

Dani Rodrik's weblog

Unconventional thoughts on economic development and globalization

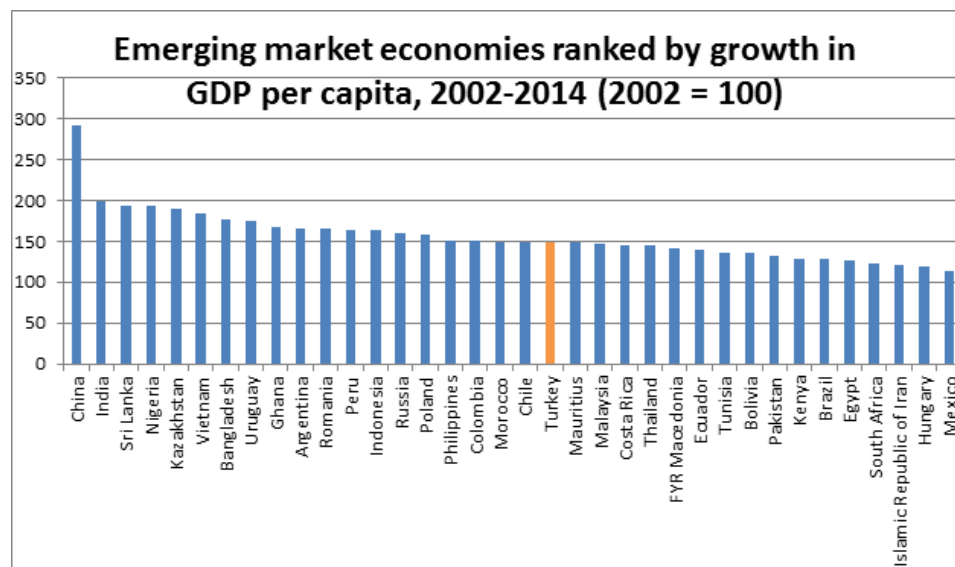
April 16, 2015

Turkish economic myths

Preparing for a [panel discussion](#) on Turkey gave me the opportunity of putting together some notes and slides on the country's economy.

That Turkey is not doing well at the moment, economically or politically, is well known. But the roots of the problem remain misunderstood. Many analysts blame the weakening of “structural reforms” (on economics) and the turn towards authoritarianism after the Gezi protests in 2013 (on the politics). See for example [here](#). In truth, Turkey's problems on both fronts predate the recent slowdown in growth and have been long ingrained in the governing party's (AKP) strategy. I have [discussed the politics](#) before at length. Here I focus on the economics.

First, let's dispense with some misconceptions about how well the Turkish economy did under Erdogan. As the chart below shows, Turkey's growth performance since 2002 (when AKP took over) has been middling. A 50% increase in per-capita GDP (at constant prices) is nothing to scoff at, but it is below what Sri Lanka, Bangladesh, Uruguay, Peru, Argentina, Ghana, Indonesia, Philippines and many others – not to mention China and India – have achieved. (And no, Turkey's income did not triple over this period, as government officials [claim](#).)

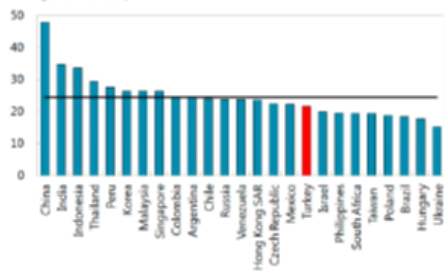


Source: IMF

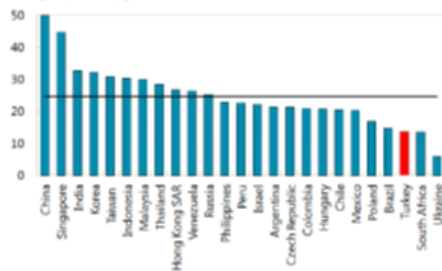
Poverty rates and inequality have trended down under Erdogan, but again that is typical for this period for the middle income countries that serves as comparators for Turkey. In Latin America, for example, where inequality is high and endemic, the Gini coefficient has come down in virtually every country since the early 2000s. Again, nothing out of the ordinary about the Turkish experience.

The comparative experience suggests that Turkey (and other similar countries) benefited from an unusually favorable external environment. In particular, financial globalization and the availability of cheap foreign capital seems to have played a critical role.

