On the Path to High-Income Status or to Middle-Income Trap: The Turkish Economy in Search of Its Future

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1 Introduction

The growth episode of the Turkish economy in the 2000s was written based on two integrated fundamentals: fixing the deteriorating dynamics and implementing further reforms to stimulate economic activity. This basic formula led to attractive rates of economic growth, fueled particularly by domestic private investments along with revived consumption and exports. Integrated with the political stability established by single-party governments in the post-2002 period, the improving economic outlook also helped Turkey enjoy record levels of foreign investment, adding momentum to the growth story.

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In that sense, the 2008–2009 Global Financial Crisis (GFC) serves as a milestone against which to test the strength of the Turkish economy. While having contracted in 2009, the economy weathered the storm quite well and exhibited conspicuous growth rates following the crisis. On the other hand, gearing up the economy at high speed started to show side effects, with a concomitant risk of overheating. In this context, the rising ratio of current account deficit with regard to GDP appeared as a leading concern that contributed to the vulnerabilities of the economy. At that point, policies to cool down the economy were successfully implemented, which soon brought the growth rates to the required but not-so-desired lower levels.

What the Turkish experience in the postcrisis period implies is that for an ideally fast and – more importantly – sustainable growth rate, the economy needs a new generation of structural reforms that simultaneously heal fragilities and vitalize economic activity. In this framework, this edited volume scrutinizes the last 15 years of the Turkish economy, while also attempting to do something more that was absent in many earlier studies covering Turkey. Each chapter in this volume aims to provide professional assessments and assistance to the relevant parties, particularly policymakers, on the new directions to take the Turkish economy.

For this purpose, the book is composed of three broad sections covering the key dimensions of the Turkish economy in search of its future: (1) state, institutions, and political economy; (2) the financial system; and (3) the real economy.

2 State, Institutions, and Political Economy

The quality of institutions is crucial for a strong fiscal capacity and a sustainable welfare state. Although there have been noteworthy improvements in governance in Turkey since 2002, it is undeniable that Turkey could and should improve its quality of institutions even more to escape from the middle-income trap. In addition, business–government relations need to be more effective. It is known that governance and institutions, could have sizeable effects on economic development. Social trust, which is observed to be weak in Turkey, is crucial to improving the quality of institutions. This is because, in all countries, a lack of trust could lead to heavy-handed regulations, inefficient bureaucracy, and a cumbersome legal system. Hence, given the vital importance of the issue, this section analyses business–government relationships, the transformation of elites, the role of the military in the formation of coalitions, social trust, and bureaucratic performance in Turkey to show paths to improving the quality of institutions. In addition, it also examines the political economy of policy formation in social policy and strategic industrial policies.

The section starts with a chapter that focuses on the role of the state in the Turkish economy over the last 15 years. In this chapter (The Role of the State in the Turkish Economy), Gur evaluates the effect of government policies on the Turkish economy and advances some policy proposals to make state mechanisms more growth- and development-friendly. There is no doubt that Turkey needs new investments and reforms to raise its income level and extract itself from the middle-income trap. To make this happen, the author suggests that the state should undertake a number of important tasks in various areas, from industrial policies to institutional reforms.

In the next chapter (Political Economy of Transformation of Capital Structure in Turkey: A Historical and Comparative View), A. Babacan provides a historical and comparative view of the way the capital structure has evolved in Turkey. The political economy approach employed here offers novel and comprehensive insight into the transformation of Turkish capital structure. In this context, Babacan positions the two main business groups of industrial and businessmen's associations in the country, namely, MUSIAD and TUSIAD, within the framework of this transformation. The roles of these groups appear more clearly in this historical process as representatives of the two different political-economic bases in terms of magnitude, volume, geography, mental and cultural codes/roots, and, hence, differentiated visions and structural realities.

