Discussion Paper Series -2009/04

Quo Vadis Turkish Economy?

Thinking Through the Recent Record, Policy Debates, and the Way Forward

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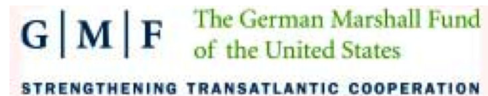

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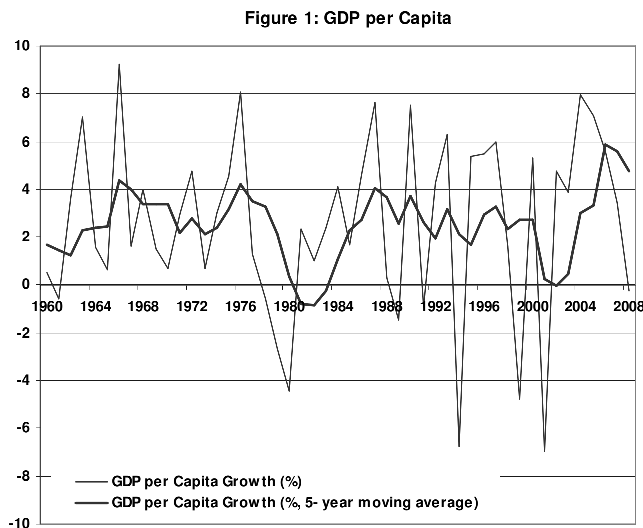
I. Introduction

From 2002 through 2007, Turkey has experienced its highest per capita income growth since the 1960s, but this year, it is likely to see one of its steepest drops (Figure 1). While an unprecedented global crisis is largely to blame and much of the damage was unavoidable given the magnitude of the shock, stalled reform momentum before, and indecisive management during the crisis, appear to have made things worse.

Having faced a dramatic deterioration in the growth outlook, the policy makers' response to the crisis has been a sharp easing of monetary and fiscal policies. In the process, Turkey's public sector primary (non-interest) balance has swung from a surplus of some 5% of GDP in early 2007, to over 2% deficit this year – the first such deficit since the early 1990s. The government looks aware and willing to stabilize the deterioration, but there are question marks as to whether it will be able to deliver. Meanwhile on the monetary policy front, the response was no less aggressive: The real policy rate has been brought down to almost zero from over 10% in less than a year ago.[1]

Figure 1: GDP per Capita



Although these policies may be justified under the circumstances, they will have to be reversed sooner or later because of the threat they constitute to macro stability. Should the current fiscal stance remain uncorrected, for instance, the debt-to-income ratio will continue to rise rapidly. Inflation trending up is not a major risk for the moment, but inflation expectations remain sticky, showing disbelief that inflation will ever go to below 6% levels in

[1] While some of the deterioration was cyclical, i.e. due to lost tax revenue because of a shrinking economy, growth in expenditures was dramatic during this period (more on this below). As for monetary policy, the Bank's rate action was not sufficient to normalize the credit market, with the overall credit growth remaining anemic at the time of this writing.

the near term, which is far from what could be considered "price stability." More broadly, it is not too far-fetched to think that the inability to formulate a credible "exit strategy" and a new road map of reform could lead to a rapid reversal of the impressive gains made since 2002, and in investor perceptions.

Ironically, despite all the stimulative policies in place, the strength of recovery and the growth outlook continue to remain uncertain, not only because of a more difficult global environment, but also because Turkey's latest "growth spurt" appears to have run its course. In summary, having entered the current crisis without a full consolidation of macroeconomic stability, the risk of being stuck in a relatively "low growth-high inflation" equilibrium in the years ahead, is not negligible. One of the most critical questions at the current juncture then, looks to be the following: How will Turkey return to disciplined policies and reinvigorate reforms in a much less favorable growth environment than before?

Answering this question requires putting the Turkish success story of recent years in perspective and reviewing the country's policy options and reform agenda going forward, which is what we ventured to do in this note. In Section II, we argue that, while Turkey did well in the past several years in the aftermath of its own financial crisis in 2001, so did pretty much every other major economy in Turkey's peer group. In good part, this was because, as it is now evident, the world was in a credit bubble and countries integrated to global trade and finance were the natural beneficiaries. The main issue here is that, Turkey's own policies (the so-called "pull factors") were pragmatic and commendable, but the role of a benign global environment (the "push factors") cannot be ignored – a point that needs to be taken into consideration going forward.

We then take a glance at Turkey's policy options in Section III, with special reference to the current economic discourse in the country. Some of the more serious policy advice on the table carries a heavy dose of -- what may be coined -- "China-envy", which boils down to the following two suggestions: (a) use monetary policy to keep the *real* exchange rate undervalued to encourage the manufacturing (tradable) sector; and (b) raise the domestic saving rate to finance investment (and hence growth) without running large current account deficits. But as we argue below, not only that the *desirability* of this advice is somewhat debatable, its *feasibility*, in the sense of a practical ability to carry it out given the realities of the Turkish economy seems very questionable.

In Section IV, we speculate on what could be done, cognizant of our inability to tackle the issue satisfactorily within the scope of this paper. Many of the "orthodox" reform areas promoted by the IFIs, and which, in one way or another, entered the government's policy documents-- reform the labor market, broaden the tax base, eliminate the informal economy, streamline public expenditure, reform social security and health system, and so on -- are sensible. But unless they are adequately prioritized, owned up, and a consensus built around

them, chances of their implementation are slim. The recently-popularized "Growth Diagnostics" approach, though a bit too heuristic, could be employed as a way of identifying the key *obstacles* to Turkish growth in our view, and help to narrow down an otherwise overwhelming to-do list of reforms. "Structural fiscal reforms" look like one such area. Section V concludes.

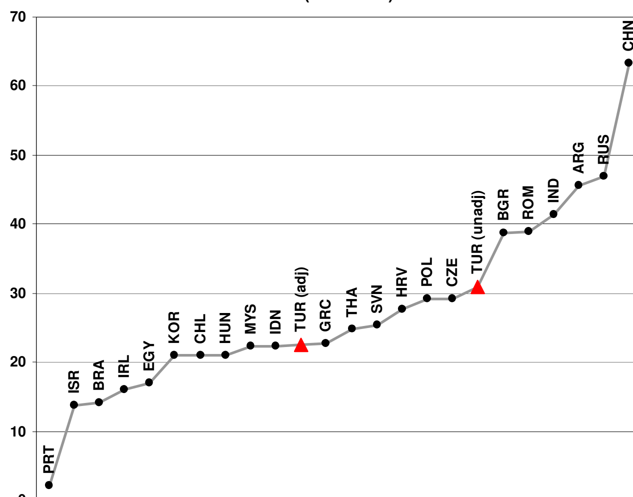
II. Some skeptical notes on the recent record

Success is how high you bounce
when you hit bottom.
General George S. Patton

The post-crisis recovery period of 2002-2007 was impressive by several counts. Turkey grew by some 7% per annum during this period, public debt (EU-defined gross central government) declined from a peak of almost 80% at end-2001, to some 40% in late 2007, and inflation dropped to single digits. One should recognize however that this was an exceptionally benign period for the global economy, with many countries in Turkey's peer group showing similarly strong performances.

