backdrop of the events that were roiling the financial markets. In the accompanying charts, I plot the time series for the three crises against a time scale displaying calendar quarters when peak amounts of inflowing funds occurred.[2] Financial inflows reached their peaks in 1993: I, 2000: II, and 2008: II, respectively, so these quarters are taken as t=0 for the three crises.

Figure 1. Net Financial Flows (% of XGS)

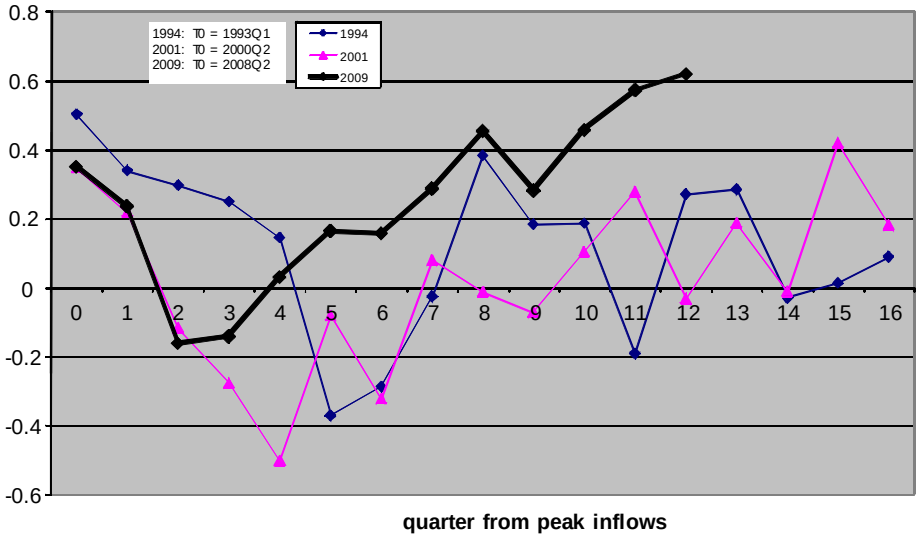


Figure 1 compares the patterns of financial flows during these three crises. It clearly shows that Turkey was a large net recipient of financial inflows at the onset of each crisis. At their peak, *net* inflows amounted to somewhere between 35 percent and 50 percent of the gross volume of exports of goods

[1] See Uygur (2010) for a detailed discussion of Turkey's performance during the recent crisis, along with an evaluation of the policies followed.

[2] Unless specified otherwise, all data come from the Central Bank's online data-retrieval facility.

and services. The figure also shows the rapidity of the turnaround. In 2001 and 2008, these large inflows not only quickly evaporated, but within two quarters they had been replaced by sizable net outflows. The first three quarters of the 2001 and 2008 crises, in fact, bear an uncanny resemblance to each other.

But thereafter an interesting divergence sets in. For the 2001 crisis, it took roughly two years for financial inflows to turn positive once again. In the current crisis, the resumption of capital inflows happened much more quickly, and by t=5 (2009: III), Turkey had become a sizable recipient of inflows once again. Financial inflows continued to increase still further, and, within three years (2010: II, the latest quarter for which we have data), net inflows had reached levels that exceeded previous peaks. What happened was that the stabilization of global financial market conditions and the policy-driven sharp reduction in interest rates in the advanced economies produced a resurgence in capital flows to emerging markets. Turkey was among the beneficiaries. As we shall see, however, this may well turn out to be a mixed blessing.

When foreign financing dries up, the current-account deficit has to be quickly reduced and eliminated. As Figure 2 shows, the Turkish economy entered all three crises with a large current-account deficit. And in all three cases, there was a subsequent major adjustment in the current account over a period of five to six quarters. The current-account balance turns positive typically within a year-and-a-half of peak inflows. But the evidence from the older crises (1994 and 2001) also shows that this adjustment tends to be temporary. Three years after these crises, Turkey was again running large current-account deficits. In the most recent crisis, the widening of the current-account deficit has been even more spectacular (in relation to the value of exports). The huge current-account imbalance Turkey was running by the middle of 2011 is, of course, the counterpart of the larger financial inflows shown in Figure 1.

Figure 2. Current Account Balance (% of XGS)