This matters for Turkey especially because low domestic saving has been the perennial constraint on the Turkish economy. As the chart below shows, the domestic saving rate is exceptionally low in Turkey:

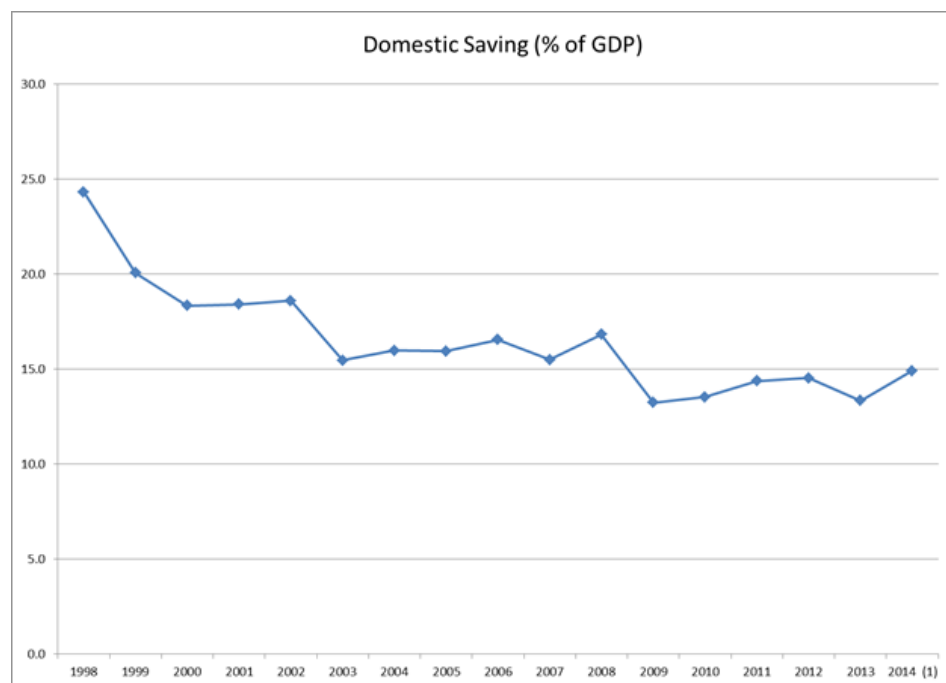
Total investment, 2013
(percent of GDP)

Sources: IMF World Economic Outlook

Gross national savings, 2013
(Percent of GDP)

Sources: IMF World Economic Outlook

Under Erdogan, the constraint has become ever more binding, as the saving rate (and particularly, the private saving rate) has come down:

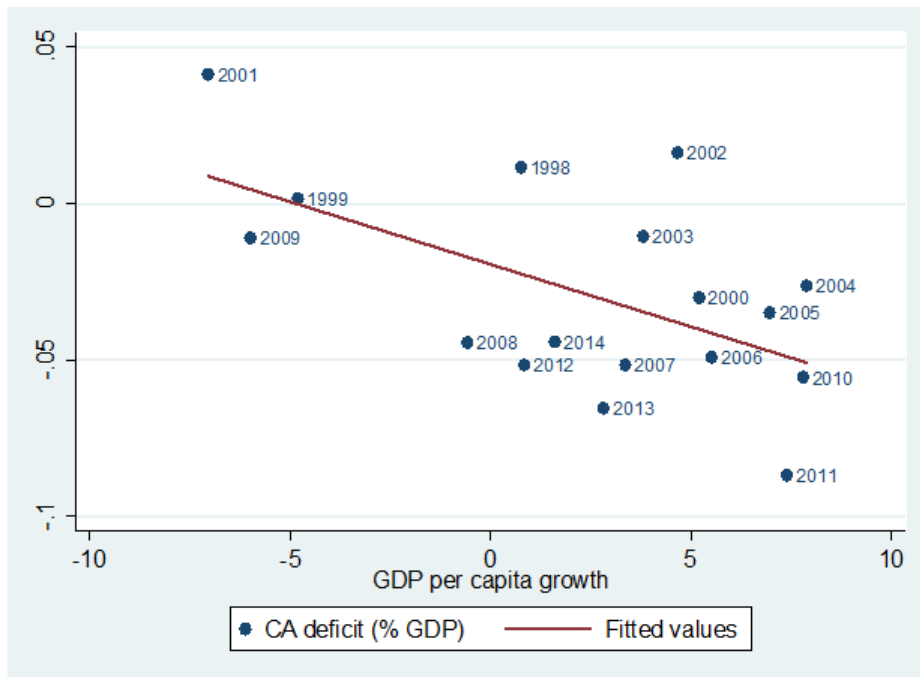


Source: Kalkinma Bakanligi

So how has Turkey overcome this constraint over the last 12 years? By applying the same recipe of macroeconomic populism it has always relied on to generate growth – by borrowing, especially short-term, to sustain domestic consumption and investment. This strategy typically bears fruit as long as finance is cheap and available. But it comes at the cost of accumulating fragility and increased vulnerability to reversals in financial market sentiment. It often ends up in crisis as the funds dry up.