Take growth, for instance. As shown in Figure 2 below, cumulative per capita growth was solid but by no means much above its peers, especially taking into account the large "output gap" (i.e. the difference between actual and potential output) with which the economy started with in the post-2001 crisis period.[2]

Figure 2: Cumulative GDP p.c. Growth (2002-2007)



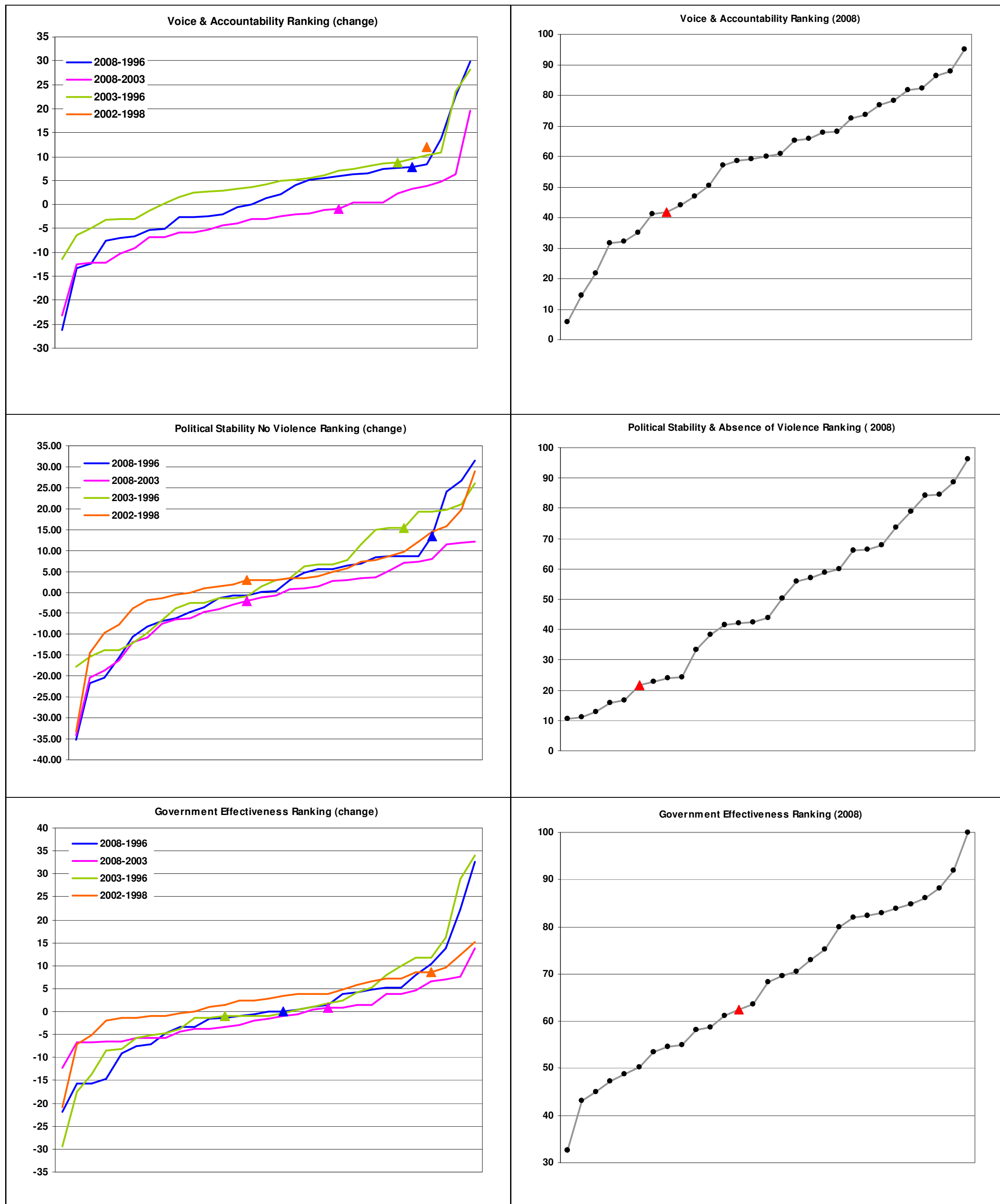
Source: International Financial Statistics. *See Figures 3 and 4 below for countries in the peer group.*

[2] The adjustment for the output gap was made by dividing 2007 *actual* income per population to 2002 *trend* income per population. Trend was calculated by applying the Hodrick-Prescott filter, as it is typically done in these circumstances.

The quality and sustainability of growth in this period was also questionable, at least on two grounds: Overall job growth was relatively weak and it looked as though the current account deficit was on an unsustainable path. Growth elasticity of employment was about 0.10-0.15 during this period, meaning 10 pp growth led to a 1-1.5 pp increase in employment. As for the CAD, Turkey's non-interest, non-debt (i.e. after adjusting for FDI and portfolio equity flows) CAD was negative, which meant current account/external debt sustainability would be assured only in a scenario in which growth remained very strong and the trend real appreciation continued. But let us now move to the more complex issue of how "institutional progress" has fared during this period in comparison to Turkey's peers.

Although this is a difficult area marred by measurement issues, a host of indices provide a short-cut of sorts in gauging structural reform outcomes, helping us to see the broad trends. The World Bank's well-known "governance indicators" are one good place to start (Figure 3). Two aspects are worth highlighting. First, progress during 2003 through 2008 (left panel), the period in which the single-party government was in power, does not look particularly impressive. Specifically, except for some upward movement in regulatory quality and control of corruption, Turkey did not appear to have made much progress in climbing up the governance ladder during the single-party tenure. Perhaps more interestingly, latest available data indicate that Turkey's remained generally below average in a group of about 30 emerging market countries including some more recent EU members. For instance, on the government effectiveness index, Turkey's ranking was 63 as of 2008, which is not only much different than where it was in 2003, but it is also worse than half the countries in the group.