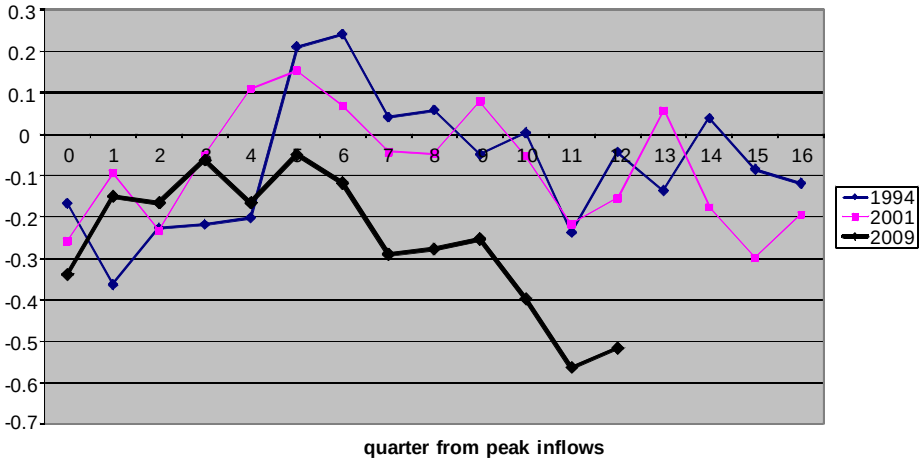
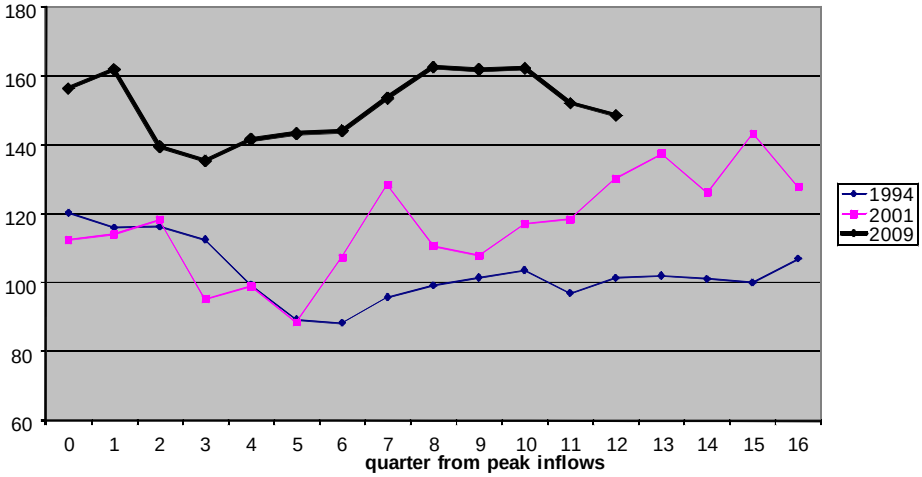


Figure 3. Real Effective Exchange Rates



The adjustment in the external balance is achieved in part through a significant realignment of the real exchange rate. In the crises of 1994 and 2001, the real exchange rate depreciated on the order of 30-40 percent. A similar depreciation took place in 2009 as well, but as Figure 3 shows, it was much more short-lived. By the second quarter of 2009, the Turkish lira had already begun to reverse its slide. This was clearly linked to the more rapid resumption of capital inflows after the latest crisis. What Figure 3 also reveals is that Turkey entered this crisis with a stronger lira than had been the case for either

of the previous two crises. This rapid currency appreciation is doubly problematic. I will return to the currency-competitiveness issue below.

Another distinguishing feature of the most recent crisis is that the adverse effects on the real economy were deeper and felt much sooner than in the earlier crises. Figures 4, 5, and 6 depict the comparative outcomes in industrial production, real GDP, and unemployment. Both real GDP and industrial production took a severe tumble as soon as financial flows turned around, and their fall was more pronounced than anything seen to date. The decline in real GDP during the first quarter of 2009 was the worst on record since 1945. But the recovery in economic activity has also been comparatively rapid. By the end of 2009, even though the Turkish economy stood considerably below its previous growth path, the worst was clearly over. As Figure 4 shows, industrial production has followed the path of the 2001 crisis fairly closely in bouncing back, even though the initial downturn was more severe.

Figure 4. Industrial Production (peak inflows quarter=100)

