NO OIL, BUT A YOUNG POPULATION: TURKEY'S ECONOMIC GROWTH PROSPECTS

Even though Turkey achieved remarkable results in economic growth, it needs to change its growth model for this to be sustainable. As with all emerging markets, Turkey is basically playing "catch up," an attempt to close the gap with advanced economies. However, as the gap closes, the growth rates will decline. The main challenge for Turkey today is transitioning its growth from this catching up process to a value-added, efficient production-oriented growth. According to the author, this challenge requires Turkey to reform its education system into one that promotes critical thinking and capitalizes on the diverse strengths each student possesses. Such an education model would be the main driver in Turkey's transition to growth based on high productivity and innovation, and would ultimately enable Turkey's growth to be sustainable.

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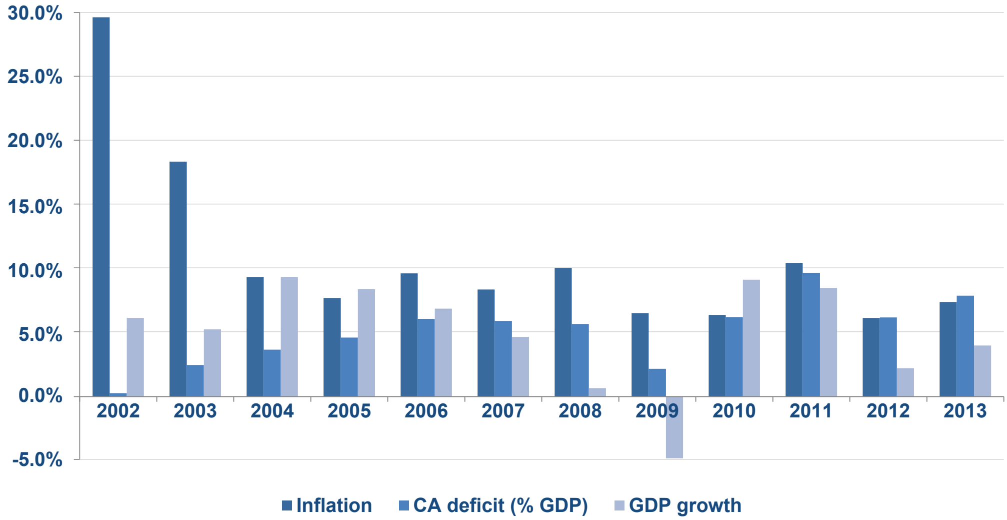
Turkey has grown rather strongly over the last 12 years. Excluding 2009, the year when the global financial crisis was most felt, the growth rate ranged from one to nine percent and averaged six percent. This rate is significantly higher than the advanced economies and slightly lower than the BRICS average of 6.3 percent. Taking China out of the equation, Brazil, Russia, and India's average growth rate during the same period was five percent, indicating that Turkey's growth rate was one of the best among the emerging economies. However, in going forward Turkey needs to change its development model to achieve more sustainable growth. Value added production and export-oriented growth is the only way to go. How are we going to achieve this? The most valuable asset Turkey has is its young population. If Turkey can educate this young population effectively it will succeed in this transition and achieve sustainable economic growth based on high productivity and innovation. This structural reform is the most important challenge Turkey faces.

Examining the nature of the existing growth of Turkey we see some fundamental characteristics and driving factors:

Turkey is an energy-importing country whose annual energy bill reaches about seven percent of its GDP. Moreover, the savings rate is low; at 14 percent, Turkey is at the bottom of the OECD countries. As a result of these two characteristics, the current account deficit is high. The country's policymakers try to follow a "5-5-5 rule," namely 5 percent GDP growth, 5 percent inflation, and 5 percent current account deficit.

