A REVIEW OF ECONOMIC DEVELOPMENTS : WHAT ARE AKP'S PLANS?

The new government formed after the elections was received positively both in financial markets and business circles. During the first five months, it can be said that the AKP government has made significant progress on most of the points listed in their Emergency Action Plan. Yet the upbeat tone in financial markets after the elections has disappeared completely after five months. There were two main reasons for this deterioration : the government proved its commitment to the IMF program through decisive action only after very strong negative reaction to their earlier appearance of lack of commitment and the seriousness of foreign policy challenges on EU integration, Cyprus and Iraq . Adhering to the IMF program and securing economic support from the U.S. or multilateral agencies are obviously necessary for the Turkish economy in the short term. But the longer term prospects depend on administrative and economic reform, aimed at a comprehensive redesign of the Turkish savings framework in both the public sector and the private sector. AKP, as a single party government with a large majority in parliament, is capable, at least on paper, of such decisive action. Whether they will succeed in taking such action remains to be seen.

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The Justice and Development Party ("AKP") came to power in Turkey in a landslide election victory in November 2002. AKP's large majority in parliament was reminiscent of the previous election victories of newly created centre-right parties in 1950, 1965 and 1983, albeit with a somewhat lower share of the vote. The complete dissatisfaction of the Turkish electorate with the political establishment was proven by the failure of all three members of the ruling coalition and the largest opposition party to clear the 10% national hurdle required to win seats in the parliament.

For the first time in Turkish election history, AKP was very active during the election campaign with regard to communicating the outline of their economic programme to investors both in Turkey and abroad. The AKP economics team, led by party founder Ali Babacan, conducted a road show in the United States and Europe, followed by several conference calls with investors. At these presentations, Babacan underscored AKP's support of the IMF program with some minor modifications regarding mainly social policies. The presentations created a very favourable impression among investors both at home and abroad.

The new government formed after the elections was received positively both in financial markets and business circles. The AKP senior management selected Abdullah Gul, one of the most prominent figures in the party, as candidate for Prime Minister since party leader Tayyip Erdogan was unable to be a member of parliament at that time. Abdullah Gul was quite popular in business circles both at home and abroad due to his moderate views and international background. The appointment of Ali Babacan as state minister in charge of macroeconomic management was also received very positively because of the good impression he made on investors during the election campaign. The only development which upset the markets during the formation of the government was the lack of a coordinating minister to take charge of the entire economics portfolio.

While the government was being formed, AKP's short term targets which were drafted in a document named the "Emergency Action Plan" were presented by party leader Tayyip Erdogan at a press conference. The key points of the plan were as follows:

- Strong commitment to the IMF program
- Minor modifications in the IMF program with regard to social policies and agriculture
- Abolishment of "Tax Year Zero" law which allowed the government to audit cash inflows of individuals
- Tax amnesty
- Expansion of the jurisdiction of the State Court of Accounts to all government institutions including the Presidency, Parliament and independent regulatory bodies
- Speed-up of collection and disposals by the Savings Deposits Insurance Fund
- Preparation of a new privatisation strategy and timetable
- Opening of energy market to competition and reduction of taxes on the sector
- Privatisation of public mining exploration rights
- 15,000 km of highway construction
- Major restructuring of agricultural policies
- Comprehensive study of state organisation targeted at elimination of redundant staff and improving efficiency

- Reduction in the number of ministries
- Devolution of further resources and responsibilities to local institutions
- Enhancement of the independence of universities
- Unification of social security institutions

After an initial shock, the financial markets responded very well to AKP's election victory. On the morning of Monday, November 4th, equity, bond and currency markets fell 5-10%, but had recovered quickly by that afternoon. Within three weeks, the USD/TRL exchange rate was down from 1.7 million to 1.5 million, the one year bond yield was down from over 70% to under 50% and the stock market had rallied by over 30%. The rationale behind the market reaction was the prospect of a single party government and the hope that such a government would be able to take more decisive action on economic reform and EU integration.

Five months later let's take a look at how much progress has been made on these points by reviewing a checklist:

- The commitment to the IMF program appeared fairly weak originally, but became stronger with the gradual decline in financial markets
- The modifications to the IMF program on social policies did not materialise
- The abolishment of "Tax Year Zero" turned out to be the first parliamentary action of the government
- A wide-ranging tax amnesty package was passed by parliament
- The jurisdiction of the State Court of Accounts was expanded to all government institutions as promised
- No speed-up was observed in the collections and disposals by the SDIF
- A privatisation strategy and timetable was presented, which contained very small changes in the strategy and timetable of the previous government
- Regulatory action was taken regarding liberalization of the energy market, but the jury is still out as to whether it has been effective
- The privatisation of public mining exploration rights has not taken place
- A significant amount of highway construction has been announced
- A major restructuring of agricultural policies has not taken place as of yet
- Elimination of redundant staff and improved efficiency have not been observed
- A 35% reduction has taken place in the number of ministries
- Drafting of a law on the devolution of further resources and responsibilities to local institutions has been initiated
- A plan on the enhancement of the independence of universities has been announced, creating a large controversy
- The unification of social security institutions has not been implemented yet

On the whole, it can be said that the AKP government has made significant progress on most of the points listed in the Emergency Action Plan. However, the upbeat tone in financial markets after the elections has disappeared completely after five months. There were two main reasons for the deterioration of this excitement:

1. The government proved its commitment to the IMF program through decisive action only after very strong negative reaction to their earlier appearance of lack of commitment
2. Serious foreign policy challenges on EU integration, Cyprus and Iraq

Since November, developments in the Turkish economy, especially in the financial markets, were heavily influenced by international developments. This is somewhat surprising, given that there is a only very small proportion of foreign investors within the investor base of Turkey's foreign and domestic. Even though public debt management issues concern primarily Turkish citizens, the dependence of the government on support from multilateral agencies to facilitate its debt management causes investors to draw a strong link between the financial prospects of the Turkish government and the state of Turkey's international relations. In addition to public debt management, the potentially very large economic impact of full EU membership induces investors to figure in probability weighted scenarios into their calculations of the returns from any of the Turkish financial markets.