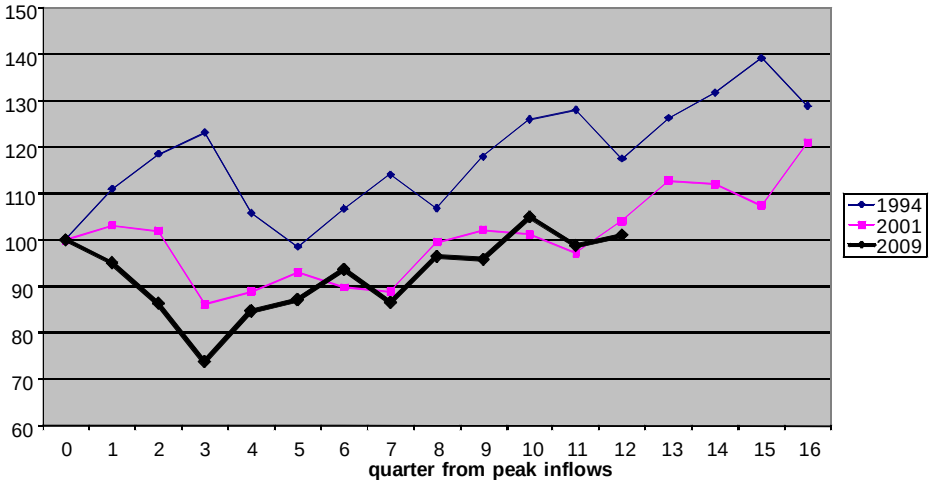
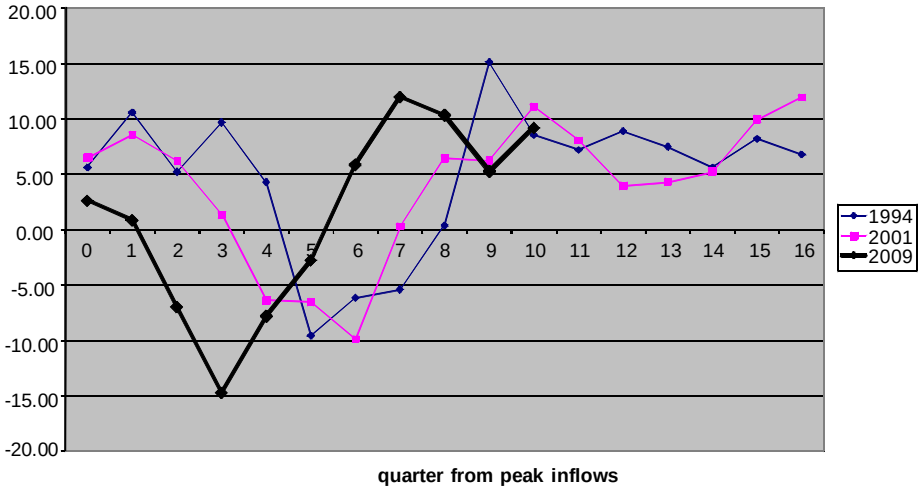
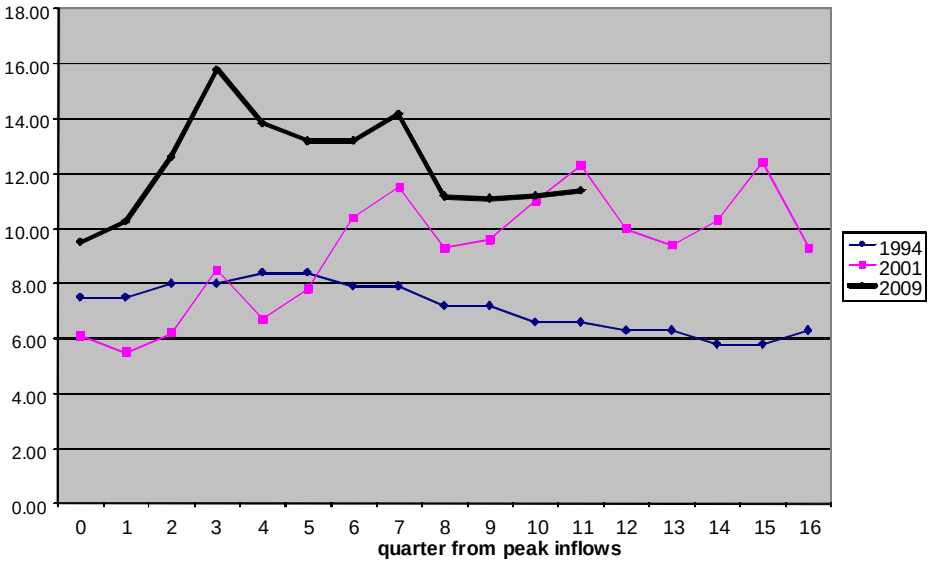


Figure 5. GDP Growth Rate (%)



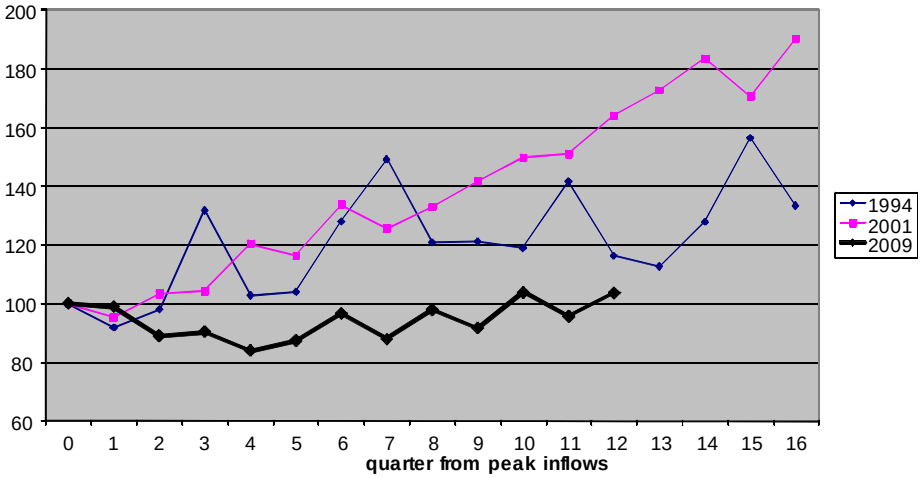
However, it is more difficult to justify optimism when considering the unemployment front (Figure 6). The rate has come down somewhat since having reached a record-breaking level, nearly 16 percent, in 2009:1. Nevertheless, the fact remains that joblessness was already persisting at much higher levels at the onset of the 2008-09 crisis than in the preceding crises. Unemployment has remained stubbornly high—above 10 percent—despite rapid growth since 2001, and this is one of the blemishes on Turkey's recent performance. Going forward, any sensible growth strategy will have to make employment creation a central plank.

Figure 6. Unemployment Rate (%)



A final dissimilarity between the most recent crisis and its predecessors relates to export performance (Figure 7). In the past, a key driver of recovery had been a rapid run-up in exports, largely given impetus by a competitive currency. As Figure 7 shows, exports took a very different path during the 2008-09 crisis. Export volume fell until early 2009 and has recovered very slowly – much more sluggishly than in the other post-crisis periods. This fairly weak export response has been due, in the first instance, to the fall in global demand, which resulted in a worldwide collapse in trade. This prevented external demand from operating as an adjustment mechanism for Turkey and other emerging markets. At the same time, the short-lived real depreciation of the Turkish lira must be seen as a causative factor. As the lira began to appreciate again in 2009, it undercut companies' incentives to export. For both sets of reasons, exports have not contributed much momentum to economic activity in the aftermath of the latest crisis.

