

## I. ECONOMIC ENVIRONMENT

### (1) INTRODUCTION

1. The Turkish economy experienced a severe recession in 1994, following a financial crisis in the early part of the year. However, with the implementation of a stabilization and structural adjustment programme, economic recovery was remarkably quick, with annual growth of 7 to 8% in GNP in the three following years.<sup>1</sup> The current account deficit, although widening, remained at manageable levels and international reserves had accumulated to US\$19 billion at the end of 1997 (equivalent to almost five months of merchandise imports), as the currency depreciated broadly in line with inflation differentials. The new trading conditions inherent in the customs union between Turkey and the EU, which entered into force in January 1996, assisted the recovery. Despite these improvements, large fiscal imbalances and persistently high inflation put into question the medium-term sustainability of recent growth performance. Moreover, slow progress has been made in carrying out the large outstanding structural reform agenda, notably in reforming the social security system and the banking sector and pursuing the privatization programme.

2. The healthy average growth rates, albeit with high variations, since the mid-1980s have been translated into a general improvement in living standards; GDP per capita doubled between 1985 and 1995. Other social indicators, such as life expectancy, infant mortality, and school enrolment at secondary level, all show continued improvement (Table I.1). However, after Mexico, Turkey has the most unequal income distribution of all OECD countries (in 1994 the poorest 20% of the population received only 5% of the income, while the richest 20% received 50%).<sup>2</sup> As discussed below, the chronically high inflation is also likely to have adversely affected income distribution.

**Table I.1**  
**Basic social indicators, 1970-97**

	1970	1980	1990	1997
Population (million, mid-year)	35	44	56	65
Growth of population (percentage change) <sup>a</sup>	..	2.3	2.4	2.2
Urban population (per cent of total)	38	44	59	70 <sup>b</sup>
Life expectancy at birth (years)	57	61	66	68 <sup>c</sup>
Total fertility rate (births per woman)	5.3	3.4	2.7	2.7 <sup>d</sup>
Infant mortality rate (per '000 live births)	150	126	67	40 <sup>c</sup>
School enrolment ratio (%): <sup>e</sup>				
Primary school	110	96	110	105 <sup>d</sup>
Secondary school	27	35	54	56 <sup>d</sup>
Human Development Indicator (HDI ranking/total countries)	..	..	73/173	74/175 <sup>f</sup>
GNP per capita (US\$, current prices)	356	1,569	2,714	2,994

.. Not available.

a Average annual growth for the previous ten (or seven) years.

b 1996 data.

c Provisional.

d 1995 data.

e Enrolment ratios may exceed 100% because pupils may be older or younger than the standard school age.

f 1994 data.

**Source:** State Institute of Statistics (1996), 1995 Statistical Yearbook of Turkey; World Bank (1997), 1997 World Development Indicators (urban population, school enrolment ratios, fertility rate and infant mortality rate); and UNDP (1997), Human Development Report.

<sup>1</sup> In line with the practice of the Turkish authorities, GNP, rather than GDP, is mainly used throughout the report. In the case of Turkey the difference between GNP and GDP is not large, with net-factor income increasing GDP by between 0.5 and 1.9% during the 1990s.

<sup>2</sup> State Institute of Statistics (1996), p. 292.

**(2) RECENT ECONOMIC DEVELOPMENTS**

**(i) Overview**

3. Since the previous Trade Policy Review in 1994, economic management has been focussed on recovery from the financial crisis of that year and structural reforms. The crisis stemmed from high fiscal deficits during the previous three years; over the period 1991 to 1993, the public sector borrowing requirement (PSBR) was more than 10% of GNP and annual average inflation was close to 70%. The real exchange rate had been allowed to appreciate, implying a loss of international competitiveness, over a period of years. Large increases in imports resulted in a current account deficit of over US\$6 billion in 1993. In January 1994, Turkey's credit-rating on sovereign debt was reduced to sub-investment grade, triggering a rapid fall in the real exchange rate, outflows of short-term capital and a decline in the Istanbul stock market. These factors, in combination with uncertainties about the directions of future policies, rendered it more difficult for the Government to borrow abroad.

4. To address this situation, in April 1994 the Government announced an emergency stabilization programme, consisting of increases in prices charged by state economic enterprises, a one-off capital levy, and an announcement of moving ahead with structural reforms, including a privatization programme. The programme contributed to a remarkable turnaround in the economy. GNP performance rebounded from a contraction of 6% in 1994 to annual growth of some 7 to 8% in the three succeeding years (Table I.2). The stock market index rose by as much as 86% in 1997 in dollar terms. Over the same period, external developments remained favourable. The current account deficit, although widening, was kept at a manageable level. International reserves rose to US\$19 billion equivalent to almost five months of merchandise imports at the end of 1997, as the lira was depreciated in nominal terms broadly in line with inflation differentials.

5. However, fiscal deficits have persisted, albeit now more linked to the social security system and interest payments than to the operations of state economic enterprises. Under the new Bank of Turkey Act, the Central Bank has reduced the monetization of the deficits ("printing money"), and the Government has increased its reliance on government securities as a source of financing. Despite the macroeconomic imbalances, the economy, as noted above, has demonstrated surprisingly strong growth. The customs union with the EU and implementation of some important structural reforms (Box I.1) in an environment of a flexible private sector, may be some of the factors explaining the recent growth performance. Strong and concerted efforts in the reform of the social security system, the privatization programme and other structural reforms seem to be the key to reducing inflationary expectations and providing for a healthy stable long-term growth.