Figure 3: Governance Indicators



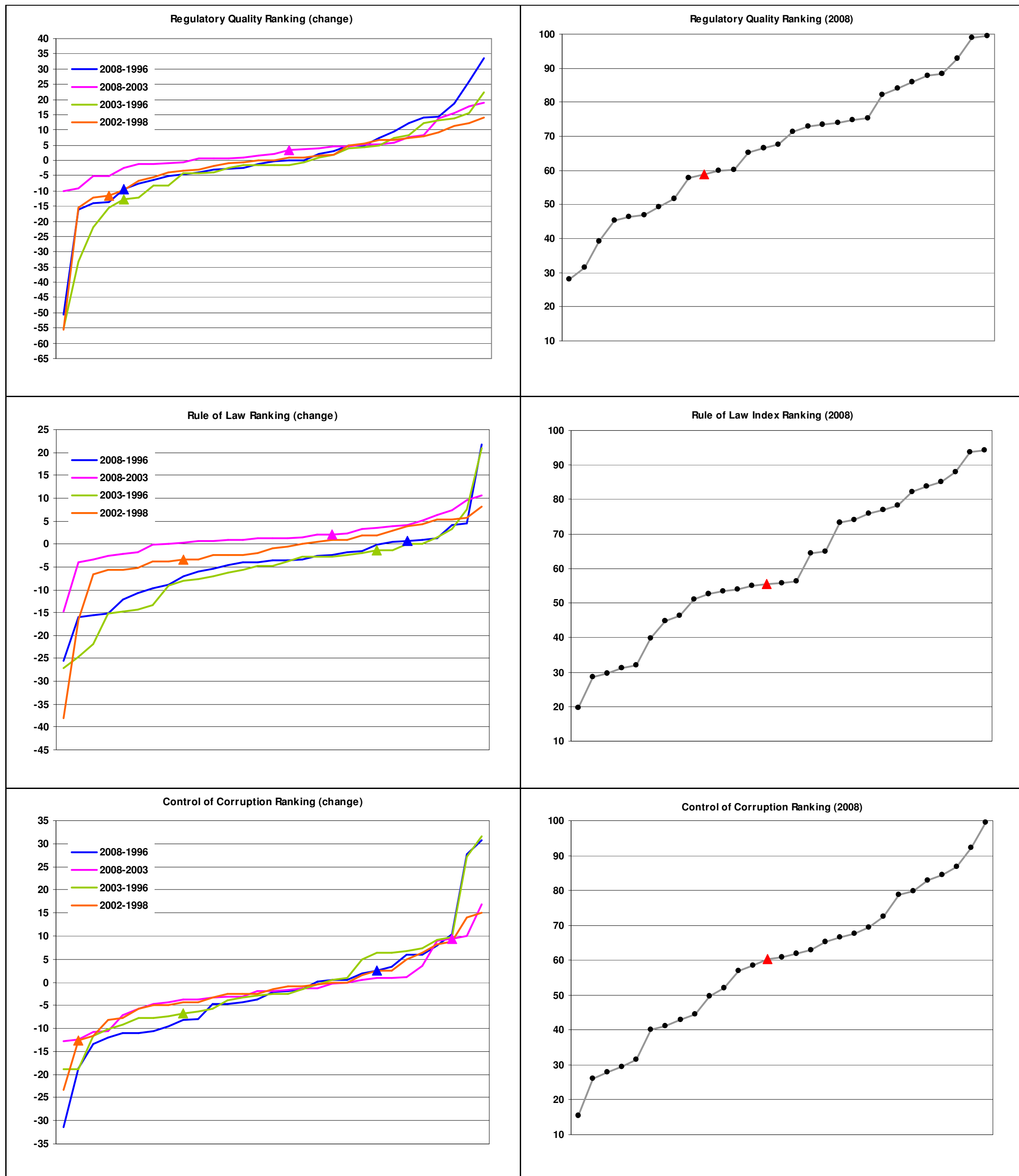
Source: World Bank (http://info.worldbank.org/governance/wgi/index.asp). Higher ranking corresponds to better outcomes. Country group includes Argentina, Brazil, Bulgaria, Chile, China, Croatia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Ireland, Israel, Korea, Malaysia, Mexico, Philippines, Poland, Portugal, Romania, Russia, Singapore, Slovenia, South Africa, Spain, Thailand, Turkey, Ukraine.

1. *Voice & Accountability* measures political, civil and human rights

2. *Political Stability & Absence of Violence* measures the likelihood of violent threats to, or changes in, government, including terrorism

3. *Government Effectiveness* measures the competence of the bureaucracy and the quality of public service delivery

Figure 3: Governance Indicators (concluded)



Source: World Bank (http://info.worldbank.org/governance/wgi/index.asp). Higher ranking corresponds to better outcomes. Country group includes Argentina, Brazil, Bulgaria, Chile, China, Croatia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Ireland, Israel, Korea, Malaysia, Mexico, Philippines, Poland, Portugal, Romania, Russia, Singapore, Slovenia, South Africa, Spain, Thailand, Turkey, Ukraine.

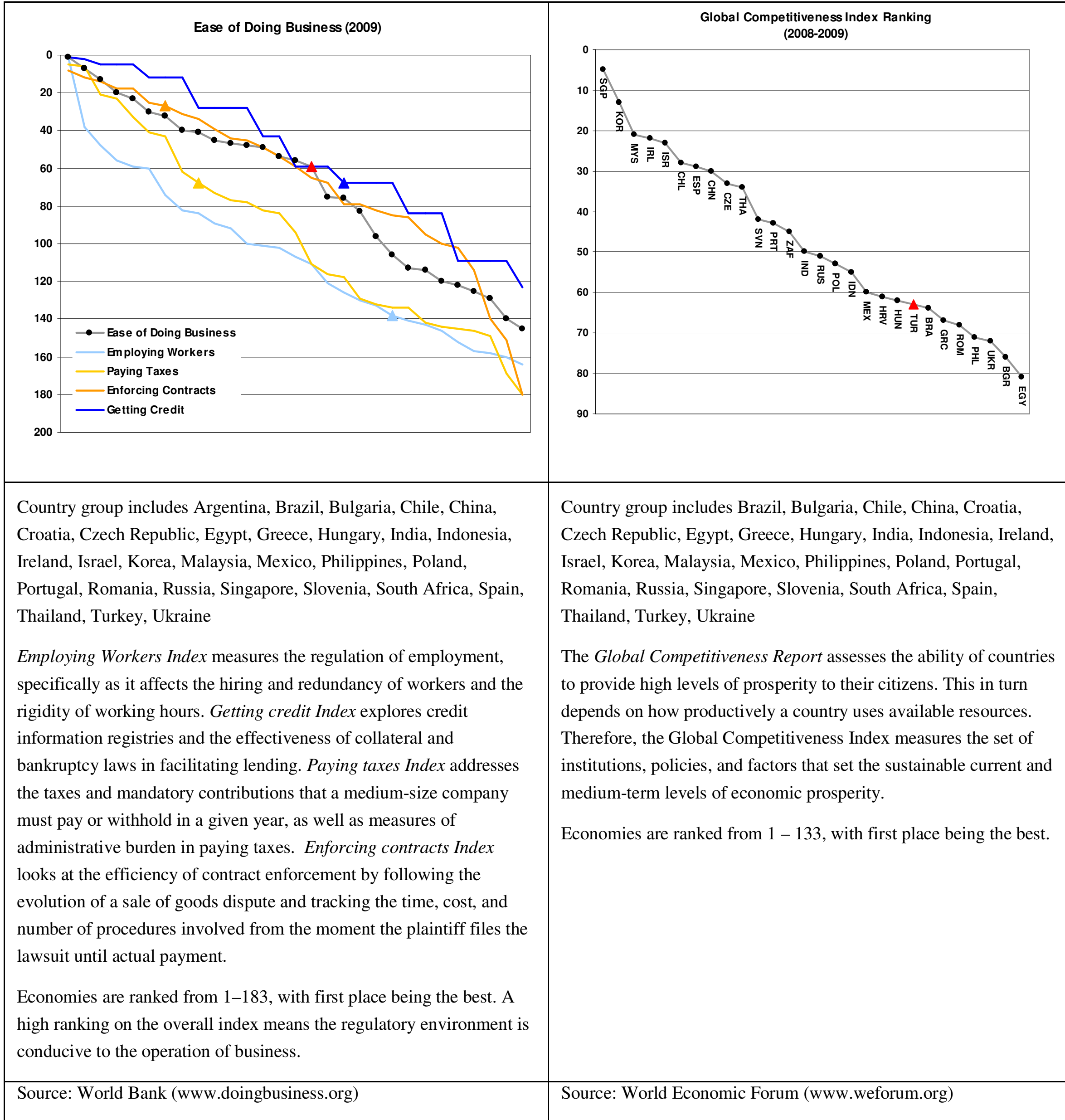
4. Regulatory Quality measures the incidence of market-unfriendly policies