Figure 7. Export Quantum (peak inflows quarter=100)



These comparisons and quick overview reveal that, despite its many strengths, the Turkish economy has emerged from the current crisis with some serious weaknesses. On the plus side, the resumption of capital inflows is indicative of a renewed vote of confidence on the part of financial markets in the underlying health of the Turkish economy. The quick rebound in economic activity likewise suggests remarkable flexibility in the economy. However, on the negative side, unemployment is still high by Turkish standards, and the real exchange rate remains overvalued. How alarming are these dark spots in the picture of economic recovery? The answer depends in large part on what we think is an appropriate growth model for Turkey.

3. Two contending growth narratives

In developing countries, growth is driven by structural change. It requires moving their resources—predominantly labor—from low-productivity activities, such as traditional agriculture and informal occupations, to modern and mostly tradable activities like manufacturing that are high-productivity. The more rapid this movement, the higher the growth rate of the economy. That so many developing countries remain poor, with the rate of convergence rarely turning positive, is indicative of the magnitude of the inherent market failures that are holding them back, not to mention the governance issues that bedevil many Third World societies. Such a poor business environment exerts a disproportionate tax on the modern parts of the economy, preventing rapid structural change. This is why growth is never an automatic process in the

developing world; it requires proactive policies in addition to sound macroeconomic fundamentals.

Among the various constraints that prevent the take-off of modern tradable activities, two in particular stand out. First, modern industrial activities will be too slow to expand if credit is hard to access or there is not enough of it. Second, investments in these activities are often discouraged by low private returns, despite the presence of high *social* returns, due to a range of learning spillovers or institutional shortcomings. Of course, under-developed countries do not suffer from just one or two maladies but from a whole host of problems. It is not uncommon for the corporate sector to be plagued both by poor finance and by poor returns. But as desirable as it may appear to be to try to tackle and resolve all such blockages simultaneously, this is neither practical nor necessary. As the experience of successful countries demonstrates, what is required is strategic prioritization. If we can identify the leading bottlenecks, we can address the problems sequentially. As part of such a project, it is of great practical importance to determine whether it is poor finance or poor returns that acts as the most onerous constraint (Hausmann, Rodrik, and Velasco, 2008).

Until recently, the mental model that dominated the conventional wisdom about economic growth was based on the presumption of capital shortage. This model held that low savings and weak financial markets at home were first-order constraints on economic growth and development. Thus, greater access to investable funds from abroad and improved financial intermediation would provide a powerful boost to domestic investment and growth along with better smoothing of consumption. As some of the downsides of financial globalization became more evident, proponents of this view began to recognize the potential for financial instability and crises. But the conclusion that they drew was that sufficiently vigilant regulation and supervision would eliminate the attendant risks. Given the presumed importance of access to international financing, the model required that national policymakers give the utmost priority to implementing appropriate regulatory structures in their financial markets.

We can restate this argument in the form of a three-pronged syllogism: (1) Developing nations are constrained by financing shortages and therefore need foreign capital to grow. (2) But foreign capital can be put at risk if prudent macroeconomic policies and appropriate prudential regulation are not pursued. (3) So developing countries must become ever more committed to erecting appropriate safeguards as they open themselves up to capital flows. This syllogism remains at the core of the case for financial globalization (Rodrik and Subramanian, 2009).

Recent evidence has thrown some cold water on the very premise of this syllogism. The cross-country evidence of the growth benefits of capital-account openness turns out to be inconclusive. Even more damaging, it appears that the countries that have grown most rapidly in recent decades are those that have relied less—not more—on foreign capital. In addition, financially globalized developing countries have experienced less, not more, consumption smoothing. These results are at variance with the presupposition that poorer nations need foreign financing in order to develop. To make sense of what is going on, we need a different mental model.

The alternative narrative goes as follows. While some nations may be severely constrained by inadequate access to financing, others—and perhaps a majority—are constrained primarily by poor returns**.** The inadequate appetite for investment, due either to low social returns or to low private appropriability of social returns, is particularly acute in tradables, which are the essential source of growth. In such settings, capital inflows exacerbate the investment constraint through their effect on the real exchange rate. The real upward movement of the home currency that accompanies capital inflows reduces the profitability of investment in tradables and depresses the private sector's willingness to invest. It thereby reduces economic growth. So openness to foreign financing ends up being a handicap rather than an advantage.

These two syndromes—poor financing and poor returns—can be differentiated by posing the following hypothetical question to would-be entrepreneurs and investors in an economy: if you were to receive an unexpected inheritance of $25 million, where would you invest it? In an economy where the most challenging constraint is lack of financing, this sudden windfall serves to relax the constraint and therefore permit the undertaking of investment projects that would not have been possible otherwise. Entrepreneurs in such an economy are therefore likely to respond to the question with a long wish list of sectors: agribusiness, tourism, call centers, auto parts, pharmaceuticals, and so on. These are all areas where profitable investments could be made if financing were available at reasonable cost.

On the other hand, when the restrictive constraint is low returns, the windfall provides no additional inducement to invest—at least not in the home economy. In this alternative economy, the respondent is most likely to fall into a long silence, scratch his head, and then say something like: "Can I take the money to Switzerland instead?"