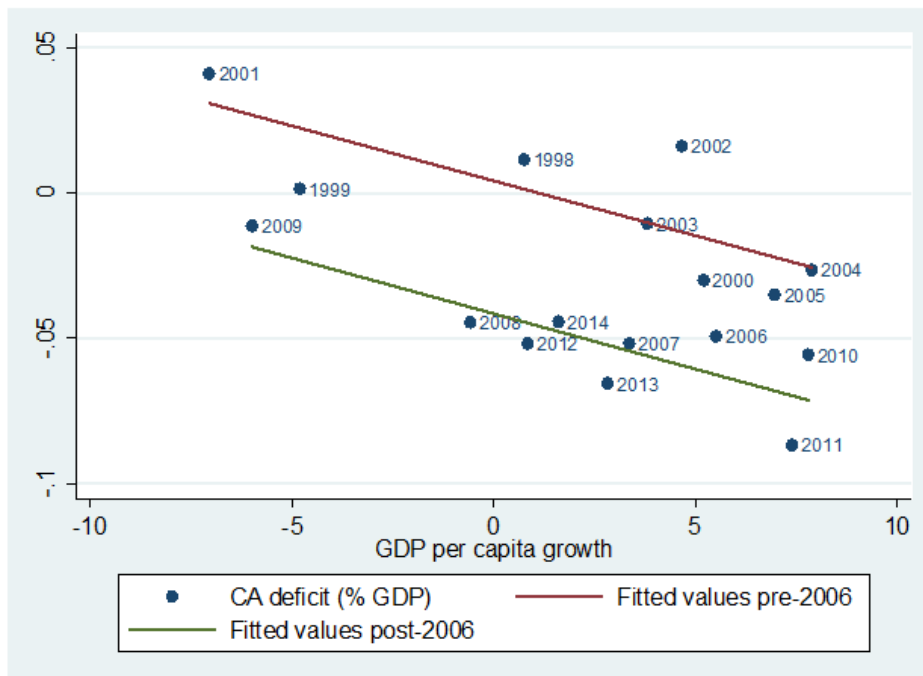
The novelty under AKP is that the populist strategy was modified in two respects. First, there was much greater reliance on foreign capital inflows and less reliance on printing money. Second, there was a switch from public-sector to private-sector borrowing.

Turkish economic growth has always been dependent on the availability of external finance. The faster the economy grows, the larger the current account deficit (which needs to be financed by capital inflows of some kind). This shows up clearly in a simple chart that plots the growth rate alongside the size of the current account deficit (CAD, as a share of GDP) since 1998:



The relationship is both statistically and quantitatively significant. An added 1 percentage point growth is associated with a 0.4% larger current account deficit (as a share of GDP).

But when we look at the above chart closely, we notice another important feature: all the observations after 2005 are below the regression line, while all those before are above the line. What seems to have happened is a clear downwards shift in the growth-CAD relationship in the early years of the AKP administration. So we really need two regression lines, one for each sub-period, as follows:

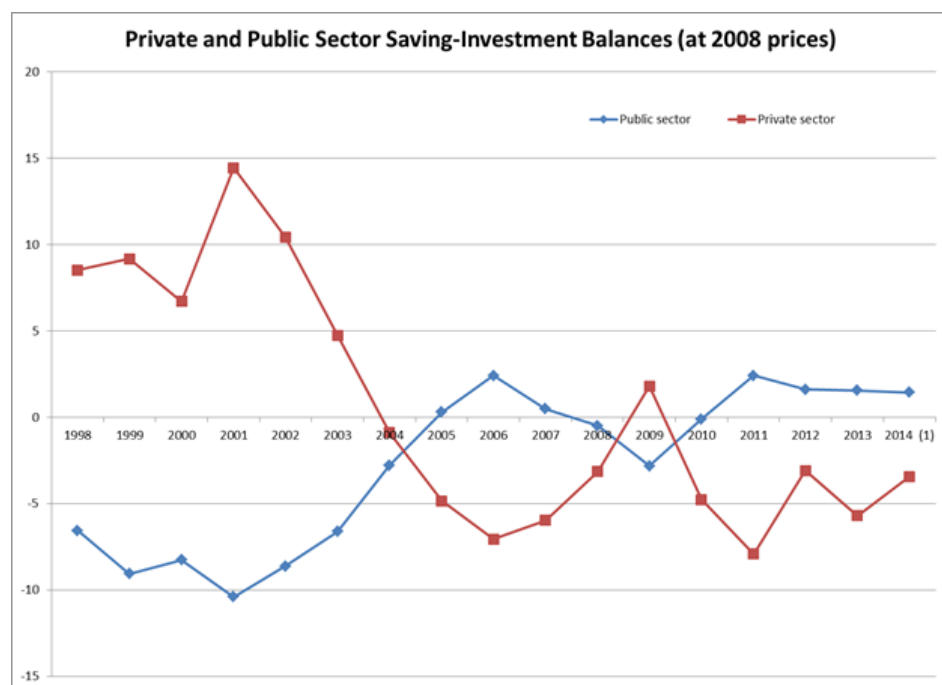


The downward shift after 2005 is of the order of 4.5% (of GDP). In other words, the growth-CAD tradeoff has worsened appreciably under the AKP government: at any level of growth, the current account deficit is larger by 4.5% (of GDP). This is a huge adverse shift, reflecting the lower domestic savings and AKP's much larger reliance at the margin on external sources of finance.

(This is a statistically significant shift, despite the paucity of observations. Note also that changes in oil prices cannot account for the shift: there was no sharp break in the country's external terms of trade after 2005.)

Moreover, what lies behind the external deficits has changed; this is the second modification of the populist strategy I mentioned above. The counterpart of the current account deficits of the last decade is a private-sector imbalance rather than a public sector imbalance. This can be seen clearly in the chart below, which shows saving-

investment balances for the private and public sector between 1998 and 2014. (Note that the data are at constant prices, a necessary correction in view of the disinflation of the early 2000s.)



Source: Kalkinma Bakanligi

The AKP government was able to move the public sector into surplus (except for the crisis year of 2009), an achievement for which it receives great credit. But this improvement was more than offset by a substantial deterioration in the private sector balance. What has happened, in other words, is that the private sector has been encouraged, through easier access to credit, to go on a borrowing binge. Financial indiscipline and reckless have not disappeared; they have moved from the public to the private sector.

In the 1980s and 1990s, there was a stream of thought – known as the Lawson doctrine -- that said we should not worry about external deficits that are the consequence of private sector saving and investment decisions. No serious economist believes this anymore in view of the systemic consequences of private sector folly. Private sector debt crises have a way of engulfing the entire economy, and largely as a consequence, unmanageable private debts tend to find their way onto the public balance sheet.

The economic populism of the AKP government has become unmistakable of late. We see this in the shifting of the blame for negative outcomes onto external enemies (the “interest-rate lobby”), the sidelining of economically literate technocrats (A. Babacan versus Y. Bulut), the increased intolerance towards the rule of law, and the desire to subjugate policy instruments to centralized control (loss of independence of regulatory bodies, pressure on central bank). Rather than a fundamental shift in the government’s approach, we need to see these as the manifestations of the predictable failure of its long-standing strategy.

The bottom line is that the AKP government did not make any fundamental changes in economic strategy. It simply gave Turkey’s traditional macroeconomic populism a modern makeover, by relying more on foreign capital markets and by boosting private expenditures. Neither of these changes rendered Turkish growth healthier or more sustainable.

What needs to be done? The preoccupation with “structural reforms” in Turkey is grounded in the view that macroeconomic reforms have largely taken root and now the time is to work on the supply side of the economy. This is an incomplete perspective, and it risks getting the priorities wrong. Macro reforms remain an unfinished agenda, especially on the saving front. What is required are policies that will tax credit and restrain short-term capital inflows while subsidizing household and corporate saving.

The likelihood that such policies will be adopted now, in the midst of a significant economic slowdown and an election battle, is of course virtually non-existent. The flexibility of the exchange rate protects the economy from old-style currency rises (as in 1994 or 2001). But the road ahead will be a bumpy one for sure.