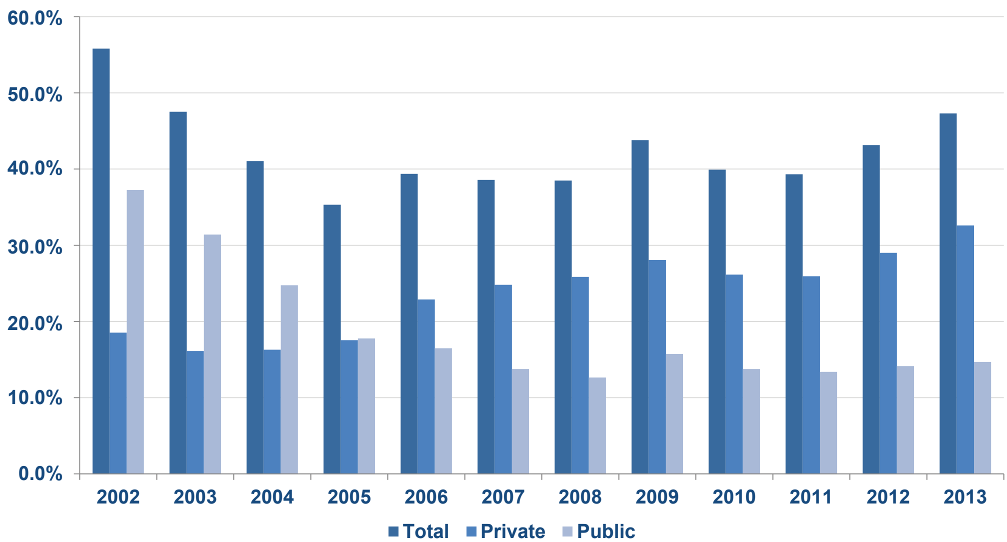
As Figures 1 and 2 illustrate, while Turkey's growth has overall been quite remarkable, rapid debt growth and high inflation indicate that this demand-driven model of growth is not working anymore.

Figure 1: Inflation, current account deficit, and GDP growth in Turkey



Source: TurkStat, CBRT

Figure 2: External debt in Turkey: Private, public and total (% of GDP)



Source: TurkStat, CBRT

"If Turkey can educate [its] young population effectively it will achieve sustainable economic growth based on high productivity and innovation."

In going forward, to achieve the 5-5-5 target, Turkey should avoid the risk of continuing with a large current account deficit that exceeds seven percent of GDP. The vulnerability of the economy to the interest rate increases in the US and Europe makes Turkey's growth prospects questionable. Turkey needs to increase its savings rate and reduce its dependence on other countries' savings. And another driver needs to be more effectively activated: youth.

The Drivers of Turkey's Economic Growth

1. Good timing: Turkey suffered a major financial crisis back in 2001, experiencing a negative six percent growth rate and a collapse in the banking industry. As the Turkish proverb puts it, "One misfortune is more effective than a thousand words." Turkey's bankers, regulators, politicians, and general public all learned important lessons from this crisis and put many things in order at the beginning of the last decade. Fiscal discipline and an independent central bank with a price stability objective have been the two key pillars of this new era.

While Turkey was putting its house in order, macro-developments in the advanced economies created a favorable environment for the emerging markets. Declining interest rates and ample liquidity allowed Turkey to tap the international money and capital markets rather easily. The private sector borrowed heavily (Figure 2) and became the engine of growth. A soaring current account deficit was the weakness of this growth model.

2. Fiscal discipline: During this period, keeping the budget in balance gave confidence to international lenders. The government used one-time privatization revenues heavily, but the bottom line for the budget deficit was well controlled. Since 2002, several elections have taken place but the government never gave into classical "election economics" of loosening fiscal discipline. This was a big success and supported the credit flow into the country.

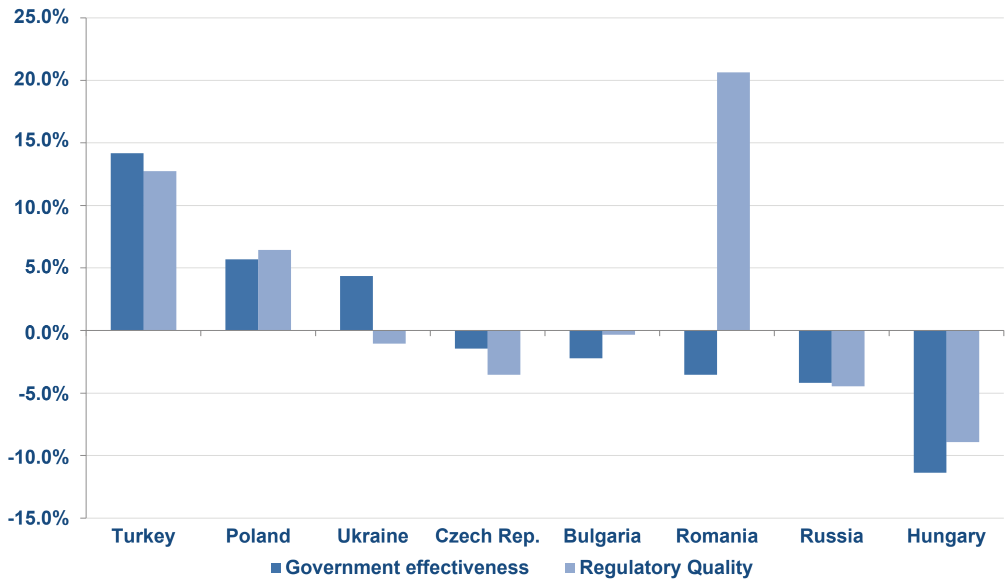
3. Monetary discipline: An important aspect of the economic stability underlying Turkey's growth performance over the last 12 years was monetary discipline. As a result of the 2001 law that granted Turkey's Central Bank independence in using its