Akarca, on the other hand, examines another important political-economy phenomenon in Turkey – the military coups in the nation's history. In his chapter (Single-Party Governments as a Cause and Coalitions as a Consequence of Coups in Turkey), Akarca asserts that single-party governments and coalitions in the country are a cause and a consequence of coups, respectively. In this connection, he documents that economic performance under coalition governments, especially those involving both right- and left-wing parties, was not as good as under single-party governments. Akarca investigates the 1950–2015 period historically and empirically through descriptive statistics and regression analysis. The results reveal that the postcoup governments in Turkey were created artificially by the military, using a coup as a tool to fashion Turkish politics. While the causes and consequences of such interventions are also discussed in the chapter, it is shown that the adverse impacts of coups in Turkey were not only restricted to the periods of military rule but also continued through the chain of the coalition governments that emerged. Akarca's chapter (Single-Party Governments as a Cause and Coalitions as a Consequence of Coups in Turkey) is especially interesting in terms of seeing the historical and institutional causes of political economy formations in Turkey.

Aysan (Between Risks and Opportunities: Social Policies in Contemporary Turkey) touches upon another important and rapidly changing institutional and political economy issue in Turkey: social policies in contemporary Turkey. This chapter deals with recent social policies in the country, which typically characterize the Turkish political-economy story, especially in the last 15 years. In this study, Aysan analyses Turkish social policies in the 2000s in relation to welfare regime discussions in the literature. He demonstrates that Turkey has experienced significant improvements both in social expenditures and the quality of social provisions in the relevant time period, while revealing that the family and the state have been the most important welfare players in Turkey. On the other hand, considering the challenges ahead, the author concludes that a new social policy strategy is needed to establish a sustainable welfare regime in Turkey, and to this end he provides some policy recommendations.

In the last chapter of the section (Turkey's Struggle to Achieve High-Income Status Through Adaptation to the Knowledge Economy), Aslan and Aslan follow a political-economy approach to analyse Turkey's developmental policies in the recent decade with a special focus on its higher-education institutions and national innovation system. Authors evaluate the performance of Turkey in different areas of the knowledge economy and put forth policy proposals to improve the education system in Turkey in order for the country to escape the middle-income trap.

3 Financial System

The 2000/2001 crisis opened up a new avenue for a structural reform route in Turkey, where efforts mainly focused on the banking sector as the major cause of the crunch. The comprehensive banking sector reform initiative turned out to be so successful that the effects of the GFC on the Turkish economy remained limited. On the other hand, new financial system reforms are now needed to make the financial system more stable and development-friendly. Hence, this section addresses the globally accepted need for "good finance" in the context of Turkey for potential improvements. Moreover, a particular emphasis is placed on banking given that the country's financial sector is still dominated by banks. For one thing, strategies of the banks have changed quite radically in the past 15 years, and it is very likely that they will change again in the years ahead. Hence, an assessment of the experience will provide valuable insight into how the banking sector should proceed in the coming decades. The same is true of subsectors like Islamic financial institutions in Turkey. That is why various subsectors in the Turkish financial system are also investigated in this section.

The section starts out with an overall outlook drawn by Ari on financial openness, financial stability, and macroeconomic performance in Turkey. Although economic theory argues that financial openness and development promote economic growth, several experiences in different developing countries do not provide firm support of this theoretical reality. The Turkish liberalization experience is one of the best examples of this disparity. Turkey suffered three full-fledged financial crises in 1994, 1998–1999, and 2000–2001, following the liberalization policies implemented through the 1980s, but managed to remarkably improve economic outcomes such as growth and inflation in the post-2001 crisis period. This result is mainly due to more effective fiscal and monetary management, strengthened banking regulation and supervision, and conservative banking practices pursued over the last decade and a half. Ari (Financial Openness, Financial Stability, and Macroeconomic Performance in Turkey: A Comparative Perspective) argues that in order to increase the possible benefits of financial openness and development for economic growth, particularly in emerging countries such as Turkey, financial liberalization needs to be implemented in a well-designed, effective supervisory and regulatory framework and in a sequenced manner.

The next chapter (Capital Inflows and Banking in the Turkish Economy), written by Aydemir and Ovenc, focuses on the capital inflows and banking in the Turkish economy. It evaluates the developments in the Turkish banking industry in the context of capital and financial inflows, with a specific focus on cross-border banking liabilities. The authors first analyse how the Turkish economy, as an emerging market, has been affected by inflows at various points in global markets. Then they describe the transformation of the Turkish banking sector by paying special attention to the post-2001 period. In particular, they investigate the association between cross-border liability and banking performance. The analysis concludes with some policy recommendations based on the current outlook of the Turkish banking sector.