Turkey faced three major foreign policy challenges in the last few months: EU integration, Cyprus and Iraq.

On both EU integration and Cyprus, developments in the second half of 2002 were positive. There appeared to be a genuine possibility that the EU summit in Copenhagen in December would yield a date for the start of membership negotiations with the EU. Both the outgoing parliament shortly before the elections and the incoming parliament after the elections took decisive action to enact significant pieces of legislation that would bring the Turkish constitutional, civil law and administration framework in line with EU standards. On Cyprus, UN Secretary General Kofi Annan announced a comprehensive plan that would lead to the unification of the island under a federal state before the accession of the island to the EU in 2004.

However, the positive initial trends did not continue on either issue. On the EU integration front, Turkey failed to secure a firm date from the Copenhagen summit, getting only the promise for a date if certain conditions were met by late 2004. On Cyprus, intense negotiations were held between the Turkish and Greek Cypriot leaders for over three months. Negotiations were stopped in early March after a failure to reach an agreement.

The markets responded negatively, but in a fairly calm manner to developments on EU integration and Cyprus. However, sentiment started to deteriorate rapidly as the United States drew closer to war in Iraq.

Soon after the election victory, AKP leader Tayyip Erdogan visited the United States, meeting with President Bush. The United States asked for Turkey's support in the coming Iraq war; and Turkey responded with requests for economic assistance to make up for the potential losses which were likely to result from the war. After intense negotiations over several months, the two sides reached a comprehensive agreement covering political, military and economic issues in late February.

Through February, markets rallied in expectation of a large economic package from the United States, reaching their peak when the government submitted a draft resolution to parliament that would authorise the deployment of U.S. troops into Turkey. However, contrary to the expectations of the Turkish and U.S: governments and all political analysts, the resolution was rejected by parliament by a razor thin small margin. Initially markets fell in response to the rejection, but recovered shortly thereafter in expectation of a re-vote. As time passed, it became clear that

negotiations with the U.S. were not going very well and the markets were very volatile during early March as the probability of a deal rose and fell.

During the week of March 17th, Turkey experienced one its low points in crisis management history. On Monday March 17th, news came out that the U.S. economic package was off the table. Markets fell immediately. The same evening, Minister Babacan stated that the negotiations with the U.S. were still in progress, causing the markets to recover the next day. On Tuesday March 18th, the Treasury conducted a very successful one year bond auction. However, on Wednesday it became clear that there were significant differences of opinion with the U.S. and that the U.S. was likely to proceed with the war in Iraq without help from Turkey. The U.S. was now demanding only access to Turkish air space and not committing any economic assistance. Over the weekend, it also became clear that there were very serious disagreements regarding the involvement of the Turkish army in Northern Iraq, drawing stern warnings from the U.S. and the U.K. as well as the EU against any Turkish intervention.

As a result, after the first week of the war in Iraq, Turkey was left with no economic assistance package, no involvement in the process in Iraq and seriously strained relationships with both the U.S. and the EU. The impact of this state of affairs on financial markets has been significant, which may also have spill-over effects on non-financial sectors of the economy.

In looking to the future and forecasting the prospects of the Turkish economy under AKP, it would be helpful to review the long term economic trends facing Turkey. The Turkish economy spent most of the 1990s grappling with crises. After a rapid period of growth in the 1980s, fueled by deregulation and liberalisation in foreign trade, industrial policy and financial markets, Turkey lost momentum in the 1990s. Serious problems were encountered in a number of areas including government finances, external accounts, banking system and agriculture.

The Turkish economy, which grew at an annual average rate of 5.5 percent under a variety of political parties and regimes in the period from 1923-1980, grew at a rate of 4.5 percent in the 1980s and only 3 percent in the 1990s. Ironically, Turkey is the only country that appears to have experienced a reduction in its productivity growth rate after making a transition from a state-guided economy to a market economy.

After 10 years of frequent financial crises and slow economic growth, Turkey is facing a series of stock problems in addition to flow problems. The organisation, capability and responsibility of the public sector is not optimal. The public debt as a percentage of GDP is high. The resulting real interest rates are high, with government borrowing crowding out lending by the banking sector to the private sector.

Given the size of the stock problem, focusing on flow problems such as next year's budget, the trade deficit or the domestic debt rollover ratio are necessary but not sufficient to move the economy from its current path to one with stability and growth. Inspiring trust with such an overhang of stock issues will not be enough to bring stability to fragile markets – a comprehensive re-design of the savings framework is required to realign the balance sheet of the country as a whole and to reduce the fragility of its financial markets. This would involve:

1. Public finance reform, including tax, budget and debt management
2. Social security reform
3. Completion of the privatisation program
4. Further rationalisation of the banking system
5. Creation of new institutions for intermediate long term investments

Adhering to the IMF program and securing economic support from the U.S. or multilateral agencies are obviously necessary for the Turkish economy in the short term. But the longer term prospects depend on administrative and economic reform, aimed at a comprehensive redesign of the Turkish savings framework in both the public sector and the private sector. AKP, as a single party government with a large majority in parliament, is capable, at least on paper, of such decisive action. Whether they will succeed in taking such action remains to be seen.