monetary policy instruments, and the subsequent adoption of the inflation-targeting regime, inflation declined to single-digit levels and mostly stayed in the 5-10 percent range in recent years.

4. Well-capitalized banking sector: Following a major financial crisis, Turkey tightened regulations in the banking sector. While the international norm for capital adequacy ratios is eight percent, Turkey set its capital adequacy requirement at 12 percent. Moreover, the ratios of Turkish banks remain even higher than this level, and as of June 2014 the Turkish banking sector's capital adequacy ratio stands at a stellar 16 percent. This solid structure has been instrumental in fending off risks that could otherwise hamper economic stability and growth by ensuring a continuous credit supply for the economy. Indeed, total loans grew by a compound annual growth rate (CAGR) of 32 percent over 2002-13 period, and the credit stock did not contract even during the global financial crisis.

5. Political stability: Since 2002, political stability has been an important tail wind for Turkey. Having a single-party government and well-coordinated regulatory bodies was instrumental in achieving a respectable growth performance over that period. By sticking to fiscal discipline, while also investing in the necessary public infrastructure, the single-party government paved the way for private sector-driven growth.

Figure 3: Changes in government effectiveness and regulatory quality indices (2002-2012)



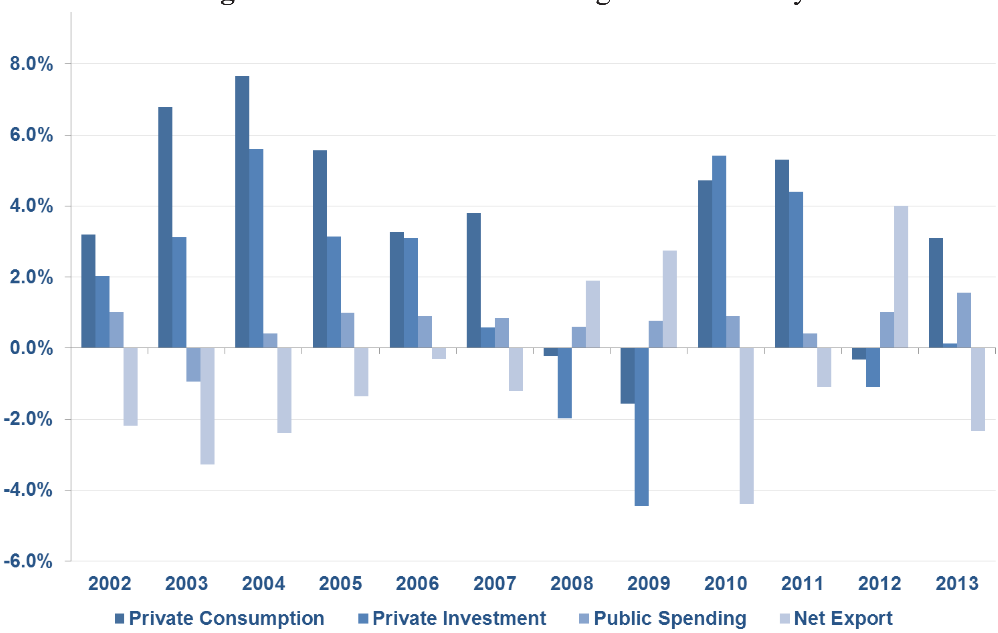
Source: World Bank

6. Institutional framework: A well-functioning market economy with its independent regulatory agencies has been another important tail wind for growth for the Turkish economy. As a result of the comprehensive reforms carried out after the 2001 crisis, Turkey improved substantially in the Heritage Foundation's Economic Freedom Index. From ranking 110th among 157 countries in 2002, Turkey climbed to 64th among 178 countries in 2014 due to improvements in various areas, including property rights, government spending, freedom from corruption, fiscal freedom, business and labor freedom, and investment and financial freedom. Moreover, Turkey posted considerable improvements in the World Bank's government effectiveness and regulatory quality indices, out-performing most of its regional peers (Figure 3).