**Table I.2**  
**Selected economic indicators, 1985-97**

	1985-92 <sup>a</sup>	1993	1994	1995	1996	1997 <sup>b</sup>
Real GNP, market prices (percentage change) <sup>c</sup>	5.0	8.1	-6.1	8.0	7.1	8.0
<u>GDP by expenditure component</u>						
Real GDP, market prices (percentage change) <sup>c</sup>	4.9	8.0	-5.5	7.2	7.0	7.2
Private consumption	4.0	8.4	-5.4	4.8	8.5	8.6
Government consumption	-5.5	5.4	-5.5	6.8	8.6	5.9
Gross fixed capital formation	4.5 <sup>d</sup>	24.9	-16.0	9.1	14.1	12.4
Exports, goods and services	8.9	7.7	15.2	8.0	22.0	22.6
Imports, goods and services	6.5	35.8	-21.9	29.6	20.5	23.5
<u>Prices and interest rates</u>			(Per cent)			
Consumer price index, urban areas (annual average)	56.5	66.1	120.7	88.5	75.9	81.8
Wholesale price index (annual average)	51.2	58.4	106.3	93.6	80.4	85.7
Interest rate on 3-months T-bill (annual rate)	54.6 <sup>e</sup>	69.8	101.2	95.0	81.7	.. <sup>g</sup>
Real exchange rate (1982=100) <sup>f</sup>	0.9	-1.1	-21.4	32.1	-1.7	-2.4
<u>Savings and investment</u>			(Per cent of GNP)			
Gross domestic savings	22.4	22.7	23.1	22.1	20.0	20.1
Public sector	..	-2.7	-1.1	-0.1	-1.9	-1.7
Gross fixed investment	23.2	26.3	24.5	24.0	25.0	25.3
Private sector	14.8	19.1	19.6	19.8	19.9	19.6
<u>Government budget</u>						
Public sector borrowing requirement	-6.6	-12.3	-7.7	-4.8	-9.1	-8.1
General government balance	-3.5	-8.9	-5.8	-5.5	-9.0	-8.1
Consolidated budget balance	-3.4	-6.7	-3.9	-4.0	-8.3	-7.5
Primary balance	-0.6	-0.9	3.8	3.3	1.7	0.3
<u>Monetary sector (end-of-period)</u>			(Percentage change)			
Nom. money plus time and savings deposit (M2)	57.9	49.6	125.4	101.3	118.9	90.1
			(Per cent)			
Private sector share of banking system credit	74.9	74.5	73.5	83.3	87.3	92.3
<u>External sector</u>			(Per cent of GNP)			
Current account balance	-0.5	-3.5	2.0	-1.4	-2.9	-2.4
Current account, adjusted for shuttle trade	..	..	..	..	-1.3	-1.4
Capital account balance	1.2	4.9	-3.2	2.7	5.3	4.7
Foreign direct investment	0.4	0.3	0.6	0.6	0.5	0.5
Portfolio investment	0.7	2.2	0.9	0.1	0.3	0.8
Total external debt	38.6	37.0	50.1	42.6	45.9	47.1
Short-term	7.1	10.2	8.6	9.1	11.1	11.1
Public medium- and long-term	30.1	23.6	36.8	29.1	26.4	24.4
Debt-service ratio <sup>h</sup>	32.4	27.0	30.5	28.7	24.1	21.1
In't reserves, mos. of merch. imports <sup>i</sup>	2.4	2.5	3.8	4.2	4.6	4.7
Merchandise trade (imports and exports)	25.4	25.0	31.3	33.3	36.1	38.2
			(Twelve-month growth rate, end-of-period, per cent)			
Merch. export growth value <sup>j</sup>	9.8	4.8	17.8	19.5	7.4	13.5
Merch. import growth value <sup>j</sup>	11.6	29.0	-24.1	55.7	22.3	11.8
<u>Memorandum item:</u>						
Nominal GNP (billion US\$)	..	181.8	130.9	171.9	184.6	196.1

.. Not available.

a Annual average.

b Provisional.

c At 1987 prices.

d 1988-1992 data.

e 1986-1992 data.

f Decrease equals depreciation. The weights in the currency basket are 0.5 for US\$ and 0.5 for DM prior to 1987 and thereafter the shares are 0.75 and 0.25, respectively.

g Sales of three-months T-bill were not realized in 1997.

h Debt-service (interest plus medium- and long-term debt repayments) as % of foreign exchange receipts.

i Total reserves, excluding gold.

j Current US\$.

Source: Government of Turkey; and IMF (various issues), *International Financial Statistics*.

**Box I.1: Key structural reforms since the 1994 Trade Policy Review**

- **Trade Reform.** As a result of the customs union with the EU, which entered into force in January 1996, Turkey substantially reduced its applied tariff rates, including the abolition of various import surcharges, except for a few lines, which are still subject to a Mass Housing Fund (MHF) levy (see Chapter III for details). The new import regime applies the EU common external tariff (CET) to most imports of industrial and processed agricultural products from third countries. The simple average MFN tariff has, as a consequence, fallen from 27% in 1993 to 13% in 1998 (second half). However, tariffs on agricultural (except processed) products have been relatively unaffected as they are not required to be lowered by the Customs Union Decision. All trade restrictions justified on balance-of-payments grounds were eliminated as of 1 January 1997.
- **Privatization and private sector participation.** In November 1994, a privatization law (Law No. 4046) was passed, establishing the Privatization High Council as the ultimate decision making body. The legalisation allowed for the sale of 49% of the state telecommunications enterprise TTAS, granting licensing of some value added telecommunications services to private investors, and privatization of 49% of the aviation state economic enterprise THY. Private-sector participation in infrastructure projects has been boosted by enactment of the build, operate (BO) law (Law No. 4283) in addition to the already existing build, operate and transfer (BOT) law (Law No. 3096 and 3996).
- **Foreign investment.** The already liberal foreign direct investment regime policies were simplified and bureaucratic procedures streamlined.
- **Financial market.** Following the mini-crisis in early 1994, legislative reforms were passed in June: (i) increase in the minimum paid-up capital to open up a bank (to TL 1 trillion); (ii) a tightening of limits on credits extended to related parties, equity participation in non-financial institutions and real estate investments; and (iii) stronger public disclosure requirements. With the passing of the Bank of Turkey Act in 1994, the legal limits of Central Bank financing of the increase in government appropriations was reduced from 10% to 6% between 1996 and 1997 and to 3% thereafter. In 1996 Turkey launched an international bond market in Istanbul (under the auspices of the Istanbul Stock Exchange) in order to cut the cost and remove obstacles to trade in Eurobonds and other securities.
- **Competition.** In February 1997, two years after the Law to Protect Competition was passed, a competition board was formed.
- **Domestic tax reform.** A two-year programme was signed in 1997 with the U.S. Internal Revenue Service (IR) for reorganization of tax administration in Turkey. A law extending the use of unique tax payer identification numbers has recently been approved by the Parliament. A draft law has been prepared, aiming at widening the tax base while ensuring a more equitable distribution of the tax burden. The bill provides for major changes in the definition of income, restricts the number and scope of exemptions, reduces the tax rates, and includes a more efficient penalty system, and measures to cover all taxable items.
- **Social security.** A draft law raising the retirement age over a five-year period to 55 (from 43) for men and 50 (from 38) for women will be prepared towards the end of 1998.