5. Rule of Law measures the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence

6. Control of Corruption measures the exercise of public power for private gain, including both petty and grand corruption and state capture

The situation is not very different in terms of the World Bank's "Doing Business Indictors" as well as the World Economic Forum's Global Competitiveness Index (Figure 4).[3] On certain categories of the former, Turkey's ranking was encouraging, but in terms of the overall index, Turkey is in the middle of the pack. The record is more concerning based on the WEF's competitiveness index, where Turkey seems to rank fairly low among its peers.

Figure 4: Doing Business & Global Competitiveness Index



Country group includes Argentina, Brazil, Bulgaria, Chile, China, Croatia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Ireland, Israel, Korea, Malaysia, Mexico, Philippines, Poland, Portugal, Romania, Russia, Singapore, Slovenia, South Africa, Spain, Thailand, Turkey, Ukraine

Employing Workers Index measures the regulation of employment, specifically as it affects the hiring and redundancy of workers and the rigidity of working hours. *Getting credit Index* explores credit information registries and the effectiveness of collateral and bankruptcy laws in facilitating lending. *Paying taxes Index* addresses the taxes and mandatory contributions that a medium-size company must pay or withhold in a given year, as well as measures of administrative burden in paying taxes. *Enforcing contracts Index* looks at the efficiency of contract enforcement by following the evolution of a sale of goods dispute and tracking the time, cost, and number of procedures involved from the moment the plaintiff files the lawsuit until actual payment.

Economies are ranked from 1–183, with first place being the best. A high ranking on the overall index means the regulatory environment is conducive to the operation of business.

Source: World Bank (www.doingbusiness.org)

Country group includes Brazil, Bulgaria, Chile, China, Croatia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Ireland, Israel, Korea, Malaysia, Mexico, Philippines, Poland, Portugal, Romania, Russia, Singapore, Slovenia, South Africa, Spain, Thailand, Turkey, Ukraine

The *Global Competitiveness Report* assesses the ability of countries to provide high levels of prosperity to their citizens. This in turn depends on how productively a country uses available resources. Therefore, the Global Competitiveness Index measures the set of institutions, policies, and factors that set the sustainable current and medium-term levels of economic prosperity.

Economies are ranked from 1 – 133, with first place being the best.

Source: World Economic Forum (www.weforum.org)

[3] More specific indicators of structural reforms such as broad measures of product and labor market flexibility are not readily available for our group of countries, but it is well-known that Turkey ranks poorly among OECD countries.

What we are saying so far can be summarized as follows: Turkey grew rapidly in recent years, but so did many other important emerging market economies, and Turkey's structural reform outcomes, measured by how far it has come in terms of a host of governance and competitiveness indicators, are not outstanding.

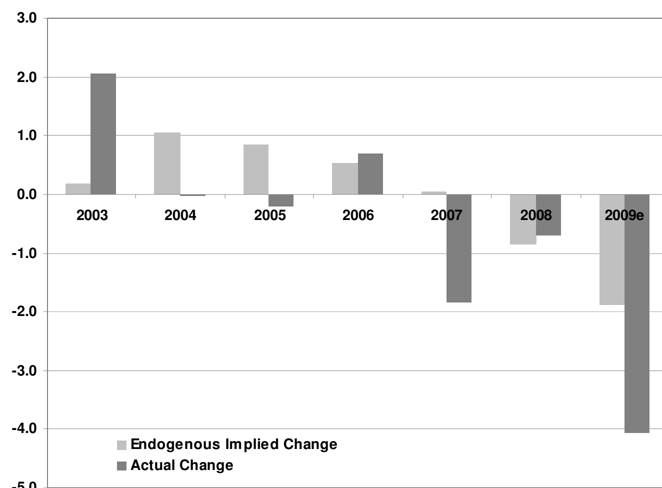
But how about the government's policy efforts during this period? After all, Turkey registered unprecedented levels of "primary surpluses" (overall balance less interest payments) during the period from 2003 through 2007 at the broader public sector level, which averaged 5% of GDP, in sharp contrast to the primary deficits of the 1990s. This performance contributed greatly to the virtuous circle of improved confidence, higher growth, lower interest rates and lower debt as a percent of GDP.

There is no doubt that the *quantitative* turnaround in fiscal performance was impressive. The problem is that important *qualitative* aspects – such as the measurement of the "true" fiscal stance and the evolution of the expenditure and revenue composition -- were largely overlooked, which have become a liability in the current, more hostile environment. It is a well-known feature of fiscal performance that it tends to be overstated in good times because one-off/non-recurrent revenues, in particular privatization receipts surge, and strong growth boost tax revenues. In order to derive the true fiscal stance then, the headline figures have to be adjusted for one-off revenues as well as for the business cycle, or the output gap. The IMF-defined primary balance does the former. Since there are no readily available estimates on the latter, we've done some calculations ourselves. Taking into account how demand conditions changed, or the output gap has evolved from 2003 through 2007, we calculated the *endogenous* change in the primary balance of the central government in the absence of explicit policy measures.[4]

Figure 5 below shows the results. Putting aside the strong adjustment in the budget stance in 2003, which corresponds to the first year of the single-party government and a time of significant uncertainties in global as well as local markets, our calculations suggest that fiscal stance was not particularly tight during the rest of the period. For instance in both 2004 and 2005, the predicted improvement in the primary surplus based on the economic cycle was 1 pp per year, but there was no change in the *actual* primary balance. More recently, we saw a massive deterioration in fiscal position notably in 2007 and in 2009, but again, these were more than justified by the slowdown in the economy. In sum, fiscal strength was a lot less

[4] Technically, this is done by multiplying the *change* in the output gap by a coefficient of 0.25, the estimated sensitivity of primary balance to demand/output conditions. This means that for each one percentage point rise (drop) in the output gap, primary balance-to-GDP ratio improves (deteriorates) by 0.25 pp.

impressive than the headline Ministry of Finance figures suggest during this period, once fiscal indicators are adjusted for one-off revenues and the business cycle.[5]



As for the revenue and expenditure composition of the budget, little has changed during this period. Reliance on indirect taxes -- especially those levied on a few low price elasticity products such as gasoline, tobacco and alcohol -- and the rigidity in the composition of expenditures, with little room left for discretionary spending, have persisted. Moreover, institutional underpinnings of budget implementation, the approval of the Public Financial Management and Control Law (PFMCL) in 2003 notwithstanding, were not sufficiently strengthened.[6] These shortcomings suggest to us that the so-called "structural fiscal reforms" were not carried out at a sufficiently aggressive pace, despite the fact that the benign context of the past several years was very conducive to pursuing these reforms.[7]

The general elections of July 2007 and the sharp economic contraction from the final quarter of last year onward – and the attendant deterioration in the fiscal position -- proved that these concerns are not academic. The deterioration that began in 2007 was large and rapid, the key reasons being weakening tax collections in 2009, but even more so, not so well-targeted "tax expenditures" in response to the crisis and an inability to restrain rapid growth in

[5] This particular shortcoming of Turkey's adjustment efforts has been pointed out by IFIs in various reports (e.g. OECD (2008), World Bank (2006), IMF (2007a)).