Sustainability of Turkey's Economic Growth

As with all emerging markets, Turkey is basically playing catch up, trying to close the gap with the advanced economies. To do so, Turkey needs infrastructure: roads, dams, power plants, residential and commercial real estate investments, shopping malls, and so on. Accordingly, Turkey adopted a growth model over the last decade that was based on developing such projects. Nevertheless, during this period, private sector debt soared and Turkey grew on the back of domestic consumption and investment expenditures, including construction spending (Figure 4).

Figure 4: Contributions to GDP growth in Turkey

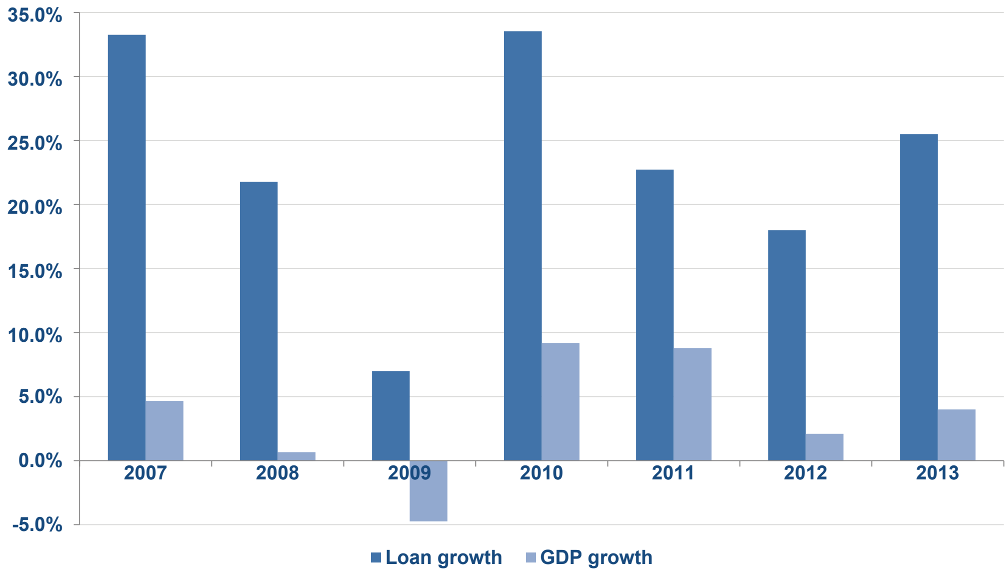


Source: TurkStat

However, if we look at the macro-parameters, the relationship between recent credit growth and GDP growth is not as strong. Credit is growing but we do not see strong GDP growth. Are we in some kind of a trap? We should know from basic economics: If debt is rising faster than income, the situation is not sustainable (Figure 5).

"The main challenge for Turkey is to transition its growth from a catching up process to value-added, efficient production-oriented growth."

Figure 5: FX-adjusted loan growth vs. GDP growth in Turkey

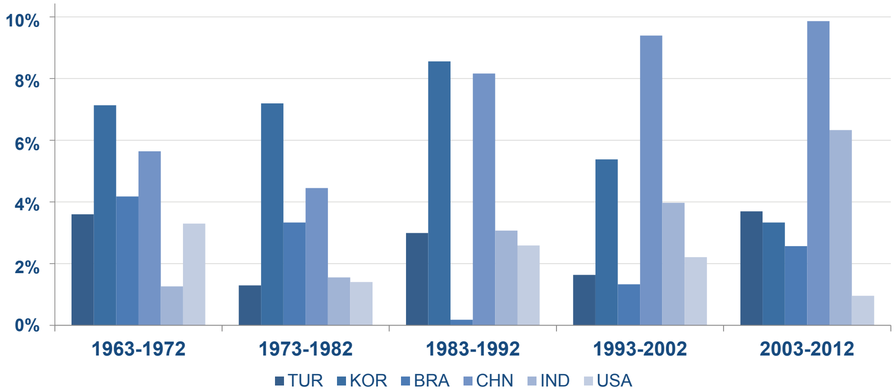


Source: BRSA, author's calculations.