As real-world counterparts to these two prototype economies, think of Brazil and Argentina. In Brazil, private entrepreneurs have no shortage of investment ideas, and even with real interest rates at double-digit levels until

recently, the investment rate stood relatively high. When the financing constraint is relaxed in Brazil, either because interest rates fall or foreign financing becomes more plentiful, domestic investment rises. In Argentina, on the other hand, a different case altogether presents itself. Here the business climate is marked by great uncertainty brought about by erratic government policies and constant changes in the rules of the game. Hence, the tendency is for private investment to remain subdued, even when financing is plentiful and cheap. What fosters private investment in the Argentine economic environment is a big boost in the relative profitability of tradables, which offsets the other distortions. So when the government was actively managing the exchange rate in recent years to maintain an undervalued peso, the private sector responded with an investment boom in tradables—despite the continuing lack of confidence in the government's economic policymaking. The Argentine economy grew rapidly during this period—more rapidly, in fact, than Brazil's.

As these examples suggest, determining desirable economic policies first requires an assessment of the nature of the main limiting constraint on the economy. If it is financing, we should look favorably upon capital inflows and moderately large current-account deficits, even though they are likely to yield undesirable currency appreciation to the point of overvaluation. The costs of such overvaluation are likely to be more than offset by the benefits of having increased availability of investable funds. For an economy like Brazil's, it is obviously more important to stimulate finance than it is to enhance returns. But the same set of economic policies would be disastrous in Argentina, where capital inflows and currency appreciation would not spur domestic investment (at least not in tradables); they would instead lower domestic savings and boost consumption (as they indeed did in the 1990s).

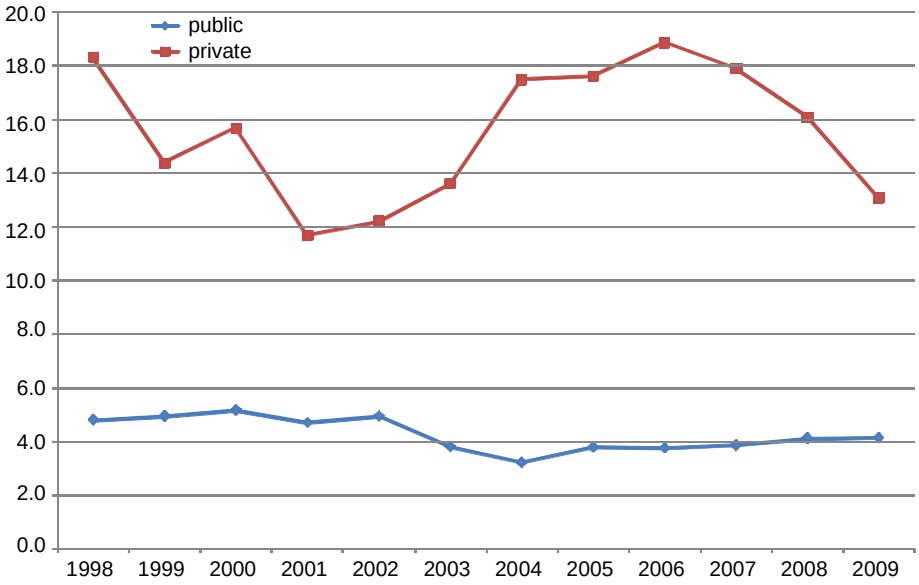
The question that faces Turkey, then, is essentially this: is Turkey more like Brazil or more like Argentina? It turns out that this is not an easy question to answer. I will provide a first pass through the evidence here, leaving a more detailed analysis for another occasion (or for others).

3.1 Reading the tea leaves of the Turkish economy

As it came out of the 2001 crisis, Turkey came to rely increasingly on foreign borrowing to fuel its growth. The widening of the current-account deficit went along with a sizable real rise in the value of the lira. What does this most recent experience tell us about the nature of the constraint that is holding Turkey back?

First, consider the evidence that would suggest that Turkey is, like Brazil, a financing-constrained economy. Real interest rates have tended to be quite high, at double-digit levels—at least until the recent crisis. Among emerging markets, Turkey's real interest rates are, in fact, second only to Brazil's (Kannan, 2008). Such steep rates render the cost of domestic financing prohibitive for all but the most profitable investments. Despite this, however, private investment has held its own, hovering in the 16-18 percent range (in relation to GDP) prior to the crisis (Figure 8). This is not so impressive when compared to Asian countries, but it must be considered a decent performance nevertheless, and indicative of the presence of high returns in general, given the cost of capital. The explanation lies in the high level of foreign borrowing in recent years, which has clearly helped sustain domestic investment and counteracted somewhat the adverse effects of high interest rates in Turkey.