[6] See OECD (2008) for a detailed assessment of the PFMCL.

[7] Interestingly, there was a lot of emphasis on these reforms in the last IMF program and there has been some important progress in the past several years like in the area of tax collection, but the overall progress has nevertheless been slow.

expenditures, notably transfers (e.g., health and local governments), because of lack of proper control mechanisms in place, such as a transparent yet flexible "fiscal rule."

One major downside to all this is that a wonderful opportunity to focus on "costly reforms", which could have been financed from a gradual lowering of the primary surpluses, has been wasted. Put differently, Turkey had a "fiscal space" of sorts to allot some of the cumulated primary surpluses of recent years to reforms, but in the current negative primary balance environment reminiscent of the 1990s, this opportunity is now gone. To think that negative primary balances are affordable for Turkey is an illusion, as debt sustainability concerns would sooner or later come back to haunt markets, as well as the policy makers.

True, we start with a relatively low public debt as a percent of GDP (around 40% in gross and 30% in net terms at end-2008), but it is rising rapidly, and will reach an estimated 47% at the end of this year. Moreover, our financial markets are not deep, the maturity of our debt is short (about 3 years on new issues), and the corporate sector suffers from currency mismatches, making it vulnerable to exchange rate shocks. In sum, Turkey's fiscal adjustment in the post-crisis period was commendable. But it was a fragile adjustment in that, come late 2009, not much of it was left, the authorities' intentions to gradually put the house back in order notwithstanding.[8]

Where do these arguments leave us? Turkey did well in the aftermath of its financial crisis until the onset of the global credit crisis, and a pragmatic and reform-minded single-party government sticking with the IMF-EU anchors made an important contribution to that. But a lot of this success was also about bouncing back from the depressed base of "the lost 1990s" and keeping up with the peers against the backdrop of a very benign global economy. What we think has happened over the past several years is that Turkey experienced a "growth spurt", thanks to a favorable constellation of diverse set of factors, including solid initial conditions set out by post-crisis reforms and a pragmatic single-party government willing to continue with these reforms.

Going forward however, it is uncertain whether this growth spurt will transform into high and sustainable growth unless the economy's "institutional underpinnings" are strengthened through a new reform agenda. Rodrik (2007), speaking of a diverse set of experiences, articulates this concern well:

> "…igniting economic growth and sustaining it are somewhat different enterprises. The former generally requires a limited range of (often unconventional) reforms that need not overly tax the institutional capacity of the economy. The latter challenge is in many ways harder, as it requires constructing over the longer term a sound

[8] See the Medium-Term Economic Program (MTEP) announced in mid-September.

> institutional underpinning to endow the economy with resilience to shocks and maintain productive dynamism. Ignoring the distinction between these two tasks leaves reformers saddled with impossibly ambitious, undifferentiated, and impractical policy agendas."

Indeed, the job ahead is much more complex and the initial conditions are entirely different than before. The economy will most likely shrink by some 5.5%-6.5% this year, "fiscal space" has been entirely exhausted, the loose monetary-fiscal policy mix will have to be reversed sooner or later, and the global economy will most likely be weaker than before and capital flows more fickle. This will require replacing a weaker global growth environment, with more reform. But for that, we need to do at least two things: Tighten our policy debates and formulate a well-prioritized, time-bound, and transparent road map of reform around an overarching vision of growth. Without the former, i.e. before a consensus over our "true" policy options is established, the latter cannot be achieved. These are the issues we now turn to.

III. Thinking through our policy options

For every complex problem there is an answer that is clear, simple, and wrong.
H. L. Mencken

Having left the best of the global environment behind us, Turkey is once again at a tricky juncture. There is a pressing need for a new game plan, instead of an unfounded hope to mean-revert to the robust growth rates of a few years ago. What should be done? What are our policy options? It may help to start by dismissing what does not fall within the set of feasible policy options, the gist of which can be summed up as proposals driven by a -- what may be coined -- "China-envy": use monetary policy to manipulate the exchange rate, and increase the domestic saving rate. Although plausible on the face of it, the usefulness of both pieces of advice is doubtful in the Turkish context in our view, particularly on feasibility grounds.[9]

[9] While feasibility is our primary interest, the theoretical and empirical basis for pursuing these policies is not self-evident, either. The most forceful arguments in favor of a positive relation between the real exchange rate and growth are made in Rodrik (2008), where the "operative channel" is the size of the tradable sector. This is interpreted as the Total Factor Productivity (TFP) channel in Montiel and Serven (2008), who explore the same relation through the alternative saving/capital accumulation channel, and find no convincing evidence that the real exchange rate increases the saving rate – and hence the growth rate. Eichengreen (2008) agrees that the real exchange rate is important for growth, but concludes that it is at best a "facilitator" than a panacea. That is, absent strong fundamentals such as "a disciplined labor force, a high savings rate, or its status as a destination for foreign investment", he argues, "policy toward the real exchange rate will accomplish nothing". The panacea role to the real exchange rate -- or to the undervaluation of the *equilibrium* real exchange rate to be more precise -- is given by Rodrik (2008) in a sense, as a "second-best" mechanism to alleviate institutional weaknesses as well as market failures in the economy. As for the saving/growth link, the standard neo-classical growth theory predicts that higher saving leads to higher

Let us start with the exchange rate. Can the *real* exchange rate be the target of monetary policy in the Turkish context?[10] Our answer is most probably not, which mainly follows from an old dictum of international economics, the so-called "impossible trinity".[11] That is, having opted for capital mobility (since 1989) and independent monetary policy/floating exchange rate combination (or Inflation Targeting regime) after a failed exchange rate-based disinflation attempt in 2000, Turkish policy-makers are now in no position to simultaneously control the growth in monetary aggregates (and hence inflation), and the exchange rate.

The reason is simple. Suppose we are experiencing a strong capital inflow episode, and attendant appreciation pressures on the *lira*. A rapid easing of interest rates and/or F/X purchases to reduce these pressures would lead to monetary expansion, and hence inflation sooner or later. Sterilization (mopping up of excess liquidity through open market operations) is one way of delinking capital inflows from the money base, but that would not be sustainable because costs associated with sterilization are often high, with domestic rates typically hovering much above foreign rates.