*Source:* Government of Turkey.

**(ii) Growth and economic structure**

6. Turkey's recent growth performance has been characterized by large fluctuations. Following two years of high growth, the Turkish economy underwent a financial crisis in 1994, and the economy contracted by 6% (Table I.2). Output in the industrial sector, notably manufacturing, was the most affected. Since then, however, the economy has shown a remarkable turnaround: annual growth of 7% or 8% in 1995 and 1996 primarily reflecting recovery in private consumption and investment,

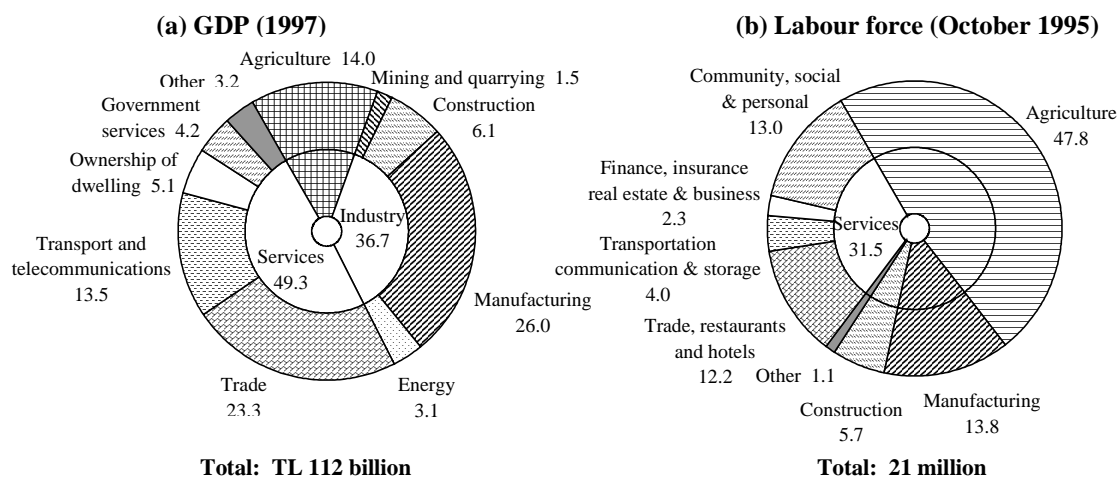
and strong export growth. The industrial sector was the most dynamic, followed by services, while the agriculture sector also picked up due to favourable weather conditions. In 1997, growth was estimated at about 8%, again driven primarily by domestic demand, but with exports also strongly increasing. Manufacturing and services were mainly responsible for the most recent recovery, whereas value added in the agricultural sector declined by 2%.

7. Since 1993, the structure of the Turkish economy has continued to shift slowly towards services and industry, away from agriculture. While the share of the agricultural sector in GDP (measured in constant prices) decreased by almost 2 percentage points between 1993 and 1997 to 14%, the services and industry sector both expanded over the same period accounting for 49% and 37% of GDP in 1997, respectively (Chart I.1). The expansion in services has in recent years been driven by activities in trade, and transport and communications. Despite its modest contribution to GDP, agriculture employs about half of the labour force, while the manufacturing industry provides some 14% of the job opportunities (Chart I.1).

**Chart I.1**

**Sectoral distribution of GDP and labour force**

Per cent, and constant 1987 prices



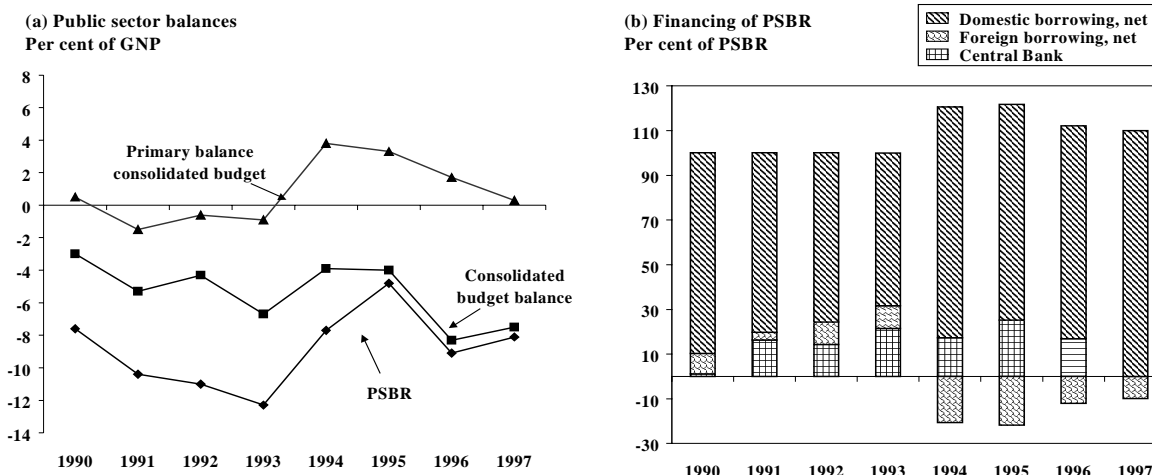
**Source:** State Planning Organization (1998), *Main Economic Indicators*, March; and State Institute of Statistics (1997), *1996 Statistical Yearbook of Turkey*, February.

**(iii) Public finances**

8. Turkey's fiscal position has been at the root of its macroeconomic imbalances; as noted above, the currency crisis in 1994 was directly linked to a deterioration in the fiscal balance. The public sector borrowing requirement (PSBR) escalated in the 1990s from 7.6% of GNP in 1990 and peaked at 12% of GNP in 1993 (Chart I.2 and Table AI.1). The stabilization plan of 1994, which included some one-off tax surcharges and spending freezes, lowered the PSBR by almost 5 percentage points. However, since the underlying causes of the imbalances were not addressed, the PSBR deteriorated again to 8% of GNP in 1997.

**Chart I.2**

**Public sector position, 1990-97**



Note: The primary balance is the fiscal deficit net of interest obligation on public debt. PSBR = Public Sector Borrowing Requirement.

Source: Government of Turkey.