Cross-country Comparison of Historical Growth Performance

Capital accumulation is fundamental in the process of development in emerging economies. This basic principle of economic growth is evident in the data. Comparing historical growth rates of real GDP per capita among the US and five emerging market economies (namely Turkey, South Korea, Brazil, China, and India), we observe that emerging markets tend to grow faster than the US, the leading advanced economy of the world. During the episodes of economic and political disturbances (such as the late 1970s-early 1980s in Turkey and the 1980s in Brazil), growth may slow down. However, as Turkey's growth performance in the 2000s shows, once the barriers to development are removed, growth rapidly picks up. In fact, as is evident from China's growth performance over the last 20 years, acceleration in economic progress is even greater in the least prosperous countries.

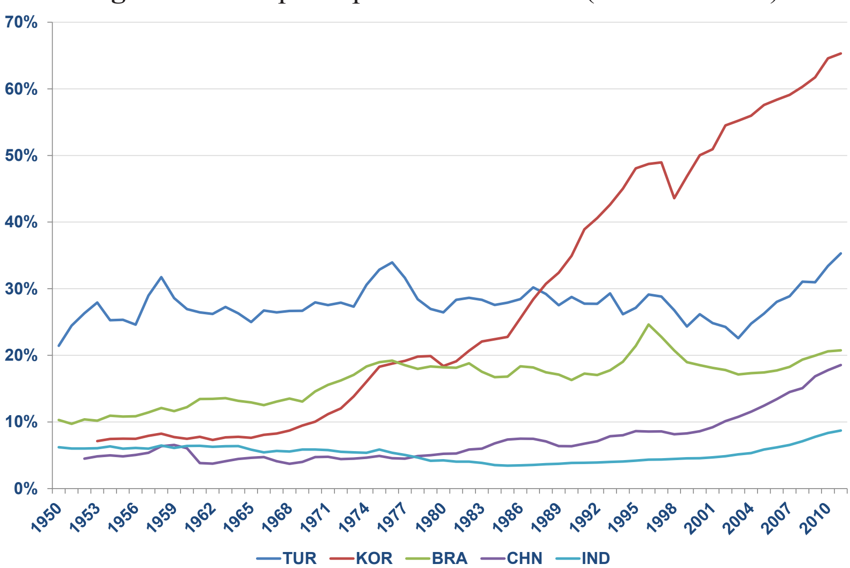
Figure 6: Average growth rates of real GDP per capita



Source: World Bank

Nevertheless, capital accumulation does not tell the whole story behind the convergence between poor and rich countries. In fact, some poor countries of the past (South Korea, in particular) have been more successful than others in catching up with the rich (Figure 7). This suggests that there is more to economic growth than capital accumulation.

Figure 7: GDP per capita relative to US (at current PPP)



Source: Penn World Tables (8.0)

Economic Growth and Education

Per capita income growth becomes more and more difficult as the catch-up process progresses. As per capita income rises, it becomes more difficult to grow by capital investments. In advanced economies, the main driver of growth is productivity and the main driver of productivity is innovation.[1]

"In order to grow successfully, Turkey equally needs engineers, composers, doctors, opera singers, Olympic gold medalists, painters, lawyers, actors, and individuals in all other professions."

Historically, countries that innovated and produced new things grew faster. From horses to cars, from propellers to jet engines, from lamps to transistors, from fixed lines to cellular phones, from the abacus to electronic calculators, from mainframes to microcomputers, from stand-alone computing to the internet, from letters to e-mail, from tube televisions to flat screens – all these inventions and innovations provided the chance to generate export-oriented growth in their respective economies.

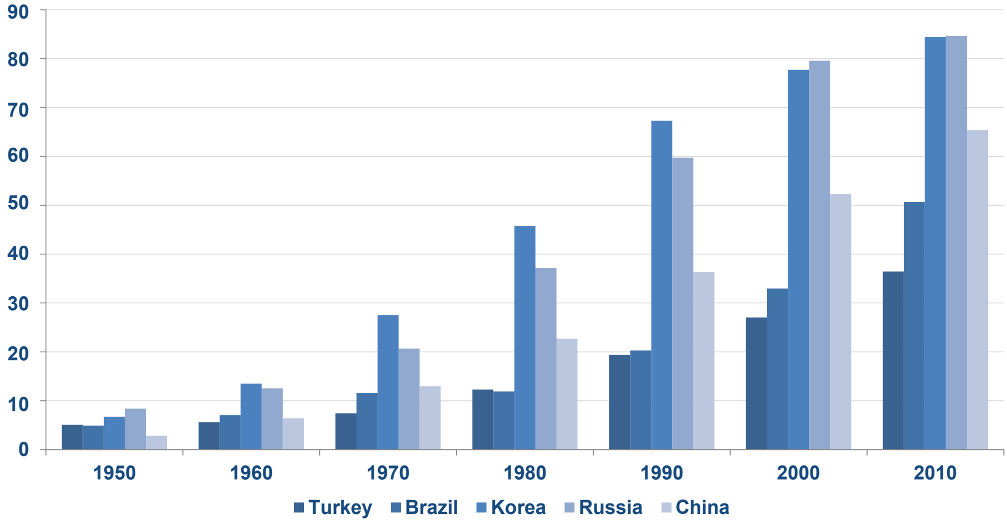
Thus, the main challenge for Turkey is to transition its growth from a catching up process to value-added, efficient production-oriented growth. In other words, Turkey should promote innovation and thereby productivity. This can only be achieved by effective, high quality education.