Put differently, engineering exchange rate depreciation through easier monetary policy within the current framework would have to assume "money illusion", i.e. a situation in which agents constantly confuse *nominal* and *real* prices. While such policy may be effective in the short run -- because as an asset price the nominal exchange rate tends to move faster than prices and people may temporarily suffer from money illusion -- it is unlikely to work in the long run, as the public would eventually adjust its expectations to a higher rate of monetary growth and hence inflation. This would mean that the monetary policy authority's attempts to depreciate the *real* exchange rate would eventually fail, with the economy ending up at higher inflation, but not necessarily at a weaker (read: more competitive) exchange rate in inflation-adjusted terms.[12]

Of course, going back to a regime of pegging or actively managing the exchange rate, or restraining the free flow of capital are always a possibility, but the crisis-ridden history of "soft pegs" and the ongoing controversy on the *effectiveness* of capital controls rule these out as realistic, sustainable, long-term options for Turkey.[13]

investment, and hence higher growth, but this result disappears in an open economy context, which is more relevant for countries like Turkey. The empirical evidence on the saving/growth link is mixed, too. One line of research has found *reverse* causality, i.e. growth (higher incomes) preceding (higher) savings rather than the other way around, while another line of research has found that saving leads growth, but that the link runs through an FDI-driven TFP channel, rather than the more traditional investment channel (Aghion et. al (2009)).

[10] We are speaking of monetary policy specifically here, because according to the conventional wisdom, fiscal policy can be effective in managing the *real* exchange rate as well as capital inflows, as we briefly mention below; see also, Fischer (2001).

[11] The impossible trinity is the observation that a country can choose no more than two of the following three features of its monetary policy regime: (1) free capital mobility across borders, (2) a fixed exchange rate, and (3) an independent monetary policy targeted toward domestic objectives.

[12] Fischer (2001).

[13] On the former, see Mishkin (2006); on the latter, see See Chapter 3 in IMF (2007b) and Magud and Reinhart (2007), which provide comprehensive discussions of a very voluminous literature

But why restrain ourselves with the impossible trinity, and why not try out an "anything goes" policy of muddle through without any commitment or an explicit framework? This is always an option of course, but we would have then ignored some five decades of monetary policy experience that a transparent framework and a clear "nominal anchor" are critical to guiding inflation expectations, and resolving the "time inconsistency problem" (i.e. the authorities' tendency to break their promises for political reasons).[14] In plain English, we need to work with the basic principle that recurrent attempts at fooling the client and concealing the product quality are doomed to fail as a business model. This maxim applied to the economy would mean that complete policy discretion with no institutional restraint is very likely to lead to worse macroeconomic outcomes, such as higher output volatility and/or higher inflation.

This is not to say that policy makers should be entirely passive in the face of strong inflows. In a financially-integrated economy with a floating exchange rate regime, capital flows need to be managed precisely because inflation needs to be contained and overvaluation of the currency -- and hence loss of competitiveness – should be avoided. We have three sets of tools to deploy in that case, which are, in the preferred order, tighter fiscal policy, aggressive communication, and stricter prudential regulations. Fiscal policy alters the *real* exchange rate mainly by restraining aggregate demand and moving expenditures away from services.[15] Communication is useful, because it signals policy makers' discomfort with the level of the real exchange rate, and therefore the possibility of F/X intervention. Finally, strengthening prudential regulation helps to rein in credit booms.[16]

All this being said, "some" real appreciation is not a bad thing. As poor countries catch up with rich ones (typically thanks to productivity increases in tradable industries), service price inflation outpaces tradable price inflation as per capita incomes start to converge to the level of rich countries. This is nothing but the so-called Balassa-Samuelson effect observed in Japan in the 1960s, as well as in the newly acceded EU countries during "convergence." But rapid appreciations on the order of 20%-30% in one year cannot be explained by this effect alone, unless the exchange rate is correcting itself from an initial state of massive undervaluation. In that case, the authorities should be expected to express concern, rather than try to justify the pace of the appreciation. Jawboning in other words, could act as "sand-

[14] Mishkin (2007).
[15] Cardarelli, Elekdag and Kose (2009). This paper also shows that sterilized F/X interventions are costly and mostly ineffective in altering the course of the exchange rate. Yet, there is no reason why intervention should not be tried especially when inflows are of a short-term and temporary nature, and F/X reserve levels are considered inadequate, say, as a percentage of country's external financing needs. Of course, sterilization is easier in some contexts than others; if the capital account is relatively closed and the financial sector is relatively underdeveloped, as in China for instance, exchange rate becomes easier to manipulate.
[16] Hilbers et. al. (2007); and Mohan and Kapur (2009).

in-the wheels" of capital inflows, as long as policy makers dare to withstand the politicians' wrath.[17]

Of course, the long-term solution to appreciation pressures is to carry out reforms earnestly – and hence increase productivity -- so that appreciation becomes "affordable." That is, in the long run, the public needs to accept that no matter how well monetary and exchange rate policies are managed, they cannot substitute for reform, and for the building of "good institutions" that enhance economy's long-term competitiveness.[18]

How about the second piece of advice, that Turkey should raise its saving rate? Leaving aside the theoretical complications, this is indeed plausible advice.[19] After all, high savers run current account *surpluses*, which, by definition, make them less vulnerable to "sudden stops" of capital inflows – and Turkey, no doubt, is not one of them. Moreover, contrary to the conventional wisdom, recent empirical research shows that countries with current account *surpluses* grow faster than those with deficits.[20]

The key problem here again is that, it is anything but trivial to turn this intention into tangible policy advice in Turkey's circumstances, an issue we've explored in a recent paper (Van Rijckeghem and Ucer (2009)). Tighter fiscal policy is one option, but, as we argue there, not only that an increase in public saving does not translate into an equivalent increase in national saving -- because of partial offsets in private saving -- the room for further fiscal adjustment is limited in Turkey's circumstances (more on this below). Another standard option is to encourage a shift from income taxes to consumption (indirect) taxes, which would stimulate saving since it would no longer be taxed, but in Turkey, consumption taxes already make up two-thirds of tax revenue, in contrast to international practice, notably in OECD countries. Liberalization of the financial sector and the development of institutions that facilitate long-term saving are other possible tools to promote saving, but laws and practices in this area do not seem to be an impediment for long-term saving in Turkey: Liberalization of deposit rates occurred in the early 1980s, while the institutional framework for long-term saving— insurance, mutual funds, and private pension funds— is also broadly in place.[21]

Two other interesting features of Turkey's "low" saving rate are worth highlighting. First, Turkey's overall saving rate is not particularly low in "normal times" in the sense that it does not compare too poorly to world averages; it is countries in China's position, mainly the

[17] The problem here is that Turkey grows very rapidly during periods of strong inflows, which becomes politically very attractive. Ideally, we should grow into a mindset where growth rates above a certain level like 5%-5.5% that are accompanied by sharp real appreciations should be deemed unsustainable, and resisted.
[18] This is essentially the point made by Calvo and Mishkin (2005).
[19] For the theoretical complications, see footnote 9 above.
[20] See Prasad et. al (2007) for this view, and Abiad et. al. (2007) for a counterexample as applied to Europe, including new member states.
[21] Incentives, notably tax-related, may be provided like through the introduction of US-style Individual Retirement Accounts where IRA contributions are deducted from taxable income, with retirement income taxed at a later stage and at a lower rate, but fiscal implications of such a move would have to be studied carefully.