9. In the past, the financing of state economic enterprises was the most important source of the overall fiscal deficits, but since 1994 this has been reduced while the financing of social security transfers and interest payments have become relatively more important. The share of the social security transfers (before transfer from the Budget) increased from 0.4% of the PSBR in 1990, to 10% in 1993 and to 33% in 1997. Over the same period, state economic enterprises as a share of PSBR fell from 60%, to 39% and to 5%.<sup>3</sup> The PSBR net of interest payments improved by as much as 3.5 percentage points in 1990, 5.8 in 1993 and 8.6 in 1997.

10. The consolidated budget deficit in 1997 was some 85% of the PSBR, but the difference, consisting of a number of "extra-budgetary" items, was substantially higher in earlier years (Chart I.2 and Table AI.1).<sup>4</sup> Extra-budgetary items consist mainly of subsidies and financing to specific sectors such as agricultural subsidies and transfers to state economic enterprises that are required to extend credits at below cost and are not subject to the same budgetary controls as other government expenditures.<sup>5</sup> Since 1994 a number of extra-budgetary funds have been transferred to the consolidated budget and are thereby subject to the more stringent budgetary vetting process.

11. The initial 1998 Budget aimed for a PSBR of 8.1% of GNP. However, according to the recent IMF Staff Monitored Programme, the Government committed itself to decrease the budget deficit to 7.6% of GNP, relying heavily on privatization receipts of US\$2 billion or 1% of GNP as a source of financing.<sup>6</sup> Whether the Government will be able to achieve the target will depend on, among other things, the long-delayed privatization of 20% of the state telecommunications company,

<sup>3</sup> These numbers are based on Table AI.1. Numbers supplied by other Government authorities indicate that the share fell from 49% to 16% and to 6% over the same period.

<sup>4</sup> The consolidated budget includes the central Government, budgetary funds, and annex budgets (covering some autonomous organizations such as universities).

<sup>5</sup> World Bank (1996), p. 23.

<sup>6</sup> The Government accounts privatization proceeds as a revenue item, as opposed to a financing item (i.e. below the line).

Türk Telecom. In the first half of 1998, US\$1 billion had been raised from privatization and used for budget-balancing purposes.

12. The persistently high deficits, caused by successive government overspending, have had serious macroeconomic implications. Monetization - causing inflation - was heavily used in the past but it has now been largely replaced by domestic borrowing (Chart I.2). Nevertheless, as much as 17% of the PSBR in 1996 was money financed.<sup>7</sup> Resort to monetization has been substantially limited with the passing of the 1994 Bank of Turkey Act, under which the legal cap of Central Bank of Turkey financing of the increase in government appropriations was reduced from 10 to 6% between 1996 and 1997 and to 3% thereafter. In fact, since 1997, the Treasury has not borrowed from the Central Bank. As a result of these changes, deficits are now mainly being financed through domestic borrowing (mainly Treasury bills), causing increased real interest rates and the associated crowding out of private investment.<sup>8</sup> By contrast, there was no net foreign borrowing in the three years after the crisis; rather, a net inflow of funds led to increasing international reserves.

#### **(iv) Exchange rate and monetary policies**

13. The main priorities of the Central Bank of Turkey are to ensure stability in money and foreign exchange markets. Although it states an unofficial inflation target, since 1995 its only apparent official goal is to hold the real exchange rate by ensuring that the Turkish lira depreciates by no more than inflation differentials against the Deutsche Mark and U.S. dollar. Day-to-day operations are directed towards smoothing fluctuations in the overnight lending rate.

14. A real overvaluation of the lira had been built up since the early 1980s, and in January 1994, when serious macroeconomic imbalances were apparent, Turkey's reduced credit rating triggered a rapid fall in the lira; both the nominal value of the lira and the real exchange rate plummeted. However, as a result of the change in the exchange rate policy the lira remained almost unchanged in real terms through 1996 and 1997.

15. Most monetary indicators suggest that, in general, monetary policy has recently been accommodating or neutral. Moreover, the Central Bank's decision to set a target between 18 and 20% for the increase in reserve money suggests that monetary policy will not be tightened to eliminate inflationary pressures. Without structural measures to reduce public expenditure and slow domestic demand, increased interest rates are likely to increase the cost of financing the Government's borrowing requirement and translate into higher inflation.

#### **(v) Inflation and interest rate developments**

16. Overall, control of inflation is the main preoccupation of macroeconomic management. Turkey's poor record in getting inflation under control is harmful to efforts to improve the distribution of wealth and income, as well as weakening growth prospects (Box I.2). In 1994, consumer price inflation peaked at 121% as a result of the sharp nominal depreciation of the currency and price adjustments by state economic enterprises, dropping to 82% in 1997 (Table I.2). Annualized inflation

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<sup>7</sup> Until 1994, the Treasury could borrow from the Central Bank up to 15% of the budget expenditures paying almost no interest to the Central Bank; this facility is called short-term advances to the Treasury.

<sup>8</sup> OECD (1997a), p. 43, shows that the proportion of bank loans for investment purposes to the size of M2Y (i.e. M2 plus foreign currency deposits held by residents in Turkish banks) has decreased from around 75% ten years ago (when inflation averaged some 40%) to about 50% in 1996, indicating that crowding out has increased over the period.

again accelerated to more than 100% by the beginning of 1998, but dropped somewhat in the first half of 1998 to an annual rate equivalent to 94%.<sup>9</sup>

**Box I.2: The high cost of inflation**

**Redistribution of income and wealth.** *Inflation tends to have a negative effect on a country's distribution of wealth and income:*

- *as opposed to real assets (such as real estate, durable goods, foreign exchange, and precious metals), the value of nominal non-indexed assets is eroded by inflation. Therefore, poor people with little or no real assets tend to have fewer possibilities to hedge against the erosion of value. Moreover, wealth shifts from rentiers to borrowers as real interest rates become negative; and*
- *high inflation, unless all prices increase at the same pace, redistributes income by distorting relative prices. Those who lose out could include retired people, and those on fixed incomes and with limited political influence.*