Here the key words are "effective" and "quality." Increasing the quantity is not enough; we must increase the quality of our education. The Programme for International Student Assessment (Pisa) scores show that we are significantly lagging behind in quality, which suggests that Turkey's success in improving its institutional framework is not matched by similar success on the quality-of-education front (Figures 9 and 10).

One may argue that, in addition to education, rule of law and political stability are also important factors for sound economic growth. No doubt this is true but to have a good legal and political system, quality education is again the main prerequisite.

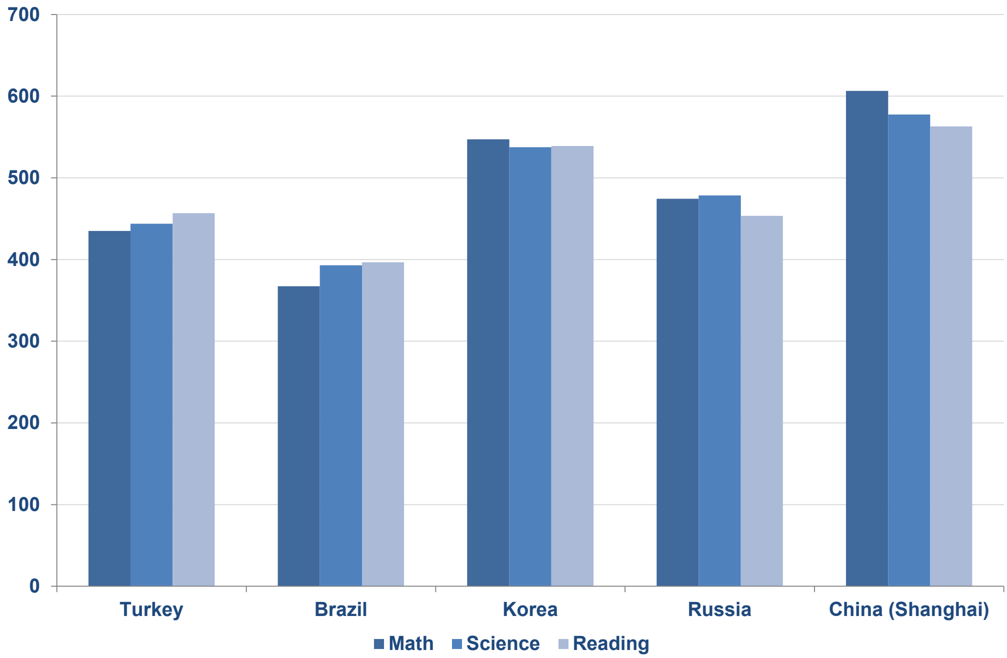
1 Robert J. Gordon, "Is the US Economic Growth Over? Faltering Innovation Confronts the Six Headwinds," *National Bureau of Economic Research*, August 2012, http://www.cfa-sf.org/files/SSRN-id2133145%20-%20Is%20US%20Economic%20Growth%20Over%20-%20Gordon.pdf

Figure 8: Attainment in secondary and tertiary education (% of adult population)



Source: Barro and Lee Dataset (2.0)