Asian countries that come across as the true outliers.[22] Second, Turkey's *private* saving rate drops sharply in "good times" -- as it has in the recent boom period from 2003 through 2007 – resulting from a confluence of many "favorable" factors, such as a relaxation of liquidity constraints through enhanced access to bank credit, catch-up from low levels of consumption of durables following crises, and a strong wealth effect associated with asset price inflation, as elsewhere.

So the question of why Turkey's saving rate is too low should be asked somewhat differently: Why is Asia saving so much? And how can Turkish policy-makers manage the next "capital inflow bonanza" more proactively, so that as dramatic a drop in the *private* saving rate can be avoided? The broad implication of all this is fairly clear: Prevent excessive drops in the *private* saving rate in good times by managing capital inflows -- and the associated credit and asset booms -- to the extent possible, but don't be too hopeful for raising the overall saving rate, given the limited policy options.

IV. "Growth Diagnostics" as an organizing framework?

You've got to be very careful if you don't know where you are going, because you might not get there.

Yogi Berra

So as the previous section suggests, a quick but a reasonably careful look at two of the most popular policy proposals on the table suggests that neither is without problems, nor easy to apply to the Turkish context. There are no silver bullets, in short. But what, then, should be done? Turkey needs to achieve high and sustainable growth to catch up with advanced countries and to meet its twin aspirations of becoming a regional power and joining the European Union. This, in turn, requires a vision and a "growth strategy." What exactly should such a strategy entail? This is a very difficult question that goes beyond this paper's scope, as well as its author's intellectual capacity. But it is probably fair to say that the task is complicated by two realities -- one academic and general, the other practical and Turkey-specific.

The academic reality is that our knowledge as to why some nations grow faster than others seems surprisingly limited, which makes the formulation of a blueprint as to what growth-friendly policies should be followed by policy-makers, very difficult or in fact, elusive.

[22] On the former question as it applies to China, see Box 2 in Van Rijckeghem and Ucer (2009).

Consider this quote from Bill Easterly, a prominent growth economist and the author of *Elusive Quest for Growth*, a skeptical treatise on growth theories and growth empirics:

> "Theoretical breakthroughs in the late 1980s […] helped inspire a remarkable effort by economists to find in the empirical data which factors reliably lead to growth. Yet hundreds of research articles later, we wound up at a surprising end point: we do not know."[23]

The findings of an ambitious recent study conducted by several top academics and policy-makers are not very different:

> "It is relatively easy to identify the shared characteristics of the high-growth cases and easy to appreciate their collective importance.[24] But it is hard to know how to replicate these characteristics. Some of them are the outcome of innumerable decisions and interactions by firms, households, and officials. Some are the result of evolution, not design. None is a straightforward policy."[25]

The so-called "Washington Consensus", popularized in the 1990s is the closest that the policy-making community has ever come to the formulation of a blueprint for economic development, but the approach, rightly or wrongly, has now lost its appeal and/or has been largely discredited. One of the main criticisms against the Washington Consensus, best articulated by Rodrik (2007), is that it has too much of a "laundry list" character and does not leave sufficient scope and flexibility for countries to formulate their own indigenous approaches, so long as they adhere to some deeper principles (e.g., sound money, property rights).

This is a very agreeable and basic insight that brings us to the second, Turkey-specific reality mentioned above: Turkey looks to us as a pretty good example of the kind of paralysis caused by a laundry list approach to reform. Put differently, any observer who goes through the Turkish government documents of the past several years would recognize that the country is trying to do too many things at once, without sufficient prioritization.

A quick glance at the latest government program, for instance, shows this clearly. The list of intentions is quite long, but the details as to how these multiple objectives will be achieved are largely missing – so that it does not take long before a seasoned observer concludes that implementation will almost certainly lack behind. It is no wonder in other words, that we have a slow going reform process in practice, and a strange blend of Washington Consensus-like reforms (calls for flexible labor markets, better tax system, independent regulatory bodies, and so on) and interventionism of an old style (an obsession with regional incentive

[23] Easterly (2009).
[24] The common characteristics of the success stories hardly make up a surprising list. They include openness, leadership and governance, macro stability, market-based resource allocation, and high saving and investment rates.
[25] Commission on Growth and Development (2008).

schemes, a continued urge to intervene in the functioning of independent bodies including the central bank, a rapidly expanding state housing agency somewhat opaque in its operations, and so on). We simply do not seem sufficiently focused.

What can we do, then? One possibility is to think along the lines of the "Growth Diagnostic (GD)" approach advanced by Hausmann, Rodrik and Velasco (see Chapter 2, in Rodrik (2007); henceforth HRV). Inspired by the Theorem of the Second Best, HRV proposes to focus on the "most binding constraint" on growth, following a decision-tree process. Branching into two broad paths, namely "low return to economic activity" (which is about low social return or low private return) and "high cost of finance" (which is about bad domestic or international finance), the decision-tree helps the policy-maker to focus on the most critical constraint, rather than trying to do a bit of everything out of a "laundry list" of reforms.[26]

Interestingly, one of the masterminds behind the approach, Ricardo Hausmann, tries out the approach for Turkey in a conference paper.[27] Starting from Turkey's high real interest rate/large current account deficit combination, he diagnoses the most binding constraint as "low savings".[28] And his advice boils down to the following: Continue to tighten fiscal policy and take into account the real exchange rate in the implementation of monetary policy. In many ways, this thought process takes us back to square one however, or to the same set of issues that we've grappled with in previous sections, and where we saw that policy options are rather limited. In Hausmann's rundown of the GD approach for Turkey, there is very little mention of Turkey's "institutional shortcomings." In fact, he outright dismisses a few currently popular efforts, such as improving the investment environment, as a distraction from the search for "the most binding constraint." [29]

But using the same diagnostic approach, one could argue that rather than the saving rate (or factor accumulation), productivity or more specifically total factor productivity (TFP), may be the main obstacle in the case of Turkey. One piece of cursory evidence for this is provided by Turkey's relatively low standing in institutional indices reviewed in Section II above, the World Economic Forum's Competitiveness Index, in particular. But more direct evidence is also available from a few recent empirical studies, which, based on a simple "growth accounting" framework, show that Turkey's TFP record has been quite weak in the past several decades.[30]

[26] In so doing, the process seeks to capture all major obstacles that could be hindering progress, namely asset accumulation, productivity and appropriability. "Low return to economic activity" is mainly about low social return or low private return and hence about factors that stand in the way of productivity and appropriability, while "high cost of finance" is about bad domestic and international finance, and hence inadequate financial intermediation and low savings.
[27] Hausmann (2007).
[28] Parenthetically, we should note that Hausmann's diagnostic walk looks similar to the one done for Brazil in the original paper.
[29] For various case studies, see www.hks.harvard.edu/fs/drodrik/Growth_Diagnostics_Index.html
[30] See Saygili and Cihan (2008) for the economy as a whole, and Altug and Filiztekin (2006) for the manufacturing sector.