**Decline in future output.** *Several empirical studies have found a negative relationship between inflation and growth (Fischer, 1991, 1993; Cozier and Selody, 1992; Barro, 1995, 1996; and Andrés and Hernando, 1997). The reason is that high inflation is often associated with more variable inflation. The more variable inflation is, the more difficult it becomes to disentangle relative price changes (which may require change in behaviour) rather than just inflation. Therefore, if firms and households confuse movements in the price level with changes in relative prices, this can lead to distortions, productivity decline and lower growth. Also, high variable inflation, without relative price changes, may have a deterrent effect on growth since it complicates the possibility to forecast inflation, a variable that is used in investment decisions, and may therefore lead to inefficient decisions. Some countries facing persistently high inflation, resort to indexation instead of tackling the underlying cause. However, indexation may worsen the situation because it tends to freeze the hierarchy of all relative prices and to lock-in real rigidities in the economy.*

*Source: Burda and Wyplosz (1993), Macroeconomics - A European Text; and OECD (1997), Economic Surveys - Turkey 1997.*

17. The high budget deficits and the associated fast growth in monetary aggregates, as described above, represent the main underlying cause of inflation. Indexation, which is widely used in setting wages and salaries, was also a contributing factor in maintaining inflationary expectations. In the short-run, the rate of nominal depreciation of the Turkish lira is also a key element that may become even more important as the economy is opened up and the share of imports in the domestic economy increases.

18. Real interest rates on Treasury bills are very high. Some policy slippages at the time of the September 1995 call for early elections, and in combination with the suspension of some macroeconomic performance criteria (notably nominal limits on exchange rate movements that had been introduced under the 1994 IMF Stand-by Agreement), resulted in a hike in T-bill rates. By spring 1996 the Treasury was able to fund its borrowing only at a real interest rate of 40% and an average maturity of four months.<sup>10</sup> The real interest rate has recently fallen and maturities rose to a year in 1997.

**(vi) Balance of payments**

19. From the crisis in early 1994 until the end of 1996, the current account deficit (excluding shuttle trade) increased to over US\$5 billion in 1996, or 2.9% of GNP (Tables I.2 and AI.2). These

<sup>9</sup> State Planning Organization (1998). As measured by the whole-sale-price index, the rate of inflation in the 12 months to June 1998 was 76.7%, down from 91.0% in the 12 months to December 1997.

<sup>10</sup> OECD (1997a).



deficits were financed by private and official borrowing, of which a substantial part was short-term, particularly in 1996. International reserves accumulated to US\$19 billion (equivalent to almost five months of merchandise imports) at the end of 1997; however, in a situation of macroeconomic imbalances and delays in the implementation of important structural reforms, the external position continues to attract attention.

20. Interpretation of the external accounts is complicated by the large unrecorded trade with the countries of the former Soviet Union and Eastern Europe (Box I.3). Balance-of-payments data prior to 1996 do not include this so-called "shuttle" trade, which is understood to be mainly in textiles, leather goods and households products. Although no firm estimates are available, some observers put the shuttle trade as high as 25 to 50% of Turkey's total exports of goods. The Central Bank's estimates of the adjusted current account deficits in 1996 and 1997 show an improved position of some US\$3 billion and US\$2 billion while the capital account surpluses were US\$1 billion and US\$0.7 billion lower, respectively (Table AI.3).

**Box I.3: What is shuttle trade?**

*Recent studies indicate that official data substantially underestimate trade in goods. Large unrecorded trade (notably in textiles, leather goods and household products) takes place with the former Soviet Union and Eastern Europe. This "shuttle" (or "suitcase") trade is transported by cargo planes, buses equipped with cargo trailers, and refitted cruise ships.*

*There are no firm estimates on the magnitude of the shuttle trade. One recent study by the State Institute of Statistics (SIS), which used a survey of 3,000 foreign visitors, estimated it to be US\$1.6 billion in the first six months of 1996. Another study, by the Central Bank of Turkey (CBT), which directly measured the trade undertaken by 1,000 shuttle traders, estimated total shuttle trade in 1996 at almost US\$9 billion.*

*What are the implications for the current account? In addition to the uncertainties in the size of the shuttle trade, there are some problems in the official estimate on trade in services; while trade in goods is under-reported, trade in services is over-reported. Data for a large proportion of services credits are derived from data on foreign exchange transactions in the banking system. Some of these transactions are believed to be shuttle trade. Moreover, the recent liberalization of foreign exchange accounts in Turkey and the increasing dollarization of the economy may imply that a large proportion of these accounts represents resident-to-resident transactions, but these transactions are excluded from the balance-of-payments records.*

*Taking all these factors into account, the CBT estimates the revised current account balance to increase by some US\$3 billion in 1996 (deficit of US\$2.4 billion compared with US\$5.4 billion), with a corresponding adjustment in the capital account. The adjustment on the 1997 current account was US\$2 billion. Balance-of-payments data for 1996 and 1997 adjusted for shuttle trade are presented in Table AI.3.*

*Source: IMF (1997), Staff Country Report No.97/110, November; and State Planning Organization (1998), Main Economic Indicators, March.*

*Current account developments*

21. The current account deficit (excluding "shuttle" trade) averaged some 0.5% of GNP from 1985 to 1992 (Table I.2). However, slack fiscal and monetary policies contributed to the widening of the trade deficit to US\$14 billion and the current account deficit increased to 3.5% of GNP in 1993 (Table AI.2). Corrective actions under the stabilization programme in 1994 led to a US\$10 billion reduction in the trade gap. In 1995 domestic demand again accelerated and the trade deficit widened correspondingly; this was further stimulated by the inception of the EU customs union. Overall, the current account deficit reached a 2.4% of GNP in 1997, or 1.4% when adjusted for "shuttle" trade.

22. Turkey has a substantial, and increasing, credit balance on "other goods, services, and income transfers" amounting to about US\$12 billion in 1997, sharply up from US\$4 billion in 1993 (Table AI.2). The main credit item, tourism, which increased from US\$4 billion in 1993 to US\$7 billion in 1997, was to some extent offset by travel abroad. On the debit side, interest payments on Turkey's large foreign debt amounted to as much as US\$4.6 billion in 1997.

23. Net private unrequited transfers, consisting almost entirely of workers' remittances, amounted to some US\$4.6 billion in 1997. Official unrequited transfers have decreased in importance since 1993, down from US\$0.7 billion to US\$0.3 billion in 1997. Presently, it is dominated by payments from Saudi Arabia and other countries, as partial compensation for the cost to Turkey of applying sanctions against Iraq.