Figure 8. Private and Public Investment (% of GDP)

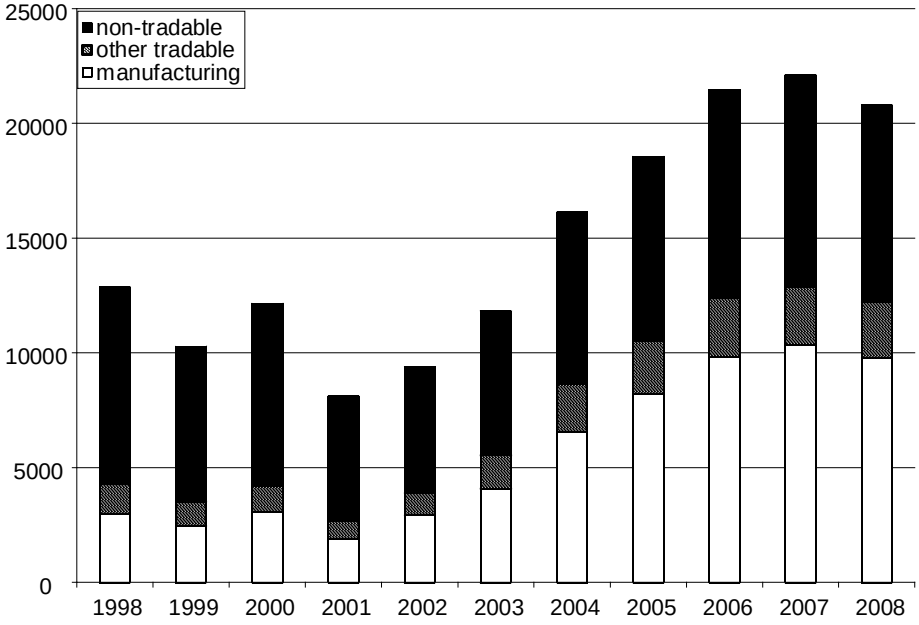


Source: State Planning Organization (SPO)

Second, the composition of investment has been moving in the direction of tradables, and manufacturing in particular (Figure 9), which is perhaps an even more striking factor. In 2000, manufacturing made up a quarter of total investment; by 2008, this ratio had increased to almost 50 percent! This is a remarkable transformation, rendered all the more so by the fact that the real exchange rate had appreciated by around 20 percent in the interval. A somewhat similar picture can be seen when we turn to exports, where significant

gains in both expansion and diversification were recorded in recent years (see World Bank, 2008, Chap. 2). Taken together, the strength of manufacturing investment and of exports, despite the currency's strength, is another piece of evidence suggesting private returns are high.

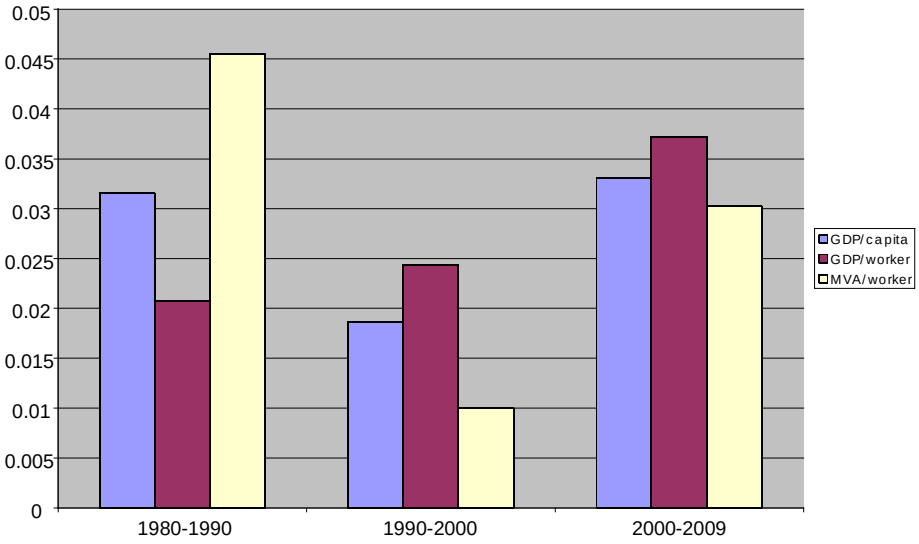
Figure 9. Composition of Fixed Capital Formation (at 1998 TRL, in Millions)



Source: SPO

Third, the recent track record of economic growth and industrial productivity on the back of foreign borrowing has been impressive. Figure 10 summarizes economic outcomes during three separate periods of Turkey's recent history: the 1980s, the 1990s, and 2000-2008. For each period, the chart displays the growth rates in three measures of productivity: GDP per capita, GDP per worker, and manufacturing value-added per worker. The post-2000 period looks uniformly good, irrespective of which measure of productivity growth we focus on. With the exception of the growth in MVA per worker, post-2000 performance outclasses that of all previous periods.

Figure 10. Performance by Period (annual rates of growth)