Dolgun and Gunduz (Turkish Banking Industry: A CAMELS Analysis) approach the Turkish banking system from another angle and assess it using the CAMELS method, with a focus on recent financial developments. Their analysis reveals that the return on assets and return on equity of the Turkish banking industry are at relatively acceptable levels and have been following an upward trend lately. An increase in profitability strengthens capital while a slowdown in loan growth rate limits risk-weighted asset growth. The Turkish banking system continues to remain resilient to interest-rate shocks and maintains its strength against exchange rate risks. The authors show that foreign resources of the banking sector remain stable and the liquidity buffers are sufficient to weather any shock that could arise as a result of global liquidity conditions. The article also discusses current and future opportunities and challenges facing the Turkish financial industry. With respect to opportunities, there is ample room for the development and diversification of financial markets, institutions, and instruments. However, relying mostly on the banking sector, having an increasing loan-to-deposit ratio, facing tightening global liquidity conditions, and depending on foreign capital inflows are highlighted as important challenges for the Turkish financial sector. Readers interested in the financial growth strategy of Turkey in the last 15 years will find this chapter especially useful in terms of acquiring a thorough understanding of the associated dynamics.

In another piece, Yas, Aslan, and Ozdemir (Modern History of Islamic Finance and a Strategic Roadmap for Its Development in Turkey) analyse another growing segment of the financial markets in Turkey, namely, Islamic finance. Turkey has been providing Islamic financial services for more than 30 years now. On the other hand, while it is ranked second in terms of GDP among Muslim-majority countries, its share of total Islamic assets is just around 3 percent. However, Turkey has placed special emphasis on promoting Islamic financial markets in recent years. The government has declared that the share of Islamic banks should reach 15 percent of the industry by 2023. In this sense, this chapter discusses the challenges that the Islamic finance industry has encountered and provides a general framework for designing the initiatives needed and integrating them in the financial sector policies. To this end, the modern history of Islamic finance of Turkey, Islamic capital markets, the Sukuk market, Islamic indices and funds, Takaful (Islamic insurance), and Islamic pension funds are all briefly discussed in the chapter.

In a similar framework, recent financial and real sector reforms have sought to raise savings rates in Turkey. In this context, the chapter (Saving Behaviour in Turkey: Where Are We? And What Can We Do About It?) written by Tatliyer provides a critical assessment of the measurement of savings in the country and raises some doubts on the presumed consensus that the nation's savings rates are low. Analysing the course of saving behaviour in Turkey since the 1990s, the author argues that roughly half of the decrease in the aggregate savings rate can be attributed to the rapid increase in education and health expenditures, which can simply be regarded as investments under a broader savings definition. He further suggests that limiting credit expansion and improving credit composition, which can be fulfilled by developing Islamic financial instruments as well as wealth and pension funds, for example, could induce households to save more and boost the productivity level of the whole economy.

4 Real Economy

In 2005, Turkey graduated to the status of upper-middle-income country and tripled its GDP per capita within a decade following the rise of the single-party government to power. In that regard, the ongoing target is to climb up the income ladder within a reasonable timespan so that the economy does not become stuck in the so-called middle-income trap. On the other hand, completing the transition to a high-income economy can only be achieved on a more solid basis, in which competitiveness is strengthened and weaknesses are fixed. In this connection, data clearly reveal that Turkey deals with the deficits it runs on energy and technology, further indicating that it must adopt reforms that would reduce its level of dependence on foreign inputs. That is why some chapters in this section focus on gaining national competence in related areas. While inhibiting imports is a big necessity for Turkey, efforts also need to be directed at exports, with the aim of boosting the value and the penetration of products and services.

Empirical results in the literature indicate that technological change and innovation are significant drivers of economic development, but inclusive growth is also essential for a sustainable story. In this regard, Gunay and Kazazoglu (Towards Inclusive Growth and Sustainable Development: Science, Technology, and Innovation Strategies and Policy Implications) focus on the recent status of national science, technology, and innovation (STI) policies in Turkey and their relevant impacts. Based on a detailed analysis, they conclude that Turkey has made significant progress in building up its STI capacities since 2007, though it still underperforms in many key performance indicators compared to the OECD median and the EU average. In this context, the authors offer specific policy recommendations for Turkey around the second-generation STI reforms underlined.