*Capital flows and foreign debt developments*

24. Capital inflows grew rapidly up to 1994, owing to a sharp increase in private inflows, as well as official flows (plus the continued high levels of workers remittances as noted above). However, overall capital inflows fell sharply in 1994. At the time of the currency crisis, foreign private creditors declared their reluctance to finance the current account, which they considered too high; credit disbursement by private lenders plummeted from US\$3.8 billion in 1993 to US\$0.9 billion in 1994.<sup>11</sup> In addition, net portfolio investment fell. Since the crisis, however, external financing, although expensive, has not yet posed a serious problem, with lower debt-service ratios than in the 1980s.

25. Net portfolio investment fluctuated considerably more in the 1990s than the flows of net foreign direct investment (Table AI.2). While it rose steadily in the early 1990s, it fell sharply during the crisis in 1994 and continued to fall in 1995. In 1997, portfolio inflows increased substantially, attracted by high real interest rates.

26. An increase in foreign direct investment had been expected following the establishment of the customs union with the EU but this has not yet materialized. Deterrent factors may include continued political uncertainties, high inflation and corresponding foreign exchange rate adjustments, and a continued degree of regional instability. Successful implementation of the privatization programme (Chapter III (4)(i)) would provide scope for additional inflows in the short-run, but its more lasting benefit would be through efficiency gains and a boost to private sector confidence. Net foreign direct investment has varied between some US\$550 million and US\$770 million since 1993 (Table I.3). Except at aggregate levels, data are not available on realized foreign direct investment by sector or country of origin. However, annual data on approved permits indicate that inflows of foreign direct investment continue to be heavily dominated by the EU (Table I.3); between 1993 and 1997 the largest shares were from France (accounting for 29% of total permits) and the Netherlands (12% of total permits). The majority of the foreign direct investment permits during this period were for the manufacturing sector followed by services, albeit with large fluctuations over the period (Table I.3).

27. Despite downgradings of Turkey's credit rating, external debt built from US\$67 billion (or 37% of GNP) in 1993 to US\$81 billion (equivalent to 42% of GNP) in the first quarter of 1997; of this, about one quarter was accounted for by short-term debt. However, Turkey has so far had no difficulties in servicing its debt; as noted, the ratio of external debt service to total foreign exchange receipts is still below the levels of the 1980s.

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<sup>11</sup> Uygur (1996), p. 25.

**Table I.3**  
**Foreign investment, 1990-97**  
 (US\$ million, and %)

	1990	1991	1992	1993	1994	1995	1996	1997
Foreign direct investment (US\$ million)								
Permit	1,861	1,967	1,820	2,125	1,485	2,938	3,837	1,678
Inflows (realized)	788	910	912	797	637	935	937	558
Net (realized)	700	783	779	622	559	772	612	554
Portfolio, net (US\$ million)	547	623	2,411	3,917	1,158	237	570	1,634
Total investment, net (US\$ million)	1,247	1,406	3,190	4,539	1,717	1,009	1,182	2,188
Total as per cent of GNP	0.8	0.9	2.0	2.5	1.3	0.6	0.6	1.1
Foreign direct investment permits by country of origin (per cent of total):								
EU	69	53	62	56	66	64	85	61
France	36	13	19	11	17	16	62	6
Netherlands	4	14	15	10	13	19	9	12
Germany	8	10	11	8	15	13	6	17
Italy	4	9	7	20	11	3	1	7
United Kingdom	15	4	6	5	4	6	4	7
Belgium-Luxembourg	1	2	2	2	4	3	2	2
Switzerland	7	23	11	19	11	8	5	10
United States	7	6	11	7	4	11	4	3
Others	17	18	16	19	20	17	6	25
Foreign direct investment permits by activity (per cent of total):								
Agriculture	3	1	2	1	2	1	2	1
Mining	3	2	1	1	0	2	0	2
Manufacturing	65	56	70	76	75	68	17	52
Services (including construction)	29	41	27	22	23	29	81	46

Source: State Planning Organization (various issues), Main Economic Indicators; and data supplied by the Undersecretariat of Treasury, General Directorate of Foreign Investment.

### (3) COMPOSITION AND DIRECTION OF TRADE

28. The share of merchandise trade to GNP increased from 9% in 1979, when the economy still pursued an import-substitution policy, to 25% in 1993 and to 38% in 1997. However, as noted above, the trade data are underestimated due to lack of detailed information on "shuttle" trade with the countries of the former Soviet Union and Eastern Europe (Box I.3).

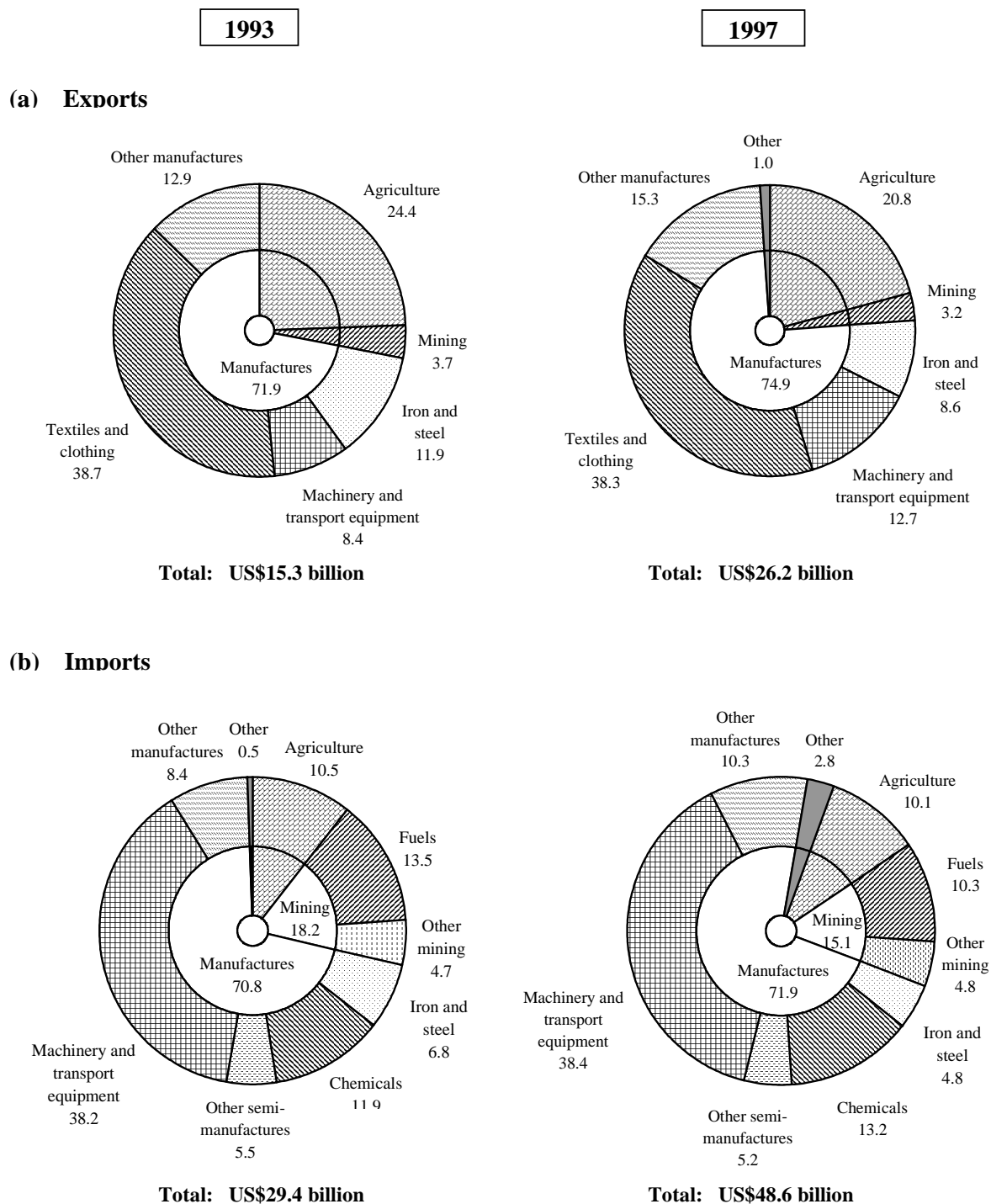
#### (i) Composition of merchandise trade