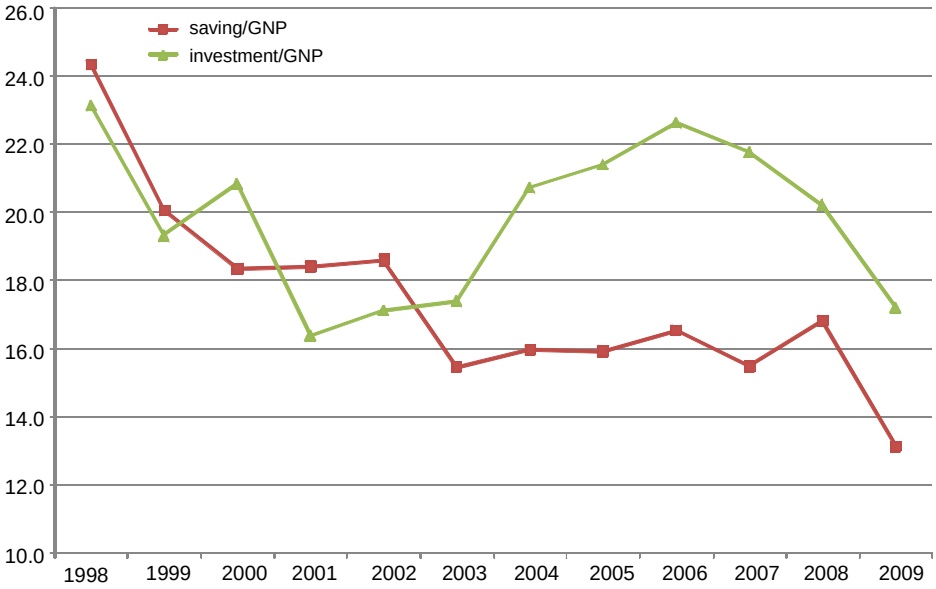
Source: World Bank, World Development Indicators and SPO.

It is clear that recent economic growth has come at the expense of widening current-account deficits and a pushing up of the real exchange rate. But the indicators reviewed above suggest that this growth has overall been healthy in a number of respects: it has come through higher investment in tradables, especially in manufacturing, which has exhibited a strong performance despite some degree of overvaluation of the currency. So far, the picture suggests an economy that is constrained more by financing unavailability than by low returns.

Now consider the other side of the story. First, it is worth reiterating that aggregate investment remains low in Turkey, despite the support it receives from foreign investors. At its peak in 2006, gross capital formation amounted to 23 percent of GDP (Figure 11), which is considerably lower than the rates recorded by high-performing Asian economies. It may be true that Turkey invests more than would be expected for a country where real interest rates are so high, but it is equally true that there is considerable upside room for boosting the investment component of the economy. There is no reason why the Turkish economy cannot grow even more rapidly (and, indeed, it will certainly have to if the excess supply of labor is to be absorbed in the coming years).

Figure 11 shows why industrial investment remains less than it should be, regardless of the condition of the current account. The domestic savings rate fell during the 2000s and still remains quite depressed. The record figure of 23 percent of GDP in 2006 was only achieved thanks to a substantial influx of funds from abroad, amounting to 6 percent of GDP. Ideally, Turkey's investment rate should be closer to 28 percent. However, as long as it remains outside the Eurozone, it dare not risk running current-account deficits that are not sustainable and "safe," i.e., below 6 percent—and, indeed, even this number may be too high. Violating this guideline would leave the country at risk of sustaining periodic sudden bouts of capital flight. In other words, with domestic savings so low, there are inherent limits to the extent to which the current account can help to provide the financing for domestic investment, even if we assume that the biggest constraint on the economy lies on the financing side. Regardless of the nature of the constraint, raising growth in the future will necessitate a dramatic expansion in domestic savings.

Figure 11. Saving and Investment (% of GNP)

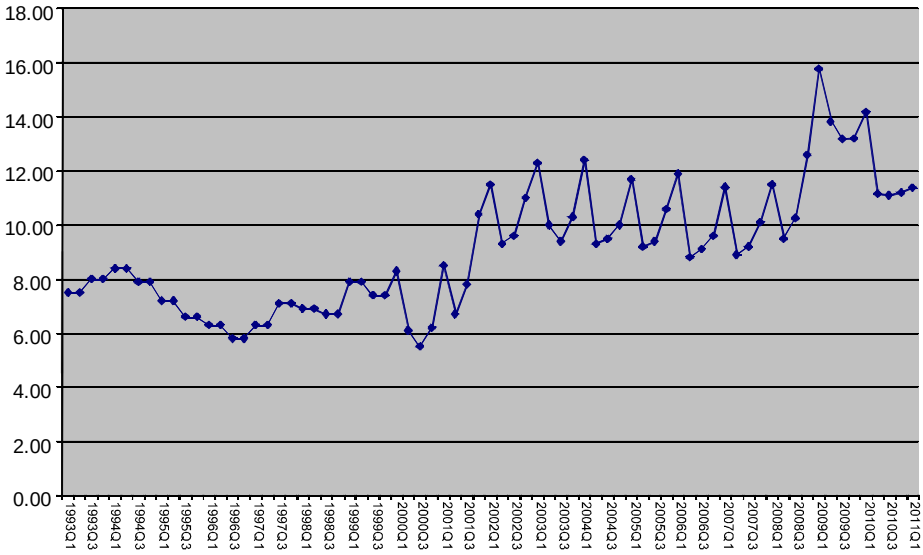


Source: SPO

One aspect of Turkey's economy that fairly cries out for a rethink of economic strategy is its dismal record on employment creation and on unemployment. As Figure 12 demonstrates, Turkey's unemployment rate jumped from a range of 6-8 percent during the 1990s to a new plateau of 9-12 percent fol-

lowing the 2001 crisis. In the wake of the latest crisis, unemployment may well get stuck at even higher levels still. This is both an economic and social problem. On the economic front, it would mean a gross underutilization of domestic resources. On the social front, it would be the harbinger of political tensions and divisions that could worsen if left unresolved. If both scenarios are to be avoided, any strategy for healthy economic growth will need to feature job creation at its center. The goal should be both a higher growth rate and greater expansion of high-productivity sectors with good employment potential.