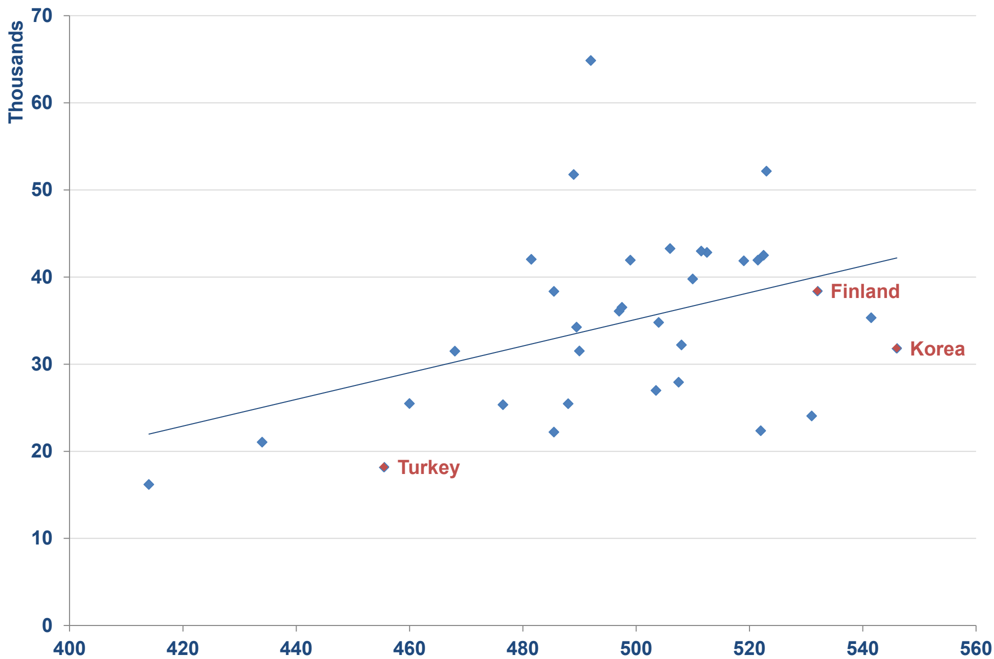
Figure 9: Average PISA scores of EM's over 2000-2012.*



* 2003-2012 for Turkey, 2009-2012 for China (Shanghai)

Source: OECD

Figure 10: OECD PISA scores and GDP per capita (at PPP) in 2012



Source: OECD, World Bank

No Oil, but Plenty of Young People

Turkey has the most valuable natural resource a country can have: a young population. If we furnish our youth with quality education, we will achieve our government's targets for 2023 and beyond. We must radically change, and ideally revolutionize, the education system. Today's education system is discipline-based, command- and control-oriented, centrally-designed, and testing-centric. This model is clearly contrary to human nature.

Ken Robinson has identified a number of requirements for the education system to foster creativity and innovation.[2] In line with his prescriptions, first, we have to accept that humans are naturally different and diverse. Look at your children: are they all the same? Second, all humans possess curiosity as a fundamental part of their character. In every historical period, humans have been trying to learn about many different things. Finally, all humans have some form of creativity. Creativity should not be thought of merely as an artistic characteristic. We all create our lives. Our CVs are the factual evidence of this process of life creation.

2 Ken Robinson, "How to Escape Education's Death Valley," April 2013, http://www.ted.com/talks/ken_robinson_how_to_escape_education_s_death_valley

Given these human qualities, the education system should be customized to emphasize learning. Benjamin Franklin's famous quote best explains the concept of learning: "Tell me and I forget. Teach me and I remember. Involve me and I learn." The education system should involve the individual. Teachers should mentor, provoke, stimulate, and engage their students. Only in this way can we achieve customized, high quality education, which should place equal emphasis on science, literature, the humanities, art, and physical education.

"The concept of 'customization' must be adopted in our education system."

Furthermore, education should teach people how to think, not what to think. In order to achieve this, we must first put the concept of discovering students' abilities in the center, and build the entire system around it. Research shows that each person has certain abilities that may range from math to dancing, from literature to painting, from physics to singing, from speaking to thinking, and so on. The challenge is to find one's abilities and facilitate the flourishing of his or her contribution to society. To be competitive, we must give equal importance to all these subject matters. In order to grow successfully, Turkey equally needs engineers, composers, doctors, opera singers, Olympic gold medalists, painters, lawyers, actors, and individuals in all other professions.

Second, we must understand that education involves more than just graduating from college. In today's fast-changing world, continuing education is equally, if not more, important. We must have systems in place to retrain our workforce in an efficient way.

Finally, we have to explore all new trends and methods in education, ranging from basic online education to the reversal of the classroom concept advocated by the Khan Academy.[3] Education is cheaper and more accessible than ever. Therefore, with the right choices, we can make strides in educating youth and the existing workforce in a short period of time.