29. The share of manufacturing in Turkey's merchandise exports has increased in the 1990s, continuing the trend seen in the 1980s. The share increased from 72% in 1993 to 75% in 1997 and increased by 78% in value, while primary products fell from 28% to 24%. In addition to the leading textiles sub sector, important contributions to the expansion of the manufacturing sector were made by machinery and transport equipment (Table AI.4 and Chart I.3). The contribution of clothing has fluctuated over the past four years, accounting for 26% in 1997. The iron and steel sector reduced its share of total merchandise exports, but continues to be an important export item. However, reflecting their comparative advantage, labour-intensive industries, textiles, food, and iron and steel, still account for about 40% of merchandise exports.

**Chart I.3**

**Product composition of merchandise trade, 1993 and 1997**

Per cent



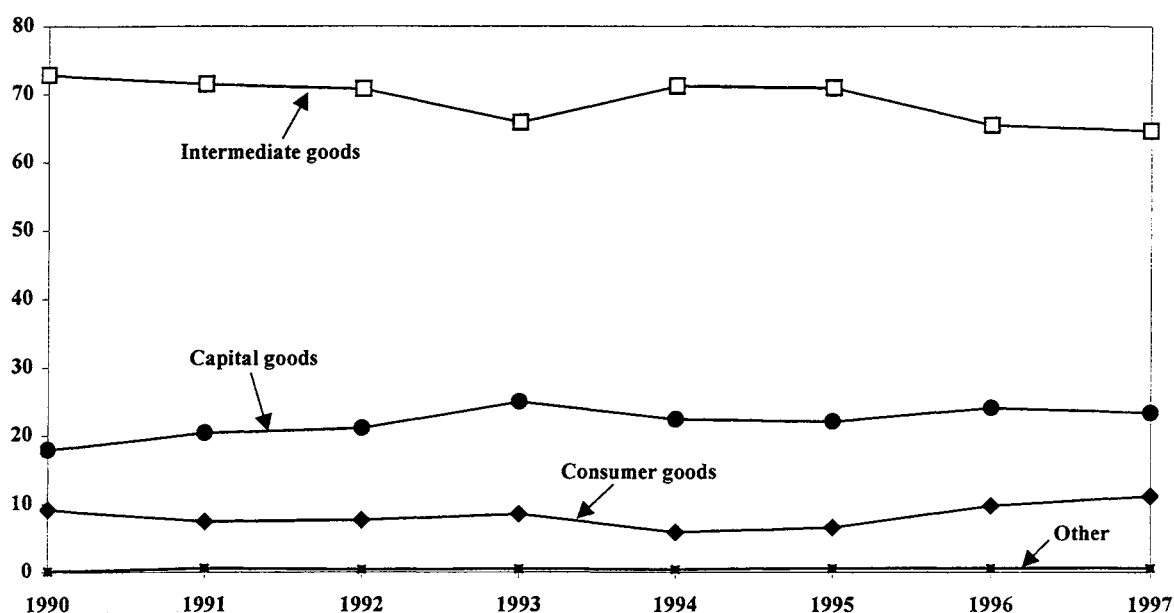
Source: UNSD, Comtrade database (SITC Rev.1).

30. Similarly, manufacturing dominates imports, amounting to 72% in 1997, of which machinery and transport equipment and chemicals are the most important items (Table AI.5 and Chart I.3). Agricultural products, mainly specialty foodstuffs and tropical crops not produced domestically, continued to account for a small fraction of imports. The structure of imports by function has remained broadly the same during the 1990s (Chart I.4). Intermediate goods dominate merchandise imports, accounting for some 66%, while investment goods account for almost one quarter. However, in 1997 consumer goods increased, reflecting imports of cars and consumer durables.

**Chart I.4**

**Merchandise imports by function, 1990-97**

Per cent of total



Note: The classification is based on UN Broad Economic Categories (BEC) classification.