Figure 12. Unemployment Rate (%)



The bottom line is this. Foreign borrowing does contribute to economic growth in Turkey, because private returns in tradables are relatively high and current-account deficits permit greater investment than would be possible otherwise (despite the associated reduction in competitiveness). However, this model places too low a ceiling on the sustainable rate of economic growth and does not permit a rapid enough generation of jobs to prevent unemployment from rising. Faster growth would require, under the prevailing strategy, an unsustainably large external deficit. The only alternative is to move to a model of growth that breaks the link between growth and the current-account deficit. This alternative strategy would require a formidable effort to mobilize domestic savings among the population; at the same time, it would have to ensure that high private returns in tradables were maintained.

4. Concluding Remarks

We can summarize the story outlined here as follows. Turkey *needs* to grow more rapidly; and it *can* also grow more rapidly. The country has a growth potential that its recent performance, successful as it may have been, has not fully exploited.

An economic-development model that relies on foreign savings and large current-account deficits can generate respectable growth, but it runs into inherent problems. For one thing, given the present low level of domestic savings, a substantial rise in domestic investment would push the external deficits to heights that would clearly be unsustainable and dangerous. And second, even moderate reliance on foreign financing, as we have seen during the recent crisis, leaves the domestic economy vulnerable to sudden losses of confidence abroad that are followed by withdrawals of funds locally. A comparison with Brazil is again instructive here. Brazil entered the 2008-09 crisis with a much smaller external imbalance than Turkey, and as a result it has experienced a much shallower recession.

If growth is going to be financed domestically, Turkey will need a permanently higher savings rate. The government fiscal policy has a critical role here. The most direct way to lift domestic savings is to increase the structural surplus of the public sector. The medium-term programs of the government must target a large enough fiscal surplus to leave room for the Central Bank to move interest rates to a permanently lower plateau. The resulting rise in public saving will reduce capital inflows, prevent the current-account deficit from worsening, and help sustain a more competitive currency. This step is critical in moving Turkey onto a new growth path.

But more will need to happen for all the pieces to fall into place. A few numbers can help quantify the nature of the challenge facing Turkey in moving to an alternative growth model. First, a sustainable and safe current-account deficit for Turkey should not exceed 3 percent of GDP, so let's take that number as the upper limit on the resource transfer from abroad. Second, a desirable target for the domestic investment effort would be around 28 percent, to ensure that high enough growth keeps unemployment in check. This implies a domestic savings rate of at least 25 percent, which is a whopping 9 percentage points higher than the 16 percent achieved by the Turkish economy in the years just prior to the 2008-09 crisis (see Figure 11). Obviously, such a large run-up in savings cannot be achieved through a rebalancing of public-sector accounts alone. So is this target at all realistic?

The record of fast-growing countries—not just Asian economies but also Chile since the mid-1980s—suggests a positive answer. All these economies experienced significant savings transitions at the start of their growth accelerations (Rodrik, 2000). A positive growth dynamic is, in fact, a pivotal factor in sustaining a rapid expansion in private (and especially corporate) savings. Indeed, when economic growth rises in a sustained manner, it also induces higher savings. For companies, the prospect of strong earnings growth leads them to retain a greater share of their earnings, which in turn feeds into higher investment and growth. A determined fiscal effort, along with a competitive currency, then, has the potential to foster the private savings required to close the gap.

If a shift in fiscal policy forms the first plank of the new growth strategy, a second could be the signaling of a new policy attitude towards the exchange rate. Currently, the official line is that the Central Bank intervenes in currency markets only to smooth short-term fluctuations, without taking a stand on the medium-term level of the lira. This has to be replaced with a clear statement of preference for avoiding overvaluation. The Central Bank, the Treasury, and the Finance Ministry would need to cooperate and coordinate when capital inflows threatened to push the value of the currency up. Policymakers have many policy instruments to resort to in order to stem upward movement of the currency; a combination of sterilized intervention, prudential restrictions on inflows, liquidity requirements aimed at limiting foreign borrowing, and other fiscal measures are effective if deployed with sufficient determination. None of this needs to be inconsistent with inflation targeting as long as the performance of tradables features prominently in the Central Bank's evaluation of potential growth of the real economy, and fiscal policy allows enough room for monetary policy to be counter-cyclical with respect to capital inflows.

The key point is that private-sector saving and investment behavior is unlikely to be transformed unless there is a credible shift in the policy profile with regard to both the fiscal stance and the exchange rate.

References

Hausmann, R., D. Rodrik, and A. Velasco, (2008), "Growth Diagnostics," in J. Stiglitz and N. Serra, eds., *The Washington Consensus Reconsidered: Towards a New Global Governance*, Oxford University Press, New York.

Kannan, P., (2008), "Perspectives on High Real Interest Rates in Turkey," *IMF Working Paper No. 08/251*.

Rodrik, D., and A. Subramanian, (2009), "Why Did Financial Globalization Disappoint?" *IMF Staff Papers*, Volume 56, Number 1.

Rodrik, D., (2000), "Saving Transitions," *The World Bank Economic Review*, Vol. 14, No. 3.

Uygur, E., (2010), *The Global Crisis and the Turkish Economy*, Third World Network Global Economy Series No. 21, Penang, Malaysia.

World Bank, *Turkey: Country Economic Memorandum*, Vol. II.