One alternative line of thinking about Turkey's most binding constraint, therefore, would center on the *efficiency* of investment, rather than low levels of saving and investment. Once this constraint is relaxed, one could argue, the economy would grow faster (for given levels of investment), and then higher savings would *follow* from higher incomes. Note that this sort of thinking, where growth is TFP- rather than saving/investment-constrained, would also help to contain Turkey's current account deficit to a large extent.[31]

Now as we go down the HRV decision tree, suppose we take the "productivity" route (i.e. look for main reasons that lead to low social and private returns), as opposed to Hausmann's "bad finance" route (where low savings turn out to be the problem). Where could the "most binding constraint on growth" be? Our hunch is that "government failures" in the HRV decision-tree, or somewhat more specifically "structural fiscal reforms", are one sure place to focus, based on the following simple observation. The budget is the main policy instrument at our disposal, but it is becoming harder to strike a balance between conflicting objectives pulling in opposite directions. On the one hand, the budget should help us to achieve key macroeconomic objectives, such as to increase government savings, reduce public debt, and crowd in private sector investment.

At the same time however, it should do all this while avoiding distortionary policies that stand in the way of efficiency gains (or higher TFP) such as high taxes, labor costs, a stifling bureaucracy, and so on, all of which ultimately encourage informality.[32] Put differently, we've now reached a state where it is becoming increasingly difficult to reconcile these two objectives, in the absence of significant reform, or strike the right balance between the two government failures identified in HRV, the so-called macro risks (monetary, financial and fiscal stability) and the micro risks (property rights, corruption, taxes).

To make the point a bit more concrete, consider the central Hausmann advice of improving public savings to raise the overall saving rate. This is hardly a removal of growth obstacle in our view, as fiscal tightening through the "usual suspects" (an increase in indirect taxes and a cut in current and capital expenditures) while by-passing deeper reform issues (such as social security and heath, tax reform, infrastructure, civil service reform and so on) would cause other distortions in the economy, such as increasing costs for the private sector, squeezing disposable incomes, delaying infrastructure investment, and encouraging smuggling.

These counter-arguments do not obviate the usefulness of the Growth Diagnostics approach as a way of focusing the reform agenda; it just suggests that tighter and more careful thinking

[31] This follows from simple macro identities. Current account deficit is nothing but the difference between investment and saving. Recall now the basic growth accounting framework, where productivity is broken down to two broad determinants: TFP and capital deepening (i.e. change in capital per labor). If somehow TFP is unleashed, we could then have more growth per investment, which could, in turn, bring about the required savings.

[32] On the link between informality and unproductivity, see La Porta and Shleifer (2008) and McKinsey (2003), the latter specifically on Turkey. For a recent general look at the informality issue in Turkey, see Deloitte (2007).

is required to put it to good use. But one thing is certain: Adopting a bit of everything approach to reform or pre-occupying ourselves with simple but equally wrong prescriptions and short-cuts won't do. More likely than not, the result will be further interventionism, distortions, loss of macro stability, and low growth that won't allow a "catch up", as the Turkish experience teaches us.

One idea we think is worth giving serious consideration in this connection, is to rethink the institutional infrastructure of policy-making in Turkey, with a view to enhancing capacity and centralizing policy formulation, including a possible reorganization of the respective roles of the Treasury, State Planning Organization, and the Ministry of Finance in the formulation, implementation and monitoring of the reform program. Put this way, the issue goes beyond appointing a competent coordinating minister and/or establishing a diligent Investor Relations Office. In addition, a candid assessment of reform efforts thus far with their pluses and minuses and as to how the different pieces fit together, and providing a detailed, time-bound road map on the way forward would also add huge amount of credence to the reform program. The latter may be the first important step toward formulating a GD approach for Turkey, which would help to identify the most binding constraint(s) and re-focus our reform efforts.

V. Concluding thoughts

The most important things to say are those which often I did not think necessary for me to say - because they were too obvious.
André Gide

Our conclusions are as follows. First, we should spend more time and energy on understanding the recent record. We should face up to the fact that the stellar performance from 2001 onward through late 2007 owed a great deal to the benign global environment. During this period, we were slow in earnestly pressing ahead with reforms that would help us climb up the "institutional quality" ladder. At present, among our peers we do not have a particularly impressive record. Our disciplined macro policies, which were mainly about a stellar fiscal performance, should also be taken with a grain of salt, because it also benefited from strong growth while fiscal reform issues were largely ignored.

Second, the current state of policy debates in the country is shallow and populist. It is shallow because it entails a shallow rhetoric of quick fixes. It is populist because it promises too much, without paying much attention to the constraints and trade-offs involved. We often forget that in the new world of highly integrated markets, "arbitrage" -- of goods, capital, and people – reigns, leaving us a depressingly few parameters to tinker with. This makes once favored strategies, such as "picking the winners", "subsidizing and protecting certain industries", "increasing minimum wages to raise our workers living standards", "preventing financial flows," etc. largely ineffective, or simply the wrong policy. The truth is that

sovereign governments can do little in this environment to protect its citizens, other than perhaps equipping them with better "coping mechanisms" such as good education.

The two specific and serious proposals in our context call for weaker exchange rates and higher saving rates. This sort of "China-envy", however, is unlikely to take Turkey very far. We must accept that we are at a different stage of economic development than China; we cannot exist in certain product categories any longer, given our GDP p.c.; and we must spend instead our energies on figuring out how we will make the shift to high value-added products. Contemplating an economic development strategy based on an undervalued exchange rate or advising an increase in the saving rates seem neither right, nor feasible in the Turkish context. In short, we need to refocus our thinking from exchange rate and the saving rate, to TFP. That is a very difficult issue, true, but that's where it looks like, "the ring was lost", to follow Turkey's own Nasreddin Hodja's famous story. Understanding the recent record and our true policy options are important because, after all, no therapy can be successful without the patient's full recognition of the problem.

Third, there is a need to focus our reform agenda. There is little objectionable to the gist of what Turkey has been trying to do over the past few years: stabilize the macro economy while reforming its supply side. What seems to be missing is not so much the general direction and intentions, but focus and prioritization, and rigorous analyses that back these intentions. "Growth Diagnostics" may help to prioritize, though serious thinking is necessary to identify the true binding constraints. Asking the most binding constraint on Turkish TFP growth could be one way to start.

Fourth, whatever reform map is drawn up, it should be fully owned from the very top, and a public consensus built around it. Like the old joke goes: how many psychiatrists does it take to change a light bulb? Just one: But the light bulb has really got to want to change. In this connection, the importance of marketing reforms should never be underestimated.

The paper did not have many answers. Hopefully though, by posing the right questions and raising the right issues, it will contribute to a more informed and constructive debate toward formulating the right growth strategy for Turkey. Because without such a strategy, Turkey will just muddle through – but with muddle through alone, we cannot catch up, we just get by – something we can ill afford, given our young and unskilled population.

Let us end with a few remarks on the role of the IMF and EU in all this. There is little doubt that the IMF-EU anchors were a key contributor to Turkey's impressive transformation in recent years. The dramatic shift in the global environment and the stalled reform momentum domestically suggest that the need to stick with these anchors is even greater now. Then again, they can only facilitate reform. They cannot replace home-grown efforts, given the complexity of the task ahead.

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