In this context, Yulek (Thinking About a New Industrial Policy Framework for Turkey) emphasizes that Turkey can be considered a medium-level industrialized economy that faces difficulties in progressing to Stages II and Stage III in the industrialization process. On the other hand, it is well recognized that furthering the level of industrialization in Turkey is likely to help boost overall economic growth rates, increase export earnings, and get the country out of the current middle-income trap. In this connection, the chapter suggests that in order to continue its progress in the industrialization process, Turkey's industrial policy framework, its administrative structure, and its state formation with respect to facilitating better strategic industrial policy need to be reviewed. For this purpose, key policy proposals developed by the author are outlined in the chapter.

In another chapter (Turkish Labour Market: Outlook, Key Challenges, and Policy Recommendations), Bilgin and Danis focus on the persistently high unemployment rate in the country. They argue that the problem is the result of several rigidities and structural issues in the economy. In this context, they examine the Turkish labor market in detail in terms of supply and demand and develop some recommendations that would ensure long-lasting improvement. The authors conclude that the inability of the Turkish economy to generate sufficient employment makes structural reforms related to the labor market inevitable.

The following chapter (Developing National Competence in Nuclear Energy: The Case of Turkey) by Karahan focuses on the energy policy of Turkey. As is well known, Turkey has long dealt with the problem of a current account deficit, which largely stems from its energy dependence on foreign countries. The insufficiency of national energy resources poses challenges for Turkey not only economically but also in terms of energy supply security. In this regard, Karahan touches upon the recent attempts of the country regarding the adoption of nuclear power plants (NPPs). She claims that while Turkey has understandably launched its nuclear adventure based on international collaboration, countries relying on external expertise in NPPs must do their best to be intelligent customers. Based on this argument, she draws a basic framework for Turkey to adopt a national energy strategy.

Furthermore, M. Babacan (Beyond Planning and Liberalization: Foreign Trade and Industrial Development in Turkey) investigates the Turkish foreign trade strategy that is considered to be one of the main contributors to Turkey's growth story in the last 15 years. After a brief open-economy experience during the 1920s, the Turkish economy could be regarded as state-controlled, planned, and partially closed for the following half century, where trade meanwhile played a limited role. In this period, industry developed to a limited extent under an import-substitution strategy adopted in the 1960s and 1970s. In the 1980s, on the other hand, Turkey witnessed a period of commercial and financial openness, with an export-oriented industrial production and growth model that led to high growth rates along with increasing indebtedness as well as budget and current account deficits. Political and macroeconomic instability for the entire 1990s caused unsteady growth cycles under the unfinished industrialization and non-regulated liberalization processes. In this context, the author asserts that the AK Party period (2002–2017) represents a threshold for Turkish industrial, commercial, and financial expansion within a relatively stable environment, which then faced several challenges. New challenges due to the changing nature of world politics, regional and internal dynamics, and global economic developments are now forcing Turkey to revisit its export-led growth strategy based on reindustrialization by producing more capital-intensive goods with a greater technology component. In this connection, the chapter asserts that Turkey's rising global trade could support strong reindustrialization in strategic sectors.

The last chapter of the section focuses on the challenges of Turkish family businesses related to effective management strategies. This chapter stresses the importance of effective management for the sustainability of family businesses in Turkey. Family firms dominate business life and make a large contribution to job creation and exports in Turkey. The authors of the chapter (Developing National Competence in Nuclear Energy: The Case of Turkey), Cirpan and Alayoglu, argue that family dynamics tend to affect business dynamics, and vice versa. Thus, managing family relationships is an important characteristic of a family business. When they are managed effectively, success on many fronts is achieved; if they are not, however, the business, not to mention the family, may face many problems, leading to bankruptcy. Therefore, it is important to determine the predictors of family business sustainability for the benefit of both the economy and the families owning the firms.

Cirpan and Alayoglu explain how to resolve the problems and conflicts in Turkish family businesses and suggest some systems and strategies for effective management.

To conclude, avoiding the so-called middle-income trap and reaching a higher level of income require more thought and policy experimentation in a rapidly changing global environment. Hence, to this end, the chapters in this volume focus on different economic aspects of Turkey's economy and provide an overview of their subject matters while also putting forth policy recommendations. Such an approach is indeed well needed. Therefore, we wish to see more academic work that would go beyond analysing the past to offer policy advice. In this edited book, we have done our best to follow that approach. We hope the book will prove useful in that regard.