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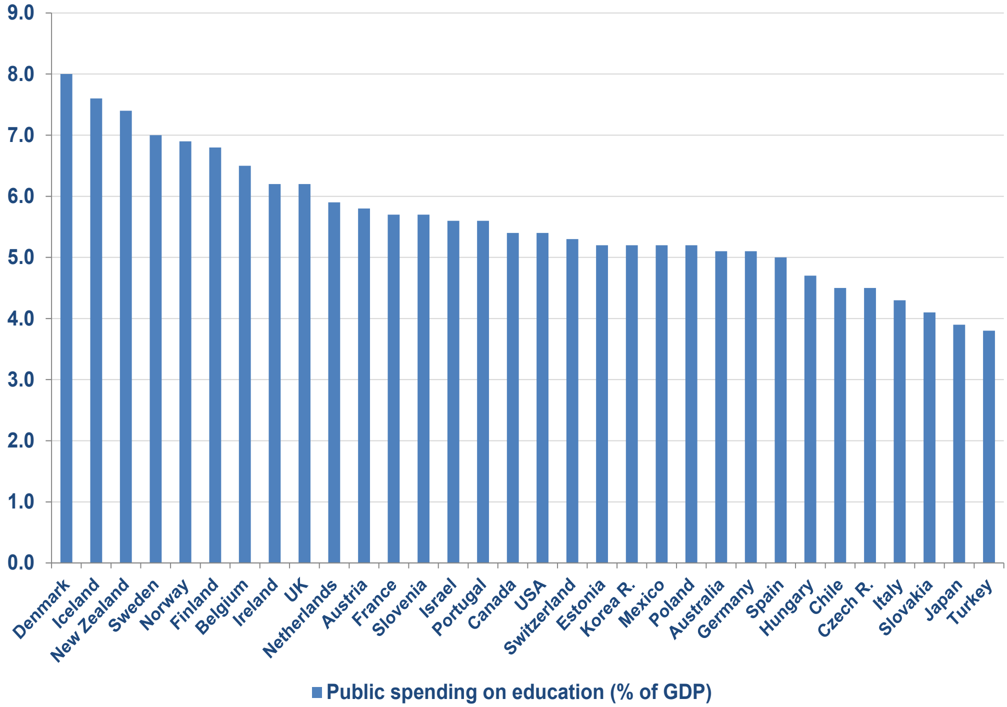
3 The Khan Academy is a non-profit organization that produces free, online video tutorials on a variety of subjects. The tutorials apply an atypical format of teaching in which an outside voice teaches the subject matter presented by writings and drawings that appear on a black screen. In contrast to conventional method where lectures are held in a classroom and homework/problem solving is done outside of it, online lectures in Khan method allows classroom time to be devoted to problem solving; hence the "reversal of the classroom concept."

Clearly reform in education is only possible with greater budget allocations from the government. More broadly speaking, government support will be needed for increased research and development activities, along with more incentives for entrepreneurial investments.

Figure 11: Public expenditures on education in OECD countries (as % of GDP) in 2012



Source: World Bank, Ministry of Development of Turkey

In Finland, for instance, where Pisa scores are among the highest, the curriculum is very broad, testing is used to diagnose, and dropout-rates are almost zero. As it happens, Finland is also among the countries where public expenditure on education (as percent of GDP) is very high compared to other OECD countries (Figure 11). Even though it might not be fair to compare Finland, a country with five million people, to a country with a population of 77 million people, such as Turkey, it still gives an indication as to the right direction of movement for our education system. Indeed, Korea – whose population is about 50 million – also outpaces Turkey, with its public spending on education exceeding 5 percent of GDP.

Looking to the Future

What will be the future like? The changes we are experiencing are accelerating each decade. Thus, it is very difficult to predict the professions of the future. Indeed, the professions in demand today are very different from those 20 years or even 10 years ago, as student preferences in higher education are changing markedly. If we examine university placement exam scores, we see that the demand for degrees in law, psychology, and architecture is increasing more rapidly than past favorites, such as business.

Against this rapid pace of change, the only principle we should follow is to have an education system that finds the creativity in each individual. This can only be achieved with the kind of education that will cultivate each and every person's individual qualities. The concept of "customization" must be adopted in our education system.

High-quality education promoting innovation and productivity is the only way to transform our economic development to achieve sustainable, export-driven growth. It is also the only way to make Turkey an economically competitive and politically stable country that guarantees rule of law. We must realize that timing is critical in this challenge. If we miss this opportunity, our young population will not be the asset it has the potential to be.