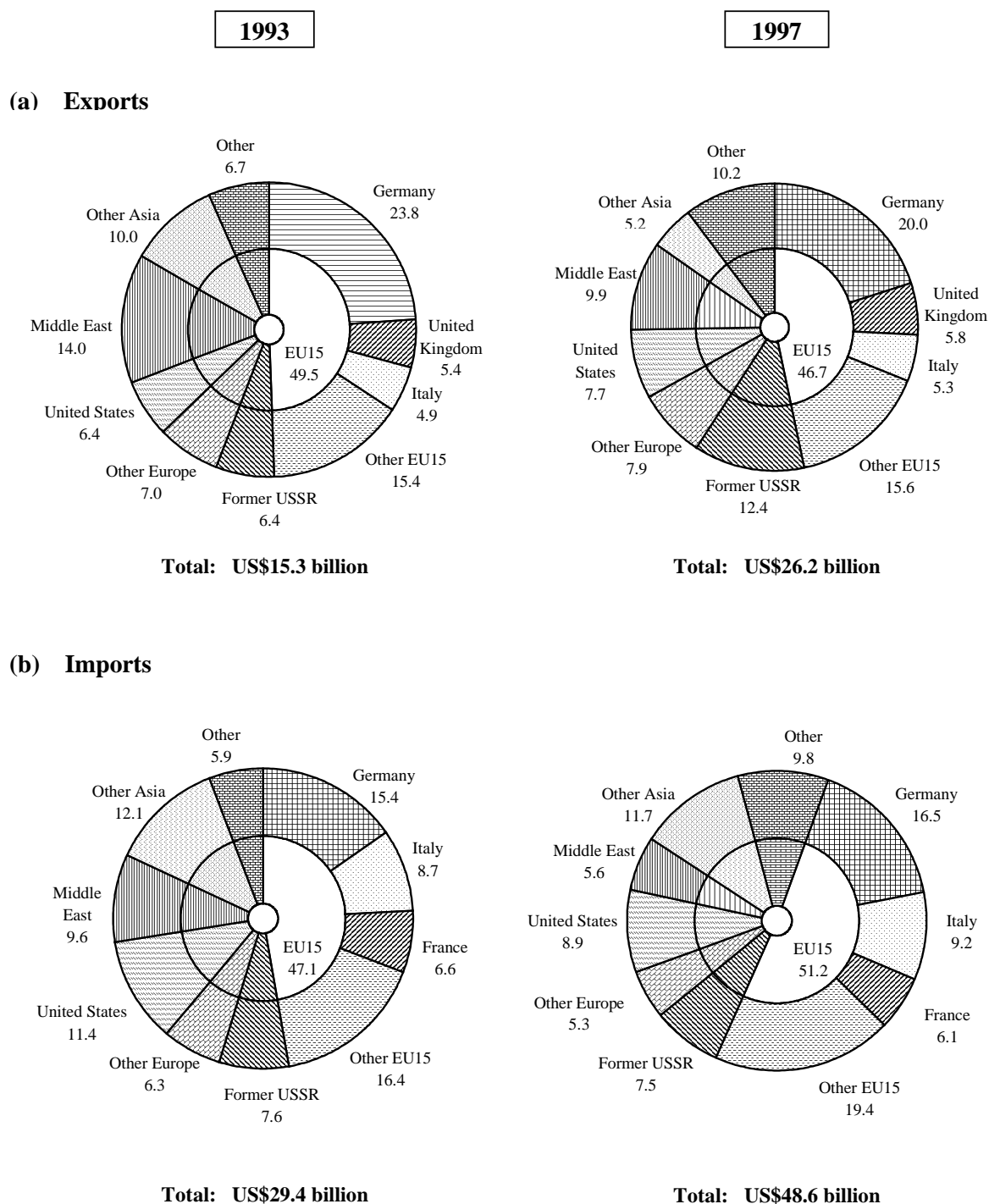
Source: State Planning Organization (1998), *Main Economic Indicators*, March.

**(ii) Direction of merchandise trade**

31. The intensity of Turkey's trade with Western Europe has increased since the previous Trade Policy Review, in particular since the customs union decision (CUD) with the EU. In 1997, the EU accounted for 51% of imports compared to 47% in 1993 (Tables AI.6 and AI.7 and Chart I.5). However, exports to the EU have fluctuated between 47 and 51% of the total. Germany is Turkey's largest single trading partner (18% of total merchandise trade in 1997), followed by the United States (8%) and Italy (8%). Exports to the former Soviet Union have sharply increased, from 6% of merchandise exports in 1993 to 12% in 1997. Trade with Middle-Eastern countries (10% of exports and 6% of imports in 1997) recently decreased following the fall in the oil price and the imposition of sanctions on Iraq.

**Chart I.5**  
**Direction of merchandise trade, 1993 and 1997**

Per cent



Source: UNSD, Comtrade database (SITC Rev.1).

32. Turkey's intra-industry trade (ITT) with the EU, which refers to trade of goods in the same industrial category, is small, albeit growing, with the ratio of ITT to total trade increasing from 13 in 1993 to 21 in 1997. Turkey's ITT with the rest of the world is only slightly higher than that with EU, with an ITT ratio of 28 in 1997.

### **(iii) Trade in services**

33. Services are an important part of international trade for Turkey. Balance-of-payments data indicate that Turkey has continued to be a substantial net exporter of services since its previous Review.<sup>12</sup> Receipts on services increased from US\$10.7 billion (equivalent to 6% of GNP) in 1993 to US\$13.0 billion (7% of GNP) in 1996; in 1996 tourism accounted for about 43% of total receipts, while construction services made up another 15%. The major items on the debit account, which amounted to US\$6.4 billion in 1996, are personal, cultural and recreational services (29% of debits in 1996), freight services (20%) and travel (20%). Data on trade in services by major trading partners are not available.

### **(4) OUTLOOK**

34. Although the prospects for the Turkish economy have improved considerably since the last Review, the economy is still performing below its full potential. The imbalance in the government budget continues to be detrimental for the outlook of the economy. Inflation remains high and the borrowing requirement of the public sector has driven up real interest rates increasing the costs of private investment. Moreover, slow progress in the implementation of key structural reforms, such as the overhaul of the social security system, risk delaying the recovery of the fiscal position. The efficiency of the economy would also benefit from speedy privatization of state economic enterprises and the banking sector.

35. The recently concluded customs union between Turkey and EU is expected to have a major, positive impact on the economy, but it has also created a number of challenges, including the need to replace revenues from border taxes. An expected upsurge in foreign direct investment does not appear to have materialized; rather, the increase in inflows of short-term capital in recent years may give cause for concern over the future burden of foreign debt financing. Controlling the debt burden - internal and external - may therefore be the major constraint on Turkey's macroeconomic performance.

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<sup>12</sup> It should be noted that official statistics on services over-record actual flows (see Box I.3).